HM TREASURY

Removing the requirement to annuitise by age 75

A summary of the consultation responses and the Government's response

December 2010

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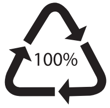

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1 Introduction

1.1 As the UK population ages, the Government is committed to encouraging people to save more for their retirement. The introduction of automatic enrolment from 2012 will ensure that millions of employees will be newly saving or saving more into a workplace pension scheme. However, the Government believes that it is also important that the tax rules for retirement should become more flexible, in order to make pension saving more attractive and encourage people to take greater responsibility for their financial future.

1.2 At present, individuals with tax-relieved pension savings are required to secure an income by age 75. Alternatively Secured Pensions (ASPs) exist for people reaching age 75 with principled objections to mortality pooling, but these are subject to strict income withdrawal limits and tax charges of up to 82%. In practice, annuitisation by age 75 is effectively compulsory for almost all pension savers.

1.3 The requirement to secure an income by age 75 was introduced in 1976, since when the average life expectancy of a healthy 65 year-old man has increased by 8 years. Continuing increases in both longevity and the length of working lives mean that the existing rules will become restrictive for an increasing number of people.

1.4 The Government's intention is to create a new system of rules that aligns with the broader objectives for the taxation of pension saving: to create a fair and sustainable regime that gives individuals (as well as employers, providers and schemes) appropriate flexibility to make arrangements that suit their circumstances and preferences. The Government set out its proposals for implementing the restriction of higher rate tax relief on 14 October and will shortly publish a call for evidence on early access to pension savings.

1.5 In the context of these wider objectives, the Government intends to reform the tax framework for retirement in line with five key principles:

Box 1.A: Principles for a new tax framework for retirement

1. The purpose of tax-relieved pension saving is to provide an income in retirement.
2. Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.
3. Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.
4. In line with the "exempt exempt, taxed" (EET) model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.
5. On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.

1.6 Under the new proposals, an individual will be able to purchase an annuity with all or part of their pension savings from age 55 without restriction. The age 75 restrictions on value protection, trivial commutation and pension commencement lump sums will also be removed.

1.7 At present, Unsecured Pensions (USPs) and ASPs allow individuals to draw down income from invested pension savings before and after age 75 respectively. These products are subject to different recovery charges and annual withdrawal limits. The Government's proposals replace USPs and ASPs with a single product - capped drawdown - available from age 55 without restriction.

1.8 The proposals will also provide additional flexibility for individuals wishing to draw down more than the capped annual limit. Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR) will be able to draw down unlimited amounts from their pension pots in a flexible drawdown model, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering flexible drawdown has sufficient secured income to avoid subsequently falling back on the state.

2 The consultation

2.1 The Government announced that it will end the existing rules that create an effective obligation to purchase an annuity by age 75 with effect from April 2011 in the Emergency Budget on 22 June 2010. The Budget also introduced transitional measures for those yet to secure a retirement income turning 75 in the meantime and confirmed that the Government would launch a consultation on the detail of the change.

2.2 The objective of this consultation was to use external expertise to develop the reforms in line with the core principles, and to identify any unintended consequences. The consultation was launched on 15 July 2010 and closed on 10 September 2010. The consultation document, *Removing the requirement to annuitise by age 75,* set out detailed proposals for implementing this reform and invited comments from interested parties.

Box 2.A: Consultation questions

The Government welcomed views on the proposals and the impact assessment from all interested parties, particularly in relation to the following questions:

Developing a tax framework for retirement (Chapter 2)

- the level of an appropriate annual drawdown limit for capped drawdown;
- its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75;

Minimum Income Requirement (Chapter 3)

- what income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate;
- what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages;
- whether a different MIR should be set for individuals and couples;
- how often the MIR level should be reviewed;
- how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR;

The UK annuity market (Chapter 4)

- whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks;
- how the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75; and
- whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

2.3 The Government received 185 responses from a wide cross-section of individuals, pension professionals, advisers, trade bodies and academics; these are listed in Annex B. Most respondents welcomed the Government's aim of increasing flexibility. Questions were raised about specific aspects of the proposals, including the taxation of death benefits, the design of capped drawdown and flexible drawdown, and the impact on providers.

2.4 The Government has considered all the responses received. This document summarises the responses received and sets out the Government's intended policy approach as informed by the consultation exercise. The Government's intention remains to introduce legislation in the 2011 Finance Bill, and the Government has today published draft legislation for consultation. The Government welcomes comments on the draft legislation from interested parties.

3 Responses to the consultation questions

3.1 This chapter summarises the views expressed in response to each of the consultation questions, and sets out the Government's proposed approach in light of the responses received.

The Government welcomes views on the level of an appropriate annual drawdown limit for capped drawdown.

3.2 Many respondents agreed that the current annual withdrawal limit in an Unsecured Pension (120% of the value of a comparable annuity)[1] should be lower in capped drawdown to mitigate the risk of individuals exhausting funds in later life. A number of respondents submitted detailed modelling to demonstrate that the risk of running out of funds increases significantly at higher ages, and that it becomes increasingly difficult to match the benefits provided by an annuity.

3.3 Suggestions as to what a lower withdrawal limit should be ranged from 30% to 100% of the value of a comparable annuity; 100% was the most common proposal. Some respondents suggested that a universal lower withdrawal limit would make drawdown unnecessarily restrictive and recommended retaining 120%.

3.4 A number of respondents suggested that different limits should apply at different ages. Two broad approaches were proposed:

- a withdrawal limit increasing gradually with age from a low initial level. This would allow individuals to withdraw a consistent level of income over their retirement by withdrawing a greater share of a diminishing total fund over time. However, this approach would result in significantly lower initial income than at present; and
- a withdrawal limit decreasing with age from an initial level above 100%. This would conserve funds at higher ages and would reflect the fact that expenditure is often greatest in the early years of retirement. However, this approach could lead to income being very low later in life, as both the overall fund size and the annual withdrawal limit decrease.

3.5 Respondents to this question also commented on the frequency of investment reviews in drawdown, recommending in most cases that these be shortened from the current five year requirement before age 75. This would reduce the risk of funds being depleted between reviews in the event of poor investment growth. Annual reviews were generally considered too short because of the unpredictability of market movements; the most common recommendation was for reviews to be held at least every three years.

Government Response

3.6 The Government recognises the trade-off in setting the withdrawal limits for capped drawdown pensions between flexibility and the risk of funds being exhausted. The Government is also committed to ensuring the new rules are as simple as possible.

[1] The precise amount is set by the pension scheme administrator using tables specifically compiled for this purpose by the Government Actuary's Department (GAD).

3.7 Different individuals will wish to use capped drawdown pensions for different purposes. Some may plan to remain in capped drawdown throughout their retirement; others may wish to remain in capped drawdown for a number of years before purchasing an annuity. Likewise, some individuals may wish to withdraw their savings at the maximum rate while others may want to leave money invested initially in order to withdraw it later in life.

3.8 For this reason, the Government believes that it would be inappropriate to set different withdrawal limits for different ages, as there is no "one size fits all" income withdrawal profile appropriate in all circumstances. Instead, the Government intends to set a single annual withdrawal limit equivalent to 100% of the value of a comparable annuity.

3.9 The Government believes that this strikes an appropriate balance between fairness and simplicity, while limiting the risk of individuals exhausting savings in later life. To further mitigate this risk, the Government believes that reviews at least every three years before age 75 and annual reviews after age 75 are appropriate in capped drawdown. The Government Actuary's Department (GAD) will issue updated tables extended beyond age 75 as the basis for calculating the annual capped drawdown limit.

3.10 The Government recognises that some risk will remain that individuals in capped drawdown could exhaust their savings prematurely or achieve significantly worse outcomes than if they had bought an annuity. This risk is inherent in any drawdown arrangement where outcomes are dependent on investment returns and individuals cannot insure against longevity via mortality pooling (as with an annuity). It will therefore be important that individuals take appropriate advice before entering a capped drawdown arrangement.

3.11 The Government proposes that the withdrawal limits of capped drawdown pensions should apply to current holders of Alternatively Secured Pensions (ASPs) from 6 April 2011. As all existing ASP holders are over 75, current ASP holders will continue to have annual investment reviews, as required for those aged over 75 in capped drawdown.

3.12 To provide certainty for current Unsecured Pension (USP) holders, and to minimise burdens on providers, the Government proposes that the new withdrawal limits and triennial reviews of capped drawdown pensions should apply only from the date of their next review. In practice, this will be the earliest of the following events after 5 April 2011:

- the 5th anniversary of the most recent review;
- following a 75th birthday: the first anniversary of the most recent review; or
- following a transfer to another drawdown provider: the first anniversary of the most recent review.

The Government welcomes views on its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

3.13 Many respondents welcomed the removal of the age 75 rule and the Government's intention to allow more flexible use of pension savings in retirement. In particular, the removal of Alternatively Secured Pensions (ASPs) was universally well received.

3.14 Some respondents believed that the Government could have been more radical, for instance by allowing a wider definition of 'dependant' so that pension wealth could be transferred to any nominated beneficiary tax-free if used to provide a pension.[2] Others requested

[2] In this context, a 'dependant' broadly is a spouse or civil partner, or a child under 23 years old.

retaining for those in capped drawdown pensions the existing provision in ASP to nominate lump sum death benefits to a charity free of tax.

3.15 The proposed 55% recovery charge on lump sum death benefits attracted criticism from many respondents, who argued that it was unfairly high, particularly for basic rate taxpayers and current USP holders. Respondents suggested various alternatives, including a lower universal charge, a lower rate for value-protection lump sums and disregarding (or taxing at a lower rate) the first £10-20k of the remaining funds.

3.16 Most individual respondents welcomed the additional flexibility offered by flexible drawdown. A number of providers expressed concerns about its proposed implementation, commenting that they would not be able to update their systems to provide flexible drawdown pensions from April 2011.

Government Response

3.17 The consultation document set out the Government's key principles for designing of the new tax framework. These included:

- that any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance; and
- that pension savings that have been accumulated with tax relief should, on death, be taxed at an appropriate rate to recover past relief given.

3.18 In setting the recovery charge for death benefits, the Government has sought to reflect these principles, as well as striking a balance between simplicity, fairness, and managing fiscal risk.

3.19 It is inevitable that a single recovery charge will over-recover relief from some individuals. The amount of tax relief received by any one individual varies widely according to their specific circumstances (e.g. the length of time over which they save, their income, and investment returns). It is not possible to tailor tax charges to match each individual's savings history.

3.20 However, it must be recognised that tax relief will make up a substantial proportion of an individual's pension fund on retirement. Table 3.A below illustrates typical proportions of tax relief for individuals in the basic and higher rate income bands:

Table 3.A: Tax relief by income bracket

Lifetime income tax bracket (after pension contributions)	Tax relief as proportion of total pension pot at retirement[3]
Basic rate	Around 25%
Higher rate	Around 55%

3.21 The recovery charge will only apply in cases where an individual has unused pension savings remaining upon death. Typically, this will occur where that individual has been in a drawdown arrangement. While many individuals will move between different income bands over their working life, HMRC estimate that around 75% of individuals currently in drawdown will have received most of their tax relief at the higher rate.

3.22 While the Government expects that a wider range of individuals may seek to enter drawdown following the reforms, it is reasonable to assume that a greater proportion of

[3] Source: HMRC calculations. Based on an individual saving over 40 years, taking into account tax relief on employee contributions, employer contributions and nominal investment growth of 6% but not including the pension commencement lump sum.

individuals who have unused funds remaining on death will have been the recipients of relief at the higher rate, when compared with the pensioner population as a whole.

3.23 Under the proposed reforms, Inheritance Tax (IHT) will not typically apply to lump sum death benefits after age 75. This is a significant simplification compared with the existing rules, where IHT is chargeable on death benefits after age 75, but not before age 75.[4] In line with the Government's core principles, it is important that the removal of IHT from death benefit lump sums does not make pensions into a vehicle for IHT avoidance.

3.24 The level of the recovery charge therefore also has to ensure that, for the purposes of inheritance, the tax treatment of pension savings is not significantly more advantageous than the tax treatment of savings in other investment vehicles which would be subject to IHT. The Government's modelling suggests that a tax charge of less than 55% would risk creating such an advantage.

3.25 In response to representations made in the course of the consultation, the Government considered some alternatives to the 55% recovery charge:

- some respondents argued for a lower recovery charge, e.g. 35%. However, this would result in a significant cost to the Exchequer, as a charge at this level would not fully recover the relief provided for many people, and would create an incentive for some individuals to save into a pension in order to avoid IHT;
- some respondents suggested that the Government could exempt a fixed initial amount from the recovery charge, e.g. £10,000 or £20,000. However, this would create significant opportunities for avoidance and administrative complexity, as individuals could split their savings between multiple drawdown arrangements so as to ensure that they fell below the taxable threshold;
- some respondents suggested that a lower recovery charge should be imposed on death benefits, and that IHT should apply to the remainder. However, this would create a significant tax advantage for individuals whose estates were below the IHT threshold, with a corresponding fiscal cost; and
- some respondents suggested that a lower recovery charge could apply to certain products (e.g. value protected annuities) which may be taken up by individuals on modest incomes. However, the Government believes that applying different tax charges to certain products would create unwarranted distortions in the market for decumulation products.

3.26 The Government has therefore concluded that none of these alternatives fits the core principles of the reform. In light of these considerations, including the expected proportion of pension funds that is comprised of tax relief and IHT avoidance issues, the Government remains of the view that 55% is the appropriate level of recovery charge for death benefits.

3.27 Most individuals can expect to live well beyond age 75. Under the existing rules, an individual would either have to purchase an annuity at age 75 (in which case, no death benefits would be payable), or enter an Alternatively Secured Pension arrangement (where death benefits would be taxed at up to 82%). The Government believes that a regime under which death benefits are taxed at 55% is significantly more attractive than the existing regime.

[4] In addition the IHT anti-avoidance charges that apply to registered pension schemes and Qualifying Non UK Pension (QNUP) schemes where the scheme member omits to take their retirement entitlements will be removed. These changes will also apply to superannuation funds that are occupational pension schemes by virtue of section 615(3) of the Income and Corporation Taxes Act 1988.

3.28 It is currently possible to pass on unused pension funds tax-free after death, as long as they are used to provide a dependant's pension. The Government intends that this should continue to be the case. The Government has considered suggestions to allow unused pension funds to be passed on (with or without a tax charge) to any nominated individual on death but believes that this would be complex and would involve significant Exchequer cost.

3.29 A number of respondents proposed that it should remain possible for individuals to pass on unused pension savings to a charity upon death free of tax, in cases where there are no dependants. The Government agrees that this option should continue to be available.

3.30 The draft legislation includes a number of measures which are intended to prevent tax avoidance. In particular, the Government proposes that:

- individuals who become temporarily resident abroad should be taxed on all withdrawals of flexible drawdown pension if they return to the UK within a five-year period; and
- individuals in flexible drawdown should not be permitted to accrue further tax-relieved pension savings, in order to prevent "recycling" of tax relief.

3.31 The Government proposes that the 55% recovery charge on lump sum death benefits should apply in respect of deaths on or after 6 April 2011.

3.32 The Government has considered representations from providers that the introduction of flexible drawdown pensions should be delayed to allow more time for providers to adapt to the changes. However, the Government believes that a delay would create further uncertainty which would make it more difficult for providers to plan for the new arrangements. The Government therefore intends to legislate for all aspects of the new tax framework, including flexible drawdown pensions, in Finance Bill 2011.

The Government welcomes views on what income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

3.33 Many respondents commented on the Government's proposals for the life annuity income allowed to count towards the MIR (index-linked or escalating annuity income). These were generally considered practical but too restrictive; many respondents requested that level annuities be permitted as well.

3.34 Level annuities do not meet the requirement set out in the consultation document to 'take into account reasonable expectations of the future cost of living'. However, they constituted approximately 87% of the volume of conventional annuities sold in 2006.[5] Furthermore, it might take many years for escalating annuity income to overtake level annuity income and even longer for the total cumulative income to be greater.[6]

3.35 To mitigate the inflation risk posed by level annuities, several respondents suggested allowing level annuities to count towards the MIR, but at a discounted value. Discounting was also proposed more widely as a mechanism for accommodating other anomalies in the allowed income – for instance, the fact that defined benefit rights accrued before 1997 do not have statutory minimum uprating.

[5] *Pension Annuities and the Open Market Option,* ABI, 2008.

[6] In an example provided by Saunderson House, escalating annuity income overtakes level annuity income after 23 years. The cumulative escalating income takes 41 years to overtake that of level annuity income.

3.36 Other suggestions for income allowed to count towards the MIR included long-dated bonds held to maturity and similar vehicles. Some requested that a minimum capital requirement (similar to an Irish Approved Retirement Fund) be introduced instead of the MIR to allow individuals with smaller pension wealth but large non-pension wealth to benefit from flexible drawdown.

3.37 Another method of effectively implementing a minimum capital requirement, proposed by several respondents, would be to allow Purchased Life Annuities (PLAs) – non-pension annuities.

3.38 Finally, several respondents requested that an individual's expected future occupational scheme or State Pension entitlement should be allowed to count towards the MIR. This could increase flexibility by allowing, for instance, an individual to use their basic State Pension entitlement to count towards the MIR before reaching State Pension Age.

Government Response

3.39 The Government believes that the MIR should be as flexible as possible and recognises that level annuities are by far the most common choice for providing a retirement income. The Government will therefore allow level annuity income to count towards the MIR. While such income does not 'take into account reasonable expectations of the future cost of living', it is possible to compensate for this in the design of the MIR.

3.40 Discounting different types of income in relation to their inflation-proofing is one such mechanism. This has been considered but rejected on grounds of complexity. In particular, the discounting of DB income is problematic given different statutory indexation minima before 1997, between 1997 and 2005 and post 2005. Instead, the Government will set the MIR at an initial level sufficient to provide a prudent buffer against the eroding effects of inflation. Annex A provides further details.

3.41 Although the Government understands that most PLAs are currently sold without surrender rights, their different tax treatment would make it possible to sell a PLA that could be cashed in on request. A PLA could then be purchased for a short period of time solely for the purposes of satisfying the MIR, violating the principle that income used to satisfy the MIR must be guaranteed for life. For this reason, PLAs will not be allowed to count towards the MIR.

3.42 As outlined in the consultation document, only pension income will be considered for the purposes of the MIR and this income must be in payment at the time of assessment. This helps reduce complexity in the assessment of the MIR. The Government will keep under review pension income that can count towards the MIR and remains open to representations.

3.43 A fundamental principle of the UK private pensions system is that the purpose of tax-relieved pension saving is to provide an income in retirement. A minimum income (rather than capital) requirement maintains consistency with this principle; the Government therefore believes that the MIR is the more appropriate mechanism.

The Government welcomes view on what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

3.44 Suggested levels for the MIR ranged from £7,000 per year to £31,000 per year. The majority believed an MIR of between £12,000 and £18,000 to be appropriate. Individuals generally preferred a lower MIR than industry bodies and pension providers.

3.45 Responses included detailed analysis by the Pensions Policy Institute and the pension academics Blake, Cannon and Tonks. Blake, Cannon and Tonks estimate that the MIR should be around £14,000 based on the interaction between the expected future values of benefit thresholds and income streams and £16,000 based on stochastic modelling techniques.

3.46 An age-related MIR was generally considered unwelcome and over-complex. Recognising the increased uncertainty about future income and expenditure needs at younger ages, some suggested that flexible drawdown should be available only from the State Pension Age or higher. Others observed that the higher cost of securing the minimum income at younger ages (i.e. in the absence of a state pension and with higher annuity rates) would mean that few people would enter flexible drawdown below the State Pension Age in any case.

Government Response

3.47 The Government recognises respondents' concerns about the potential complexity of an age-related MIR and has carefully considered all the representations submitted about the level of the MIR. To maintain simplicity and flexibility, the Government will allow flexible drawdown from age 55 onwards, with a single level of MIR applicable at all ages.

3.48 The Government recognises that it is impossible for any realistic level of the MIR to eliminate entirely the possibility of an individual in flexible drawdown falling back on the State. The Government also recognises that few individuals will enter flexible drawdown intentionally to exhaust their money and claim state benefits.

3.49 The detailed assumptions used to estimate an appropriate level for the MIR are set out in Annex A. Since the calculations are highly sensitive to all the parameters involved, any analytical estimate of the MIR is approximate and the Government must exercise a significant degree of judgement in choosing the level. Informed by these calculations and other views submitted as part of the consultation process, the Government believes that an appropriate level for the MIR is £20,000.

The Government welcomes views on whether a different MIR should be set for individuals and couples.

3.50 Many respondents believed that a different MIR for individuals and couples would most fairly reflect the associated different income requirements. However, most recognised the practical difficulties that would arise if a different MIR were set for couples, particularly following changes to marital/partnership circumstances.

Government Response

3.51 The Government believes that a different MIR level for couples and individuals would be too complex to implement in practice. The MIR will therefore be set for individuals only.

The Government welcomes views on how often the MIR level should be reviewed.

3.52 Few respondents expressed views on this issue. Of those that did, a significant number incorrectly believed that an individual's right to remain in flexible drawdown would depend on periodically satisfying an MIR assessment. This is not the case – once the MIR has been satisfied, the withdrawal limits of capped drawdown are removed and an individual remains in flexible drawdown for as long as they have funds remaining.

3.53 The intention was to consult on how frequently the Government should review the published level of the MIR. Setting it too frequently will create uncertainty whereas not setting it frequently enough could lead to Exchequer risk. Some respondents, including the ABI and AgeUK, suggested linking the MIR to average earnings, as is the case for the basic State Pension.

Government Response

3.54 The Government has considered the few responses on this issue and proposes that the MIR should be set by Treasury order at least every five years. This will provide certainty for individuals currently saving with a view to entering into flexible drawdown while allowing the level to be adjusted periodically.

The Government welcomes views on how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

3.55 Most responses to this question were received from pension providers. Many preferred responsibility for administering the MIR assessment to lie with HMRC rather than providers. Most requested detailed guidance from HMRC clarifying providers' responsibilities and liabilities, particularly in the event of an individual entering flexible drawdown after a false declaration of income.

3.56 Some providers suggested that the Impact Assessment underestimates the likely cost to providers of introducing the new rules, observing that regulatory obligations will result in costs regardless of whether providers choose to offer new products. Several commented on the costs to industry of cumulative legislative changes.

Government Response

3.57 The Government does not agree that HMRC is best placed to administer MIR assessments. An individual and the scheme paying their pension are best placed to know what part of a person's pension income can count towards the MIR, particularly if either the individual or the scheme is not resident in the UK.

3.58 The Government recognises the need for clarity about schemes' liabilities in the event of a false MIR declaration. The Government intends that these liabilities will be subject to the same 'good faith' easements as now exist for unauthorised payments if schemes release money under false declarations. Schemes will therefore not be liable for tax if the scheme administrator reasonably believed at the time of the payment that it was authorised. Draft regulations setting out the requirements for the MIR assessment will be published in due course.

3.59 The associated Impact Assessment (also published today) contains revised figures of the estimated cost of the reforms, based on consultation responses from industry. The Government recognises the additional burdens placed on industry by cumulative changes. This is one of the reasons for pressing ahead with implementation of flexible drawdown pensions from April 2011. This will allow providers more time to plan, even if they will need more time to bring flexible drawdown products to the market.

The Government welcomes views on whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

3.60 Some respondents highlighted aspects of regulations governing the payment of lifetime annuities whose removal might allow industry to provide more attractive products. In particular, some providers commented that allowing annuity income to step up or down would allow greater flexibility in response to specific events, e.g. spousal death or long-term care needs. There was no clear consensus on what further reforms would be desirable; other respondents commented that no further changes should be considered until the outcome of the Long Term Care Commission report in 2011 is known.

3.61 Many responses to this question addressed areas of pensions tax legislation beyond the removal of legislative or regulatory barriers relating to retirement income products. Concerns

raised included issues relating to the trivial commutation rules, the restrictions on pension contributions from non-earnings sources and asset redistribution rules in Small Self-Administered Schemes.

Government Response

3.62 Lifetime annuity payments are currently allowed to decrease in accordance with regulations prescribed in secondary legislation; these products are known as 'variable annuities'. More fundamental changes would require changes to the definition of a lifetime annuity in primary legislation. The Government recognises the interactions with long term care provision and agrees that further changes should not be considered ahead of the 2011 Long Term Care Commission report.

3.63 The Government welcomes these representations on wider reforms to the pensions tax system and will consider the case for any further changes as part of the Budget process.

The Government welcomes views on how the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

3.64 Many respondents commented that the increased flexibility and choice offered by the new rules will make it even more important that individuals have access to good advice. Many acknowledged the important role of Consumer Financial Education Body (CFEB) in helping individuals make appropriate choices.

3.65 However, most respondents stressed that specialist advice should be sought before entering drawdown products; of widespread concern was that the new rules might increase the likelihood of individuals seeking to enter drawdown products without a full understanding of the risks involved. Some believed that the introduction of the Retail Distribution Review in 2012 would exacerbate any trend in this direction. There was little consensus as to the likely future supply or demand characteristics of capped drawdown.

3.66 There was, however, general agreement that the value of annuities is generally not understood. In addition, many respondents commented that annuity outcomes could be improved by increased take-up of the Open Market Option (OMO) allowing an individual to 'shop around' when purchasing an annuity.

3.67 Some respondents also observed that the new rules might lead to increased demand for transfers from defined benefit (DB) schemes to defined contribution (DC) schemes to take advantage of flexible drawdown. The abolition of contracting-out for DC schemes from April 2012 was cited as a possible cause of increased demand in 2011/12.

Government Response

3.68 The Government is committed to ensuring that consumers have access to financial advice to enable them to make appropriate choices. The rollout by the CFEB of the free and impartial national financial advice service will help consumers understand these choices and will signpost consumers in the direction of specialist advice where appropriate.

3.69 The Government recognises the concerns raised about individuals entering drawdown without a full understanding of the risks involved. It is right that individuals who wish to benefit from the flexibility offered by capped drawdown pensions are able to do so but this product inevitably carries exposure to investment risk that annuities do not. The associated risk of depleting funds prematurely cannot be entirely mitigated without imposing undesirably

restrictive withdrawal limits that would undermine the flexibility that drawdown arrangements provide.

3.70 The FSA will consult on consequential changes to the Conduct of Business Sourcebook (COBS) to ensure that their rules properly take account of the proposed changes. COBS requires that a firm giving advice must ensure that a personal recommendation is suitable for its client. The FSA will ensure that consequential changes to their rules are in place in time for the April 2011 implementation.

3.71 The Government is keen to ensure that more people get the best annuity rate by taking advantage of the Open Market Option (OMO). Officials will continue to work with the insurance industry to establish how the OMO can be improved and its uptake increased. If it is not possible to make the OMO operate more effectively, the Government will consider legislative options.

3.72 The Government recognises that some individuals may wish to transfer money from occupational DB schemes into DC schemes to take advantage of flexible drawdown arrangements. The Government does not expect this to be a popular route for entering flexible drawdown as DB income will be allowed to count towards the MIR. Individuals with sufficient DB and DC income will therefore be able to meet the MIR without transferring their DB income.

The Government welcomes views on whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

3.73 Of the few direct respondents to this question, some commented that the Government's proposals might lead to a fall in demand for annuities. In particular, the pensions academics Blake, Cannon and Tonks submitted detailed analysis predicting a large fall in demand for annuities. This was based on the assumption that everyone with full basic State Pension entitlement able to secure £9,000 of escalating annuity income would access their remaining pension savings through flexible drawdown.

3.74 In general, respondents did not anticipate the removal of compulsory annuitisation having a major impact on the supply of or demand for annuities. Some noted concerns with the potential impact of the proposed Solvency II regime on the supply of annuities at attractive rates.

Government Response

3.75 The Government recognises that some individuals who would previously have purchased an annuity at age 75 will choose to stay in drawdown arrangements from April 2011. Giving individuals the flexibility to make choices appropriate to their individual circumstances is one of the key objectives of the new rules. However, purchasing an annuity will continue to be the best option for many individuals to provide an income in retirement. Individuals wishing to access flexible drawdown will need to satisfy a MIR of £20,000, in many cases by purchasing an annuity as part of this requirement. The Government believes that these factors mitigate the risk of large falls in demand for annuities.

3.76 The Government supports the objectives of the Solvency II Directive and recognises industry concerns about the potential impacts of the proposed implementing measures on annuity prices and the annuity market. The Government continues to engage closely with both industry and the Commission to address these concerns, both for business already written, and new business.

A The MIR - design and case studies

A.1 This annex sets out in more detail the technical calculations used to support the decision to set the MIR at £20,000. Since the calculations are highly sensitive to all the parameters involved, any analytical estimate of the MIR is approximate. In choosing the level, the Government must exercise judgement to strike a balance between risk mitigation and the fact that few individuals entering flexible drawdown will be likely to fall back on the State.

A.2 The purpose of the MIR is to ensure that an individual with more flexible access to their pension savings does not fall back on the State after exhausting these savings prematurely. The MIR should therefore be set at the level above which an individual cannot claim means-tested benefits, both at the time of assessment and for the duration of their retirement.

A.3 Means-tested entitlements are not based on income alone, but take into consideration other factors, such as long-term care, disability and housing circumstances. It is therefore unrealistic to specify an income level above which an individual cannot claim any means-tested benefits; the level of income at which standard Pension Credit can no longer be received (£9,620 per year) is used instead as a proxy.

A.4 The Government has estimated an appropriate level of the MIR based on the future interaction of this threshold (£9,620) with an individual's income stream. The MIR must be high enough for there to be a reasonable likelihood that the value of an individual's income stream will remain above level of income at which standard Pension Credit can no longer be received for the duration of retirement.

A.5 There is approximately an 8% chance of a 65-70 year old male surviving to age 100.[1] Based on this, the MIR should be set at a level that will remain above the £9,620 threshold for 30-35 years.

A.6 Assuming full basic State Pension entitlement (£5,078 per year) the calculations for individuals aged 65 and 70 years old are, respectively:

$$MIR = (9620 - 5078) \times 1.0475^{35} = £23,048$$
$$MIR = (9620 - 5078) \times 1.0475^{30} = £18,275$$

A.7 It is assumed for the purposes of these calculations that both the level of income at which standard Pension Credit can no longer be received and the basic State Pension are uprated by earnings growth of 4.75%. These assumptions are used for the basis of these approximations and are not statements of long-term Government policy. The 4.75% figure for earnings growth is also not an official forecast but is estimated by summing 2% (CPI target), 2% (productivity growth)[2] and 0.75% (the assumed RPI/CPI wedge).

[1] ONS - based on actual and estimated historical mortality rates and projected mortality rates from the 2008-based principal population projections.

[2] OBR pre-Budget forecast 2010.

A.8 The compounding effect over 30-35 years makes the calculations very sensitive to the assumptions made. As an example, earnings growth of 3.75% would give the following estimates for the MIR:

$$MIR = (9620 - 5078) \times 1.0375^{35} = £16,475$$
$$MIR = (9620 - 5078) \times 1.0375^{30} = £13,705$$

A.9 Combining these gives a range of estimates for the MIR of £14-23,000. Since level annuities will be allowed to count towards the MIR, an MIR at the higher end of this range will provide a prudent buffer against the eroding effects of inflation. Informed by these considerations and calculations, the Government's judgement is that an MIR of £20,000 is appropriate.

A.10 The following examples demonstrate how an individual might meet the MIR of £20,000:

Example 1: Income from state and defined contribution pensions

Basic State Pension	£5,078
Additional State Pension	£2,500
Level annuity income	£12,500
Total secured income	£20,078

3.77 A 65 year-old healthy male would require a pot of approximately £233,000 to secure level annuity income of £12,500.[3]

Example 2: Income from state and defined benefit pensions

Basic State Pension	£5,078
Additional State Pension	£530
Occupational DB income	£14,400
Total secured income	£20,008

[3] Based on the best single-life annuity with no guarantee period for a healthy male using the Moneymadeclear comparison tables on 26 November 2010

Example 3: Income from state, defined benefit and defined contribution pensions

Basic State Pension	£5,078
Additional State Pension	£1,040
Occupational DB income	£4,000
Level annuity income	£10,000
Total secured income	**£20,118**

3.78 A 65 year-old healthy male would require a pot of approximately £186,000 to secure level annuity income of £10,000.

B Consultation respondents

B.1 The Government is grateful to the following respondents for their contributions to the consultation process:

AEGON
AgeUK
AJ Bell
Alliance Bernstein
Alltrust
Annuity Direct Ltd
Aquilaheywood
Archtrust Financial Services
Ashcourt Rowan Administration
Association of British Insurers
Association of Chartered Certified Accountants
Association of Consulting Actuaries
Association of Independent Financial Advisers
Association of Member-Directed Pensions Schemes
Association of Pension Lawyers
Association of Taxation Technicians
Aviva
AXA
Barnett Waddingham
BDO Investment Management
Buck Consultants
Canada Life
Central Financial Planning
Centre for Research in Social Policy
Chartered Institute of Taxation
Confederation of British Industry
Co-Op Financial Services
CWP Financial Services
Eversheds LLP
Fidelity International
Financial Services Consumer Panel
Friends Provident
Furnshill Pension Services
FutureFocus Advisory Ltd
Hargreaves Lansdown
Hewitt Associates
Hillier Hopkins LLP
Hornbuckle Mitchell

HSBC
HW Fisher & Co
Hymans Robertson LLP
Institute of Chartered Accountants in England and Wales
Institute of Directors
Intelligent Pensions Ltd
Investment and Life Assurance Group
Investment Management Association
James Hay & IPS Partnership
Joseph Lamb
Just Retirement
Law Society of Scotland
Legal & General
Liverpool Victoria
Living Time
Lloyds Banking Group
Lowland Financial
LSCA Taxation Committee
Matrix Capital
Mattioli Woods
Mercer
MetLife
MGM Advantage
National Association of Pension Funds
Page Russell
Partnership
Pensions Income Choice Association
Pensions Management Institute
Pensions Policy Institute
Pensions Reform Action Group
PFS Asset Management Ltd
Prudential
Quantum Advisory
Retirement Angels Ltd
Rockingham Retirement
Sackers
Saunderson House
Schroders
Scottish Life
Scottish Widows
SHIP Equity Release
Skandia
Society of Pension Consultants
St. James's Place Wealth Management
Standard Life
Sun Life Financial of Canada
Tax-incentivised Savings Association
The Institute & Faculty of Actuaries
The Pensions Advisory Service

The Phoenix Group
Towers Watson
Travers Smith LLP
TTR Barnes Financial Services
UK IFA Net
UNISON
Which?
White & Co
Xafinity Paymaster
Zurich
88 individual responses

HM Treasury contacts

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk