The Actuarial Profession
making financial sense of the future

Finance Act 2004: What has changed for the ordinary member

Sheila Brown
Consultant & Actuary, Aon Consulting

Agenda

- What is an "ordinary member"?
- Overview of Finance Act changes
- Focus on tax-free cash
- What are other schemes doing?
- Member communications

What is an "ordinary member"?

- A member that meets the following criteria:
  - Earnings < Earnings Cap
  - Benefit value < Standard Lifetime Allowance
  - Contributions/accrual < Annual Allowance
- So the following are not relevant:
  - Tax charges on exceeding lifetime/annual allowance
  - Primary/enhanced transitional protection
  - Removal (or not) of earnings cap
  - Unapproved arrangements

Overview of changes

- Tax-free cash
- AVCs / member contributions
- Change in minimum retirement age
- Flexible retirement
- Death benefits
- Refunds of contributions
- Trivial commutation

Tax-free cash – DB

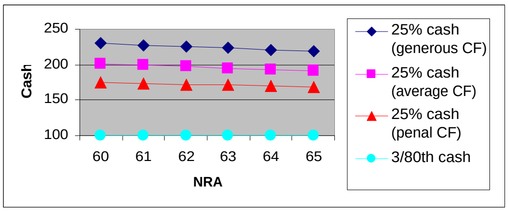
- Lump sum
  = 25% x (lump sum + 20 x residual pension)

- Rearranges to :

$$\frac{20 \times \text{pre-commutation pension}}{3 + 20 / (\text{cash factor})}$$

Tax-free cash - DB

Normal Retirement (1/60th pension)



Tax-free cash - DB

Observations from Normal Retirement graph:

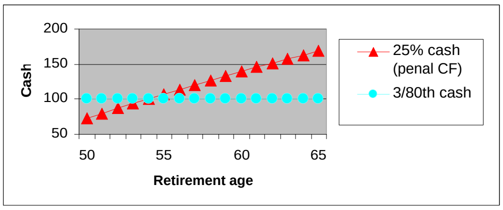
- Even with penal cash factors, there is a significant increase in the amount of tax-free cash available
- Proportion of pension commuted (NRA 65) ranges from 26% (generous CFs) to 43% (penal CFs)
- Can we really justify maintaining current factors?

Tax-free cash - DB

- When could a member receive less cash under new regime:
  - On early retirement
  - If service or salary figure was higher for cash than pension under old regime
  - If accelerated cash accrual under old regime
- Pre A-Day cash "protected" if >25% of value of benefits at A-Day.

Tax-free cash - DB

Early Retirement (4% p.a. simple ERFs from 65)



Tax-free cash – some light relief

What will people spend it on:

- 35% travel
- 33% pay off mortgage
- 21% help children get on property ladder
- 18% make provision for children's inheritances

Source: Lloyds TSB, March 2006

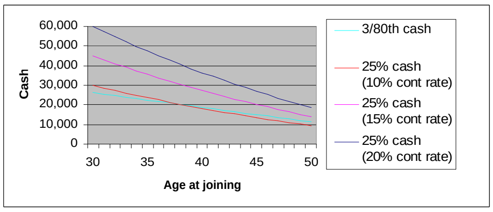
Tax-free cash - DC

- Lifetime annuity:
  - Lump sum = 25% x fund value
- Scheme pension:
  - As above (assuming that Finance Bill 2006 is enacted in its current form)

Tax-free cash - DC

Cash at age 65

(7% investment growth, 4% salary growth, remain in service until age 65, £20,000 salary at age 65)



Tax-free cash – hybrids
(including DB schemes with DC AVCs)

- Full flexibility over which section(s) the tax-free cash is taken from
- Maximum cash = 25% x 'value of benefits' ….
- …. where 'value of benefits' = cash taken + remaining DC funds + 20 x residual DB pension
- Answer depends on where cash taken from

Tax-free cash – hybrids
Example – if DB cash taken from DB section

DB section:
- Pre-commutation pension = £10,000 pa Cash factor = 15
- Cash = (20 x 10,000)/(3 + 20/15) = £46,154
- Residual pension = 10,000 – 46,154/15 = £6,923 pa

DC section:
- DC fund = £100,000 Annuity factor = 20
- Cash = 25% x 100,000 = £25,000
- Residual pension = (100,000 – 25,000)/20 = £3,750 pa

Combined: cash £71,154 plus residual pension £10,673 pa

Tax-free cash – hybrids
Example – if DB cash taken from DC section

DB section:
- Pension = £10,000 pa, Cash = £0

DC section:
- Cash = 25% x [cash + (100,000-cash) + 20 x 10,000]
  ⇒ Cash = £75,000
- DC fund available for pension = 100,000 – 75,000 = £25,000
- Residual pension = 25,000/20 = £1,250 pa

Combined: cash £75,000 plus residual pension £11,250 pa
(both higher than previous slide)

Tax-free cash – hybrids

- Who chooses – Trustees or member?
- Usually in members' interests to maximise cash from DC funds
- Resistance from Employer/Trustees?

Tax-free cash – protection
(for members without primary/enhanced protection)

- If, at 5/4/06, lump sum rights / total rights > 25% then pre A-Day cash is protected
- No need to register with HMRC
- Is cash a "right" if Trustee consent required?
- Protected cash assumed to grow in line with SLA.
- Protection lost on transferring (unless 'block transfer')

Tax-free cash - miscellaneous

- Taking into account benefits already in payment
- 3-month rule
- Bridging pension
- Recycling
- Protected rights

AVCs / member contributions

- 15% → 100% of earnings (up to £215,000 pa, and after allowing for value of DB accrual)
- No limit in year prior to retirement
- Full concurrency
  - Still a need for AVCs?
- Means-tested State benefits
  - Do AVCs offer value to those on low incomes?
- Salary/bonus sacrifice

Change in minimum retirement age

- 50 → 55 w.e.f. April 2010 (or phased in earlier)
- Earlier promise retained for members with such a right under scheme documentation
- Ill health retirement still allowed at any age
  - Trustees require written opinion from Registered Medical Practitioner
- Protected Rights – can now take before age 60

Flexible retirement

- Ability to draw pension and continue to work for that employer
- Helps facilitate phased retirements
- Could lead to fragmented benefits
- Funding & business implications

Death benefits – before retirement

- Tax-free lump sum of up to lifetime allowance
- Spouse's pension taxed as income
- So why not replace spouse's pension by additional lump sum
  - Think about it later
  - How to set level of lump sum – winners & losers
  - Paternalistic employer
  - Contracting-out restrictions

Death benefits – after retirement

- 9 different types of lump sum death benefit
- DB vs DC differences
- Retain the 5-year guarantee?
- How to avoid the tax
- Spouse's pension - simpler

Refunds of contributions

- Taxed at 20% on first £10,800 and 40% on excess
- Interest/investment return:
  - Can be paid as a 'scheme admin member payment'
  - Taxed as interest
- (Transfer value alternative after 3 months)
- COMPS: refunds no longer allowed

Trivial commutation

- Increased to value of 1% of lifetime allowance (£15,000 for 2006/07). However:
  - test covers all registered pensions; and
  - all benefits must be commuted within 12 months between ages 60 & 75
- At option of member
- 25% of trivial commutation payment is tax-free
- PAYE reference required to deduct the tax – a problem for DC schemes?

What are other schemes doing?

From data collected on Aon schemes:

- 80% will allow members to take higher tax-free cash
- 10% are closing their AVC schemes to new members (and 5% are stopping altogether)
- 40% will offer some form of flexible retirement

What are other schemes doing?

From a survey by Mercer of over 1,000 schemes:

- 75% are making changes to allow members to take higher tax-free cash
- 20% are closing their AVC schemes to new members (and 5% are stopping altogether)
- 10% plan to offer full facilities to phase pension withdrawal

Source: Mercer, April 2006

Member communications

- Sources of information on Finance Act
- Initial post A-Day communication
- Annual benefit statements
- Benefit quotations
- Retained benefit info

Any questions?