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Pension reforms – challenges and opportunities

SUMMARY

New pension reforms came into being on 6th April 2015. Is the term 'pension' still valid or are we now talking about tax efficient, intergenerational investment schemes? The materially greater freedoms that will exist have much appeal, yet they come with greatly increased complexity both in understanding and in execution. On balance these reforms are welcome, but the need for high quality advice has never been greater, both to minimise the risks, but also to maximise the opportunities that they provide.

"The goal of retirement is to live off your assets – not on them"
Frank Eberhart

THE CHANCELLOR HAS – IN THE MAIN – DONE US ALL A BIG FAVOUR

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The British have had a love-hate relationship with pensions for many decades. After some years in the doldrums, the cycle is on the upswing – or certainly deserves to be - largely due to recent changes made by the Chancellor; more on that later. A potted history of pensions and pension reform provide a useful context to these new changes.

FINAL SALARY SCHEMES – RETIREMENT PLANNING MADE EASY

Casting one's minds back to the 1960s and 1970s, it is no exaggeration to state that an inflation-linked, non-contributory pension that could be drawn at 55 or 60, based on a percentage of final salary, was a material part of the career selection process. Companies saw that good pension provision was part of an unwritten social contract between employer and employee, and participation was often compulsory. Improved benefits were fought for by unions and employees and agreed to by employers, building increased liabilities for the future, which in part lead to their eventual demise. On the downside, pensions could be a major barrier to changing jobs as moving to another company's pension scheme was often punitive.

Retirement planning was easy: all one needed to do was count how many years you had worked, multiply it by what each year accrued in terms of final salary and then multiply that by your estimated (or actual) final salary; job done. Retirees experienced little risk to income[1], no investment choices, no market crashes to concern them, no worry about running out of money. All that was left to do was to make the most of the freedom and opportunity that retirement brings. Not surprisingly, the UK's affection for pensions was high. Unfortunately, the good times would end sooner that anyone might have imagined.

Many people have forgotten – or perhaps never knew - that in the 1990s the UK had one of the best, most highly funded, final salary (otherwise known as defined benefit) pension systems in the world. Its demise began, ironically, with a Conservative government. As the good times rolled in the equity markets, companies were given a contribution holiday as their pension plans were well funded i.e. they did not have to pay anything into them, and they were actually punitively taxed on any surplus above 5% of liabilities. So instead of '*fixing the roof while the sun is shining*' companies spent the money elsewhere. In 1997, Gordon Brown then raided the pot further with his £5 billion annual tax on dividends on shares held by pension funds.

This hit on fund assets, plus the two equity market crashes in the 2000s, when combined with rising liabilities - on account of new actuarial calculation methods, shifting demographics, and low interest rates used to discount future pension liabilities - lead to a re-evaluation of the old social contract. Companies began to realise just how expensive pension promises were, and how meeting the growing funding requirements would have a material impact on their ability to reinvest in, and grow, their operating businesses to compete with newer companies with far lower and more certain pension obligations. Today UK Plc.'s pension deficit amounts to almost £370 billion[2]; to put this another way, on average, UK pension funds only hold assets matching three quarters of their liabilities. British Airways has sometimes been described as a £680 million pension deficit with wings! The majority of defined benefit schemes are now closed to new members; even John Lewis recently threw in the towel. Following Tesco's recent announcement that it would close its defined benefit scheme, only three FTSE 100 firms still have final salary plans open to new members.

FLIPPING THE RISKS ONTO INDIVIDUALS

The hole left by the demise of defined benefit pensions was filled by defined contribution plans, where employers pay a contribution each month into an employee's pension pot and employees often contribute too, although rarely enough. In addition, in 1988 the Government introduced personal pensions, i.e. a pension pot specific to an individual, rather than one offered by an employer.

[1] The misuse of pension assets by Robert Maxwell from the Mirror Group pension plans discovered in the early 1990s is a salutary reminder that some risks do exist to final salary schemes. The insolvency of a firm sponsoring a pension plan may well lead to reduced pensions, despite the Pension Protection fund in the UK.

[2] Josephine Cumbo, FT.com, February 10, 2015 'UK company pension deficits hit £370bn high'

It probably did not dawn on many just how significant or challenging this change was. Companies no longer had to worry about funding the plan and paying pensions to pensioners; or about market risks; or about longevity. They simply had to make their defined contributions each month. The reality was that these risks were foisted on individuals without the knowledge, training, or tools to make the right choices. How much should one save? What should the money be invested in? What sort of pension will this provide? What happens if markets crash? Will the money run out too soon? These are neither easy nor inconsequential questions to answer. Yet that is what individuals were, and are, expected to do when it comes to providing for their retirements in the world of defined contribution pensions.

As the popularity of personal pensions grew, many people tried to do the right thing by seeking out advice, but fell into the wrong hands of those who were intent on peddling conflicted, high cost solutions (IFAs, insurance companies and fund managers all fed off the proceeds). The pension selling scandals were perhaps the nadir of the love-hate cycle.

CONTINUOUSLY MOVING GOALPOSTS HAS SEVERELY HINDERED RETIREMENT PLANNING

Going back to basics, pension plans are a positive contributor to retirees' financial well-being. They provide tax breaks on contributions up to certain limits and, in the case of defined contribution pension plans, provide a tax efficient shelter for the accumulation of income and capital gains on the gross contributions made and invested wisely. Tax is paid on the way out.

As an aside, the narrative that '*pensions are rubbish*' has also grown, which demonstrates a worrying lack of differentiation between the very positive tax-breaks that they offer and the often poorly constructed portfolios of investment assets that sit within them. The tax-inefficiency of non-pension investments, e.g. buy-to-let, is rarely factored into any comparison between the two. Pensions have a place to play in everyone's retirement planning.

Successive governments have continuously tinkered with the pension regime. Until George Osborne stepped in, the nanny state - not trusting someone to spend money from their pot responsibly in retirement, despite having been responsible enough to save in the first place – dictated how much money could be withdrawn from a pension, and forced retirees to hand over their large, hard-earned pot of money to an insurance company (forever) in return for an income for life in the form of an annuity.

In addition, since 2006, when the lifetime allowance was introduced – being the maximum size the pot can grow to before punitive taxes must be paid on withdrawals of amounts above this limit - successive Governments have moved the goalposts several times. It started at £1.5 million in 2006, rose to £1.8 million in 2010/11 and has fallen from £1.25 million in 2014/15 to its current level of £1.25 million in 2015/16. It is due to fall to £1 million in 2016/17. Let's not forget that they have also materially changed the annual maximum pension contributions that can be made from as high as £255,000 in 2010/11 to just £40,000 going forwards. How on earth can responsible individuals be encouraged to build their pensions when there is so much uncertainty over pension regulation? Enter the Chancellor's April 2015 reforms.

AT LAST, PENSIONS HAVE THE FLEXIBILITY THEY DESERVE

Fortunately there are some significant developments in the pension legislation that make pensions more attractive than ever, if still not perfect.

Change 1: Freedom to take out as much as you like, when you like

Prior to April 2015, the amount that could be withdrawn from a pension portfolio was limited by the Government (using a calculation related to 15-year gilt yield), unless the individual had £12,000 of secure income such as annuities, state pension or defined benefit pensions. This withdrawal limit has now been abolished and, from age 55, retirees are free to take as much as they wish, when they wish. They will, of course, be required to pay tax on these withdrawals - beyond any 25% tax-free portion - at their marginal rate of income tax i.e. the highest tax band that they fall into, given all of the income they earn in that tax year.

Pension providers will also be able to make regular payments to retirees that include 25% tax-free and 75% taxable, rather than the retiree having to take the 25% tax free upfront. The flexibility on when and in what quantum withdrawals are made may provide the opportunity to smooth out when tax is paid. Cash flow modelling will be a useful tool to help make such decisions.

It is worth noting that once a retiree starts drawing money from a defined contribution pension pot their annual pension contribution allowance will fall from £40,000 a year to £10,000. If only the tax-free sum is taken, the annual allowance is unaffected. Members of final salary schemes are unaffected.

Talk of retirees depleting their pots and going wild with their cash is somewhat condescending. Most people realise how important maintaining their pot is for their future well-being. That said, some may be tempted to take some money out now.

It is important that pension pots are not seen as ATM machines! Once the 25% tax free pension commencement lump sum is taken, all withdrawals are taxed at the pension holder's marginal rate of tax. As such, the tax consequences need to be calculated carefully before any money is withdrawn. This includes the impact of 40% tax above £31,786, the loss of £1 of the personal allowance - currently £10,660 - for every £2 of income between £100,000 and £121,000 (an effective tax rate of around 60% in this band) and 45% tax above £150,000. Asking for advice is essential and could help to avoid costly tax bills.

Change 2: No requirement anymore to buy an annuity

Thankfully, another of the central pillars of nanny state influence has been abolished; retirees are no longer required to buy an annuity. They will be free to make the decision that is right for them. For some that may still be to buy an annuity now or delay the purchase until a date of their choosing. For others it will be taking out money - drawing down in pension jargon – from their pension pot at a sensible rate. The important issue is that retirees are now in control of that choice, and can seek guidance from their financial planner on what the best course of action might be for them. Another of the new reforms is to allow those who have already purchased annuities to sell them, although how quite this will work in practice (and without another scandal) remains to be seen.

Change 3: Pension pots can be passed onto anyone

Perhaps one of the most material changes that the Chancellor made was to allow pension pots to be handed on to anyone, on the death of the member. Prior to April 2015, a pension could only be passed on tax-free if death occurred before 75 and the plan member had not begun taking an income from the portfolio or taken the tax-free cash allowance. Outside of this narrow definition, any assets withdrawn suffered a usurious '*death tax*' rate of 55%, unless donated to charity.

From 6th April 2015, if the plan member dies before 75, any income or lump sum withdrawals are tax free, provided the plan has been passed on to the 'successor', i.e. the person inheriting the plan, within two years. If this transfer is delayed beyond two years then they will have to pay income tax at their marginal rate on any withdrawals.

If the member's death occurs after 75, then the beneficiary can take either a lump sum or draw down the money flexibly at any time. Where income is taken, this will be taxed at the successor's marginal rate of tax. Lump sum withdrawals will incur a 45% tax in 2015/16 (previously 55%), but will be taxed at the successor's marginal rate of tax from 2016/17.

As pension pots usually fall outside an individual's estate for inheritance tax planning, the astute reader will quickly see that these new arrangements allow for some sensible and legal intergenerational tax planning, in certain circumstances. Professional advice should always be taken as a matter of prudence when making any such choices.

Change 4: Private sector defined benefit pension transfers can be made

The new regulations also allow for those individuals with private sector defined benefit pensions to transfer the lump sum value of their pension into a defined contribution pension (e.g. a self-invested pension plan or SIPP). However, they are required to take professional advice before they do, unless the fund is below £30,000[3]. There is the potential for another scandal here too, with poor transfer values entirely possible. Advisers may also be conflicted; from a financial perspective they may stand to benefit for the transfer, whilst it may be in a client's best interest to remain in a plan with an inflation-protected income for as long as they live. It may seem tempting to transfer assets, but the preponderance of evidence is likely to favour staying put in many instances. Again, help from a trusted adviser is essential.

[3] This amount is currently under government consultation

WHERE THE CHANCELLOR HAS GOT IT WRONG

Whilst the Chancellor has made some very major and welcome changes to the pension environment - cynics might say that this was done in an attempt to raise tax receipts from withdrawals – not everything he has done is supportive of pension saving. Whilst his reduction in the annual allowance to a maximum of £40,000 may be seen as fair i.e. limiting tax breaks on contributions, his reduction of the lifetime allowance to £1 million from 2016/17 is a major hindrance in attracting individuals to save hard for their retirements. The problem is that investors have no control over how well the markets perform and risk punitive taxes - 55% on lump sum withdrawals – if balances are higher than the lifetime allowance[4]. This makes it difficult to decide how much to contribute. A pot of £1 million will not provide as much income as some might expect (see below).

There is also considerable iniquity between the lifetime allowance of those in defined benefit plans and those in defined contribution plans. In the former, the lifetime allowance is based on 20 times the income received annually in retirement, which implies a maximum annual income of £50,000 (which is likely to be inflation linked and provide spouse protection). Yet in a defined contribution plan, using this income figure, to purchase an annuity with the same features, one would require around £2 million in the pot[5], i.e. the £1 million lifetime allowance will only buy a pension of £25,000. The Chancellor should be encouraged to abolish the lifetime allowance altogether. It certainly adds a layer of uncertainty and complexity that is a detriment to pension investors.

CONCLUSION

These pension reforms should be welcomed. Yet, despite their positive contribution to flexibility, and fairness, they also bring increased choices for individuals around contribution levels, the timing and quantum of pension withdrawals and their use as tax-efficient intergenerational asset transfer opportunities. These decisions are complex and important to the future financial well-being of clients and their families and should not be taken lightly. It is hard to think of a more obvious area that a good financial planning firm can add material value to its clients than by empowering them to make informed decisions on what to do with their pensions.

If you want to find out more or talk to us about these or any other pension issues, please do not hesitate to get in touch.

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4 The lifetime allowance charge is instigated when one of a number of defined circumstances occur, which crystallises the value of the pension pot. Protections can be applied for if the value of the pot is already above the new lifetime limit.

5 Ros Altmann (2015) http://pensionsandsavings.com/uncategorized/a-savings-revolution-to-follow-the-pensions-revolution/

OTHER NOTES AND RISK WARNINGS

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