Summary

- Since freedom and choice, pensions have become an ideal means of funding long-term care. People have complete flexibility over how much money they can take and when, which means they can hold back an amount if they need to use it for long-term care. Flexi-access drawdown is one method to achieve this.
- The adequacy of pensions to do this remains subject to debate. The average pension pot is already seen as falling far below the levels needed to meet average income demands and the additional drain of paying for long-term care on top of day-to-day living costs is problematic.
- Reductions in the LTA have further compounded this problem, with social care costs potentially pushing savers over the LTA limit.
- Awareness of funding for long-term care needs to be raised. The *Just Retirement Care Index 2016* found more than three-quarters of people aged over 45 have "neither thought about care nor spoken to their families about potentially needing care".

Joining together: Pensions and care

Gill Wadsworth explores how the pensions industry can help individuals fund long-term care needs in old age

More than 10 million people in the UK will be aged 75 or over by 2040; a 100 per cent increase on the number of septuagenarians in the country today.

The social care system – already under significant pressure – will face increasing strain as older citizens seek ongoing support as their health deteriorates.

Local authorities are able to foot some of the bill but as persistent austerity measures reduce the amount of state funding available, the individual is ever-more responsible for paying for their social care.

In April this year the government delayed the imposition of a £72,000 cost cap, claiming funding pressures on local authorities made it impossible to implement such legislation, which means individuals will need to find financial support elsewhere.

Pensions link

Given their long-term funding objectives and focus on later life, the pensions industry is considering ways in which traditional retirement products can support social care needs.

Following the introduction of freedom and choice last April, which allows retirees aged 55 or over to draw their savings as they see fit, pensions look more attractive than ever as a route to funding social care.

Aegon retirement director Steven Cameron says: "Since freedom and choice, pensions have become an ideal means of funding long term care. People can have complete flexibility over how much *[money]* they take and when, which means they can hold some back notionally in case they need to use it for long-term care."

Cameron points to flexi-access drawdown as a 'huge step forward' in matching pensions with funding long-term social care.

Flexi-access drawdown allows savers to withdraw as much as little from their pension savings as they like, keeping the pot invested. The first 25 per cent is tax free while further withdrawals are subject to income tax.

Cameron says savers can ringfence a specific amount from their total pot for social care, while budgeting the rest to fund the earlier part of retirement.

He gives the example of an individual with a £700,000 defined contribution pension fund, ringfencing £100,000 for future social care, while keeping it within the drawdown product. The saver could then determine a sustainable income based on the remaining £600,000, which could support the rest of their retirement.

Cameron says: "I can see a growing demand for tools that consumers use – with the help of an adviser – to carry out modelling that help them come to more informed decisions about using a pension to provide a sustainable while holding some money back for long-term care."

Flexibility and freedom in pensions might have made them more accessible to those wanting to fund long-term care, but they are not without their drawbacks.

First is adequacy. The average pension pot is already seen as falling far below the levels needed to meet average income demands. Add the additional drain of paying for long-term care on top of day to day living costs in early retirement, and the pension looks untenable.

Adviser firm Tilney director of financial planning David Smith says: The main problem *[with using pensions to fund long-term social care]* is that, typically, pensions in isolation will not provide an adequate income to fund care costs."

Smith's comments are supported by research from Cass Business School, which issued a report in March 2016 on funding social care in later life.

Authors of the paper Les Mayhew, David Smith and Duncan Leary, of the Institute and Faculty of Actuaries and Cass Business School, state: "A typical pension income will not be sufficient to pay care home fees without state support so that most people will struggle to find just a fraction of the costs, even if they draw down all their savings."

LTA

Reductions to the lifetime allowance (LTA) from £1.25 million to £1 million in the 2016/17 tax year have further compounded this problem. The LTA restricts tax-free contributions to £1.25 million, after which savers are taxed at their normal rate while incurring tax at 55 per cent on withdrawals.

Cameron says any attempt to use pensions as a home for the cost of social care, as well as standard retirement expenses, may push individuals over the LTA, rendering them inefficient.

Cameron says: "If individuals want to fund for both standard retirement but also want to protect against long-term care costs they might find they run into problems with the LTA. I do think pensions are the right vehicle and give you right flexibility but the LTA restricts your ability to protect against this in full."

Cameron says a reversal in the reduction in the LTA should be a number one priority for the government if it wants people to use pensions to fund long-term care.

And it's not just the LTA that can make pensions an inefficient means of funding long-term social care.

Taxation

Since pensions are not subject to inheritance tax, Smith says in cases where savers have additional savings they can draw on, these should be prioritised to avoid an unnecessary charge when the retiree dies.

"Clients often have a bit of everything – bank accounts, ISAs and a pension – and they've got to decide which investment will fund long-term care. Every investment except the pension forms part of an estate for inheritance tax, so I would suggest using the other savings before a pension to fund social care," Smith says.

Paying into a pension is one of the most tax efficient means of saving for the long term, but withdrawals are still subject to income tax. This is in contrast to a care plan that incurs no tax since payments are made directly to care homes.

Just Retirement group communications director Stephen Lowe says: "One potential downside to using pensions to pay for care is current tax treatment. Payments made from a qualifying care plan to a Care Quality Commission registered care provider are not subject to income tax, while pension payments are made to the individual so they are taxed, which can make a substantial difference."

However, Cameron argues that dedicated care plans are often deemed unattractive by savers since they lack flexibility. Instead, he proposes allowing pensions to be paid directly to the care home, therefore bypassing income tax.

He says: "There isn't a huge demand from individuals to save completely separately for long-term care. It is far more palatable to build that into broader pension planning. I could envisage a government saying in future that if you pay for long-term care out of your pension you won't get taxed on proceeds if is paid directly to a care home."

Raising awareness

Irrespective of whether pensions or other savings vehicles are the best route to providing funding for long-term care, commentators claim there is widespread ignorance on the need to make the provision at all.

The *Just Retirement Care Index 2016,* which interviewed 1,200 people aged over 45, found more than three-quarters (77 per cent) have "neither thought about care nor spoken to their families about potentially needing care".

Lowe says: "When questioned further, most people seem to have some awareness that they may have to pay something towards social care but they don't know how much or for how long. There is also a proportion of people who believe the state – often the NHS – either does or should fund this cost."

Lowe suggests there is a need to invest in "awareness-building activities to ensure that people move from a state of unawareness to awareness".

He adds: "Only then can we start to build peoples' comprehension and then conviction to act to make provisions for the costs of later life."

Pensions provide a possible route to saving for social care but it is unlikely individuals will choose to ringfence specific portions of their savings. The new flexibility for DC savers means provisions can be made for any lifetime event and singling out social care is unnecessary.

The concerns are whether people understand the need to hold back a proportion of their savings to cover long-term social care costs and just how high that cost might be.

Written by Gill Wadsworth, a freelance journalist