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Open letter to:

Mark Hoban MP
Financial Secretary to the Treasury
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

15 September 2011

Dear Mark,

A call for the Government to mitigate consumer detriment caused by the calculation of maximum drawdown income

May I first of all take this opportunity to confirm my support for the majority of policy decisions taken by the Coalition Government in the field of individual savings. In previous correspondence, I voiced my concern about a number of issues with pensions policy that were adversely affecting savers in the UK. Much has been done to encourage individual savings by removing unnecessary complexity in pensions legislation. However, I believe there is one further issue that justifies further consideration.

This letter is sent to you for two reasons. Firstly, to highlight the combined impact of recent policy decisions surrounding the calculation of maximum drawdown pension. Secondly, to call for the Government to review, at policy level, whether slavishly following gilt yields and actuarial principles remains the most appropriate way to set drawdown limits, or whether other options have become more appropriate. I have suggested alternatives below which I would consider to have at least as much merit as the existing gilt yield method. I would also call on the Government to immediately re-instate the 20% uplift that was applied to pre-6 April 2011 maximum drawdown calculations as an interim step before reviewing the method for determining drawdown income limits.

Looking at the issue individuals are facing with their drawdown income, a number of factors are combining to produce a situation where many individuals are seeing a significant drop in the maximum income which they are able to draw from their pensions.

To illustrate the potential number of pensions savers affected, the drawdown concept was introduced in 1995 and has been increasing in popularity ever since. Industry statistics suggest that circa 50,000 individuals enter into new drawdown plans each year. This means that hundreds of thousands of individuals are currently using this benefit option. Our experience suggests that around 20% of drawdown savers will be taking at or near maximum income.

I am sure you are aware that one of the main attractions of income drawdown is the flexibility it offers to pension savers in terms of the income level which they can draw each year. Individuals who choose drawdown will value this flexibility and accept that it is accompanied by a risk that their maximum income will vary as a result of a number of factors, the main one typically being the value of their pension fund. The Government introduced drawdown to provide individuals with this flexibility, but introduced annual income limits and regular income reviews to prevent inappropriate fund depletion. I would respectfully suggest that the recent changes to income limits have tipped the balance too far in favour of downside protection.

Whilst drawdown investors accept that the downside protection is needed to prevent their income limits from dropping, I do not believe many will accept the slightly perverse situation that the main reason for a drop in income is the Government's decision to change the rules to provide added protection. The fact that the policy decision changing this downside protection was announced as recently as 9 December 2010 doesn't help and the effect of this late policy decision was exacerbated by an even more recent announcement of new, lower, GAD tables.

The timing of these decisions has turned out to be poor as it has coincided with a number of other factors that will drive down maximum income levels and therefore the total amount being drawn from pension schemes.

Record low gilt yields – As I write, the 15 year gilt yield sits at 2.84%. For drawdown investors facing a benefit calculation in October 2011 this will mean their maximum drawdown calculation is based on a gilt yield of 2.75%. Drawdown calculations have never previously been based on a rate as low as this. The lowest rate we have seen previously has been 3.25%, the current rate. Anyone having their benefits reviewed in October 2011 is likely to have last had their benefits calculated in October 2006. During that month, the effective gilt yield was 4.25%.

Volatile financial markets – This is an accepted risk for drawdown investors but it is an additional issue that can't be ignored when considering the impact of all factors. In early October 2006 the FTSE All-Share sat around 3,100, it is currently hovering around the 2,700 mark.

Concentration of drawdown reviews – The combination of the timing of the A-Day changes; the rules which required maximum drawdown benefits to be reviewed in a concentrated period after A-Day; the five year period before those pensions were due for review; and the timing of the current changes; means that a significant proportion of those individuals who were already in drawdown prior to A-Day will be approaching their income review. Looking at the extent of the issue, and again taking October 2011 as our example, the number of five-yearly reviews falling in that month for our clients is around 200% of the number we are expecting in both October 2012 and October 2013.

It is probably useful to provide an example of the combined impact of all of these factors.

Male, age 65, entering drawdown on 1 October 2006 with a drawdown fund of £250,000

Their maximum annual unsecured pension for the period from 1 October 2006 to 30 September 2011 will have been **£21,000**.

Five years on the same individual will be 70 with a drawdown review on 1 October 2011 with a drawdown fund of £250,000

Their maximum annual drawdown pension for the period from 1 October 2011 to 30 September 2014 will be **£16,750**.

It is important to point out it is assumed that this individual has maintained their fund value, and is five years older but still sees their maximum income drop by over **20%** (or £4,250).

If we allow for the potential impact of what I hope will be a temporary fall in stock markets and consider pensions drawn against investment income we might assume that the individual has a current fund value of **£215,000**. In this situation their maximum annual income will fall to **£14,405**, a drop of **31.5%** in income from the previous year.

Taking all of the above into consideration, I believe that there are strong grounds to reverse the decision taken and return the maximum income withdrawal calculation to 120% rather than the new basis of 100%.

I would support this immediate decision, and believe it should at least temporarily be re-instated regardless of any wider review of drawdown calculations. However, the current issues we are seeing with drawdown call into question whether it is still appropriate to base maximum drawdown calculations entirely on gilt yields.

There is a question whether it is appropriate for income limits to be based entirely on returns from an investment type that will only form part of a typical drawdown investment portfolio. There was perhaps some relevance to using the gilt yields as the basis for the calculation when drawdown investors were effectively forced to purchase an annuity at age 75. Recent changes to those rules, which I fully supported, mean that individuals are no longer forced to annuitise. This adds to the argument for removing the link to an investment type which is associated with annuitisation on income limits for individuals who may never annuitise. There is perhaps a bigger question as to whether it is appropriate for maximum income to be based on projected investment returns at all. Particularly when such a wide range of investments are now held within pension portfolios because of the growth in areas such as SIPPs and funds platforms.

This leads me to the three options which I believe the Government must consider, at policy level, as the basis for drawdown calculations:

Option 1 – Completely remove the link between current investment yields and maximum drawdown income. I have had doubts for some time concerning what, in all cases, will only be an artificial link. For all drawdown investors there are currently two ongoing concerns regarding their maximum income. Firstly that it is calculated based on an investment return that bears little or no relation to the investment mix held in their specific pension. Secondly that the limit will fluctuate based on movements in the underlying gilt yields over time.

There is little that we can do about the fact that maximum income will always be based on a percentage that is in reality only appropriate for a limited number of investors. However, the problems with fluctuations in this income can be removed by simply basing maximum income on a single percentage factor for each individual based on their age and sex. For example, you could apply a single percentage figure of 8% for males under the age of 75 and 10% for those aged 75 and above. I support this option because it creates certainty and simplicity for drawdown investors in an area where these are currently lacking.

Option 2 – Replace the gilt-based maximum drawdown calculation with one based on blended gilt and equity returns. As I have already stated, an entirely gilt-based maximum drawdown calculation does not remain appropriate in the current pension environment. Whilst I would prefer for the link between current investment yields to be removed entirely, if it must be retained, using a link which more accurately reflects the portfolios of drawdown investors would seem more appropriate.

Option 3 – Retain the gilt-based maximum drawdown calculation, but re-instate the 20% uplift in income calculations. You will have gathered that I do not support the retention of a gilt-based calculation. However, if it is to be retained, I would urge the Government to re-instate the 20% uplift. This will help to prevent the immediate hardship being felt by some pensioners because of the lack of time they have had to prepare for the change, and the combination of the various other factors which are serving to make the problem worse. Replacing quinquennial reviews with triennial reviews offers an important improvement in the downside protection. I believe that combining this change with the simultaneous removal of the 20% uplift and the change to new GAD tables has tipped the flexibility/downside protection balance in a way that creates significant consumer detriment.

I look forward to hearing from you.

This letter is written as an open letter and has been sent to industry publications.

Yours sincerely

Andy Bell

Andy Bell BSc FIA
Chief Executive