"Robespierre" Osborne and the Pension Revolution: its implications for Isle of Man Pensions

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I'm reading Hilary Mantel's "A Place of Greater Safety", set in French Revolutionary Paris. It is classic Mantel, documenting a period that spans radical religious, social and political upheaval, populated by engaging historical figures.

I've also been reading HM Treasury's March 2014 Consultation, "Freedom and choice in pensions" and would like to say it is similarly gripping, but not even a lawyer could say that with a straight face.

However, the reforms in the latter documents are genuinely significant (dare I say historic) and, if adopted in the Isle of Man (IOM), have the potential to radically change the way you think about your pension savings in the longer term.

In particular, there is a notable zealous tone to both the initial Consultation document and the subsequent response published in July 2014. In effect, the proposed pension reforms champion the freedom of the individual to be master of their destiny.

They seek to unshackle the individual from the tyranny of the annuity that has long reigned over us. They urge us to tear down the oppressive edifices of a long-standing and unreformed tax regime that corrals us into securing an income for life and inhibits our freedom to spend our hard earned cash as we like.

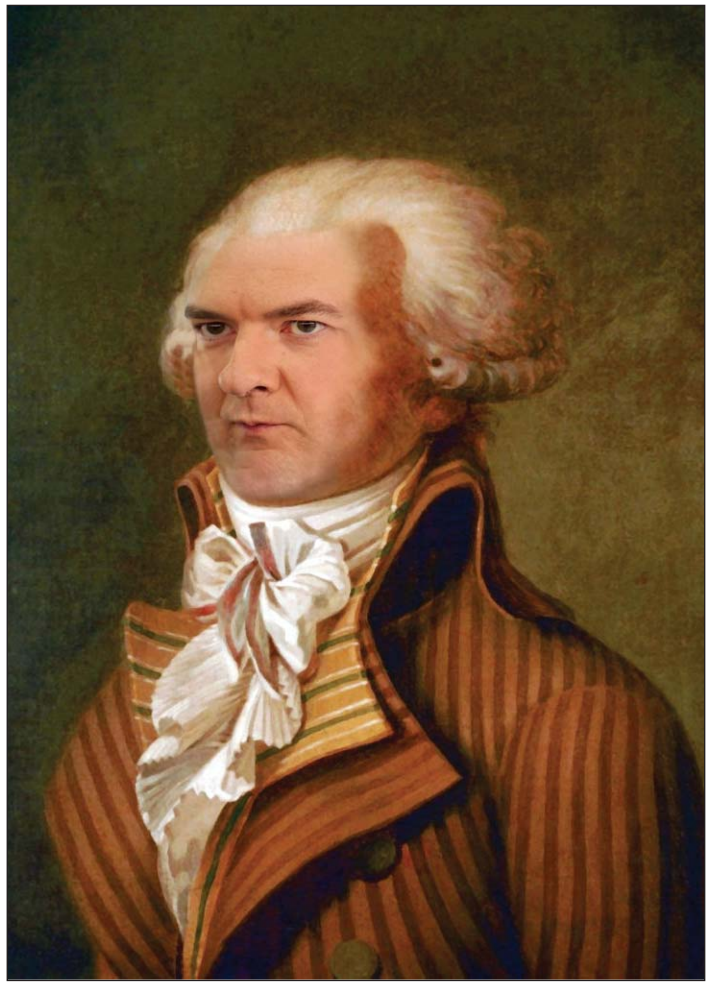
Obviously, the Consultation isn't quite in these terms (I'm channeling my inner Mantel) but the revolutionary sentiments are there. To quote Osborne: "This Government believes in the principle of freedom... Individuals who have worked hard and saved responsibly throughout their adult life should be trusted to make their own decisions with their pension savings and the reforms I announced at Budget will deliver just that... the annuities market is currently not working in the best interests of all consumers... I want as many people as possible to be able to access their pension flexibly... these major reforms amount to the biggest changes to savings for a generation... this is the most fundamental change to how people can access their pension in nearly a century."

This stuff is worthy of Robespierre in full flow at the Jacobin Club. Just as the French Revolution disrupted long established and self-interested conventions (the abolition of feudalism and a shift in power from Church to State), Osborne sees himself as standing up for the common man against the institutional power of insurance providers whose vested interests are ingrained in a tax system that favours a wholly annuitised retirement. And, like Robespierre, he knows the mob are with him (annuity rates repeatedly get a bad press) and he's not afraid to spill blood in the process (one client's shares fell by over 50 per cent following the Budget announcement).

So what is the big change and what are the implications for the IOM? In short, it is about the way income is delivered from a defined contribution pension plan (a DC plan). DC Plans were always obliged to purchase an annuity that provides an 'income for life'. This requirement has long been hardwired into tax legislation and dates back to the UK Finance Act 1921. However, in response to falling annuity rates, 'pension drawdown' was introduced in the UK in 1995 as an alternative way of drawing pension income, but the rate of drawdown was limited and could not be sustained beyond age 75 (and latterly age 77), at which point an annuity had to be purchased.

By 6 April 2011, drawdown had developed so that a DC plan need not purchase an annuity at age 77. It could, instead, offer two options: a "capped drawdown" arrangement which limits the annual income, or a "flexible drawdown" arrangement which allows a higher rate of drawdown but requires a minimum level of annual income.

Taking these in turn, capped drawdown allows a DC plan to provide annual pension drawdown capped at a percentage of the annuity rates published by the Government Actuary's Department (the GAD rate). Up to March 2013, the rate was 100% and between March 2013 and March 2014, the rate was 120 per cent of the GAD rate. With regard to flexible drawdown, the pre-2014 Budget required an individual to have a guaranteed income of £20,000 per annum.



Therefore, notwithstanding the development of drawdown post age 77, the UK government still retained significant safeguards to avoid individuals being a burden on the State. But this changed with the 2014 Budget. First, transitional measures were introduced to allow drawdown to rise from 120 per cent to 150 per cent of the GAD rate from 27 March 2014.

Additionally, the minimum income requirement dropped from £20,000 to £12,000 per annum. Then, from April 2015, individuals with DC plan savings will be able to draw on their funds "whenever and however they wish after the age of 55" (paragraph 3.13, of the Consultation). This new regime will have the snappy title of "flexi-access drawdown".

Obviously, the fact that a UK DC plan is no longer obliged to provide a 'pension for life' is a genuinely significant change. The guiding principles of the last 100 years are being cast aside in favour of the rights of the individual. It all feels very "Declaration of the Rights of Man and the Citizen" (but, as I say, they're calling it "flexi-access drawdown").

So, will you in the IOM benefit from our neighbour's Revolution? Well that is all very unclear. For a start, IOM Treasury are a cautious bunch and this is a radical step. The freedom to drawdown as much of your pension as you like could well invite the profligacy that an annuity is uniquely disposed to avoid.

Furthermore, this is a potentially bigger issue for the IOM than the UK whose higher marginal tax rates will act as a disincentive for those wishing to drawdown all of their pension savings over a short period of time.

Therefore, UK Pensioner Minister Steven Webb's rather flippant comment about pensioners purchasing Lamborghinis may be more pertinent to the IOM than to the UK. Interestingly, Webb's justification for that comment was that revisions to the State Pension were such that he felt "relaxed about how people use their own money".

If the IOM Government is going to follow the UK's lead on pension reform, a number of considerations arise. The absence of inheritance taxes and higher marginal tax rates mean the IOM Government will either have to (a) be even more 'relaxed' about the prospect of IOM residents ending up on the State pension, or (b) satisfied that the number of IOM residents who do end up on welfare due to mismanagement of their pensions will not effect a material strain on future Treasury resources.

In this regard, the IOM Government is now engaged in a review of its State pension provision. This encompasses the "Big Debate" (launched 15 September) and the commissioning of more granular analysis by consultancy firm Ci65 as to the sustainability of the IOM's welfare and social security systems. Additionally, other aspects of the IOM tax regime will need to be weaved into Treasury's final position on the UK pension reforms, not least (i) the cap on income tax charges (£120,000 p.a.), (ii) the generous annual allowance of up to £300,000 p.a. of tax free pension contributions, and (iii) the lack of a cap on pension benefits (as per the UK's lifetime allowance).

Finally, there are wider IOM plc considerations as a more restrictive drawdown regime may make us a less attractive jurisdiction for skilled employees and businesses who may be weighing up the IOM vis-a-vis another more permissive pensions regime.

Therefore, it will be interesting to see which path the IOM Government takes with regard to Osborne's pension reforms. My guess is that, in the short term, the Island will simply adopt some of the UK's transitional measures (including GAD rate withdrawals of up to 150 per cent). However, the liberalisation of the UK's pension regime (which is gathering pace following the 29 September announcement that UK inheritance tax on pensions is being axed) will pose some difficult questions for the IOM as to what shape its future pension regime should take.

What is certain, is that there will need to be more soul searching before we follow Osborne over the barricades into the brave new world of... "le flexi-access". In this regard, the timing of the IOM's review of its State pension provision could not be better.

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