



A Guide to Retirement Options

Conventional Annuity

Buying an Annuity

The most common way to take the benefits from a Personal Pension is to use your Pension fund to buy an Annuity. This means exchanging your Pension fund with an insurance Company for a guarantee that it will pay you an income for the rest of your life. Before you buy an Annuity you can take a tax free cash lump sum from your Pension fund (up to up to 25% of the total fund).

The level of Pension income that your Annuity will pay you depends on several factors:-

A. Current interest rates

Annuity rates are broadly linked to interest rates so when interest rates are high more pension can be bought because of the potential higher investment return, however, when interest rates fall this reduces the amount of Pension that can be bought. As we have been in what is perceived as a low interest rate environment for several years Annuity rates have been correspondingly low and are considered to be poor value.

However there is nothing to say that they could not fall further. There is an element of gambling with Annuity purchase, if you wait and Annuity rates rise in the interim you win with a higher income for life, but if rates fall you are left with a lower income for life other than you might have had.

B. Your age and life expectancy

The older you are when you buy an Annuity the fewer years the Insurance Company will expect to have to pay a Pension to you, for example your Pension will be higher at age 65 than it would have been at age 60 for the same size fund. The other key factor is increasing longevity; we are all living longer which is good news unless you are in the Annuity business! Insurance Companies are forever playing catch up as a population our average life expectancy continues to rise. This means Annuity rates will fall correspondingly as they have to be paid for longer. This is something that is bound to continue and it can only have a downward impact on Annuity rates, regardless of any other influencing factors.

C. Gender

Women, on average, live longer than men so an insurance company would expect to pay an annuity for more years to a woman than a man of the same age. The initial Pension for a woman at retirement will therefore be less than that of a man of the same age with the same fund.

D. Health

Increasingly Annuities are 'underwritten' to take account of any health factors that may influence your lifespan and if you are in ill health this can result in a higher Annuity rate and therefore a greater income in retirement. This can incorporate anything that could potentially reduce your life expectancy from medical conditions, family history, what you do for a living, whether you smoke, even the postcode you live in!



E. The Type of Pension

You have the choice of adding various options to your Pension Annuity. The Pension can be payable only to you for your lifetime, or it can continue to be paid to your spouse when you die. It can stay at the same level each year or you can elect for it to increase at regular intervals. It may seem a good idea to protect your income as the table below demonstrates how inflation can reduce your spending power over time. However this does of course come at a price and you have to make a decision whether the additional coast is worth the benefit and look at you Annuity in relation to your other assets and the state Pension for example which is of course protected against inflation.

The effect of inflation on £1,000

Annual Inflation rate	5 Years	10 Years	15 Years	25 years
2.25%	£894	£800	£716	£573
4%	£821	£675	£555	£375
6%	£747	£558	£417	£233
8%	£680	£463	£315	£146

Source: Prudential

You can add a guarantee period which means that should you die it would continue to be paid at the same level to your dependants for the guaranteed period. This is normally 5 or 10 years. Depending on the options selected at outset your husband or wife may continue to receive a Pension or even the remainder of the guaranteed instalments. If they die before you, your Pension cannot usually be paid out to anyone else.

Additionally you may now purchase a “value

protected” Annuity offering a lump sum death benefit of the Annuity purchase price less the Pension income paid out to date (minus 35% tax) for death prior to age 75. Also a lower percentage of the purchase price could be protected if preferred.

All of these different options affect the cost of your Annuity and can make a difference to the initial Pension you would receive. If you elect to provide for your Spouse, want your Pension to increase each year or want a guarantee period, all these options will reduce the amount of the initial Pension you will receive and it could take several years for the Pension to increase to the same level it would have been had you elected not to take any of the additional benefits as described above.

Advantages of Conventional Annuity

- 1 Guaranteed Income
- 2 Simplicity
- 3 No investment risk
- 4 Security
- 5 Immediate access to all your tax free cash sum
- 6 Depending how long you live, you may get back more than you used to buy the Annuity

Disadvantages of Conventional Annuity

- 1 You make a decision about your retirement now which you and your family are committed for the rest of your life
- 2 You may find that you would have been better off waiting - Annuity rates may rise.



3 Lack of flexibility

- 4 Your circumstances may change after you have taken the benefits e.g. you may choose to provide benefits for your spouse and they predecease you
- 5 Inflation in the future may erode the value of your benefits
- 6 If you die soon after the plan has started the payments you have received may be smaller than the amount invested in the Annuity

At this stage it should be mentioned that it is possible to either buy a conventional Annuity with the Insurance Company which holds your Pension fund, or if another life company is offering higher Annuity rates, you may transfer the value of your Pension fund to them using what it known as the "Open Market Option." It is rare for the Company holding your Pension to offer the best Annuity rate so we would always recommend investigating your "Open Market Option" as this will affect your income for the rest of your life. If you need help with this get in touch.

With Profit/Unit Linked Annuity

These are very similar in make up to conventional Annuities in that you can choose for the Annuity to continue after your death to your Spouse and choose a guaranteed period.

Unlike conventional Annuities, though, the level of income is not guaranteed, but is linked to the

performance of an investment. As long as a set rate of growth is achieved your income may be higher than under a conventional Annuity and may even increase in the future. However, the income could go down if the required growth rate is not achieved. The with profits approach is less volatile than the unit linked option but does not have as great a potential for higher income in the future as the underlying fund will normally have a less aggressive investment strategy.

Advantages of Unit Linked/With Profits Annuity

- 1 You have immediate access to all your tax free cash sum
- 2 Depending on how long you live you may get more back than you used to buy the Annuity in the first place.
- 3 The income you receive may rise in the future if performance is in excess of the set growth rate for the plan.

Disadvantages of Unit Linked/With Profit Annuity

- 1 If the set growth rate for the plan is not achieved the income level may fall
- 2 You make a decision about your retirement now which you and your family are committed to for the rest of your life.
- 3 You may find that you would have been better off waiting - Annuity rates may rise.
- 4 Your circumstances may change after you have taken the benefits
- 5 If you die soon after the plan has started the payments you have received may not represent the amount in the fund.



Impaired Life Annuity/ Lifestyle Annuity

The principles are the same as a conventional Annuity. The difference being that Insurance Companies may offer higher Annuity rates to policyholders with medical problems (impaired life annuities) such as diabetes or heart disease. Also you may benefit from a higher Annuity rate if you were employed in a hazardous occupation, are a smoker or live in what are deemed high risk postcodes (lifestyle annuities) as it is believed any of these factors could potentially reduce life expectancy.

Variable Annuities

A recent innovation in the Pension planning arena has been the arrival of Variable Annuities. It is important to note this new US-style variable Annuity bears little resemblance to the traditional Annuity recognised in the UK. It is best described as a conventional unit-linked investment product, underpinned by different types of guarantee. For example:

- Your fund is guaranteed not to fall in value regardless of underlying investment conditions.
- Minimum accumulation benefit, where funds are guaranteed to accumulate to a certain amount by a particular point in the future.
- Minimum withdrawal benefit. Where from a fixed point in the future, it is guaranteed that regular withdrawals can be made at a specific level, even if the fund itself subsequently runs out of money.

- Minimum death benefit, where a named beneficiary is provided with a specified sum in the event of the insured person dying.

By combining and tweaking these four building blocks, an offer can be designed that meets your individual needs - and they can give you the flexibility to modify your choices in the future as your circumstances change.

The first of this type of Annuity in the UK (and perhaps one of the simplest!) was the Annuity Growth Account from Canada Life which I have briefly described below. An Annuity Growth Account is a combination of a 5 year immediate Annuity contract and a unit linked investment element. The Annuity payable is the same as if you had purchased a conventional Annuity from Canada Life but, because it only has to be paid for 5 years, the cost is much less, meaning that the remaining portion of your Pension fund can be invested in any combination of Canada Life funds for 5 years until the next review date, at which time you will have the option to purchase a Lifetime Annuity or repeat the process for another 5 years, and each subsequent 5 year period thereafter until your 85th birthday, at which time you must take a Canada Life Lifetime Annuity.

Within an Annuity Growth Account you will always have investment risk, the amount of which will be determined by the choice of funds invested. Whilst you may be drawn to more cautious funds, it is important that you invest in funds with the potential to outperform the hurdle rate (the required growth rate) so that you have a realistic chance of having a larger income in the longer term than if you had purchased a conventional Annuity at outset.



Advantages of Variable Annuities

- 1 The guarantee of a fixed level of income/death benefit/lump sum
- 2 Potential for increasing income by sharing in investment growth
- 3 Flexibility to change your requirements in the future
- 4 Avoids 'once in a lifetime' commitment of conventional Annuity purchase

Disadvantages of Variable Annuities

- 1 All Guarantees come at a cost and have to be paid for explicitly
- 2 There may also be the 'opportunity cost' of not enjoying the full value of any investment growth
- 3 Charges and early surrender values can be prohibitive
- 4 Variable annuities are relatively new and some designs are a complex proposition.
- 5 Any required hurdle rates may not be achieved and your income may reduce in the future

Phased Retirement

With a Phased Retirement Account you can take your retirement income gradually instead of all at once. Your retirement income can be increased as your circumstances change. Your Pension fund is split into a number of equally sized segments, normally 1000 of them. At the start you may

decide to take 100 out of the 1000 segments. You can choose to immediately receive a tax free cash lump sum of up to 25% of the value of these 100 segments and the remainder will be used to buy an Annuity. Your remaining Pension fund (900 segments) will continue to be invested and grow in its tax free environment.

As your circumstances change you may decide to take some more of your Pension fund and receive another tax free cash sum and increase your income by purchasing another Annuity. You can continue doing this until your entire Pension fund has been used. The tax free cash sums can be valuable in your tax planning and it is possible to continue to contribute to your personal Pension if you are still working.

What happens if you die?

As far as the Phased Pension, (those segments you have already accessed) the Annuity can continue to be paid to your spouse and they may also receive some guaranteed instalments depending on how you have taken the annuities. The Pension fund which has not been used will be payable to your estate as a lump sum.

Advantages of Phased Retirement

- 1 Flexibility - If you do not need all of your Pension fund straightaway.
- 2 It can adapt to match changes in your personal circumstances.
- 3 Any Pension fund you do not use immediately will remain invested with the potential to grow in a tax free environment.
- 4 A Tax Free Cash lump Sum can be taken each time you transfer some segments into the phased part of the plan.



- 5 The remaining Pension fund (that has not been phased) is returned into your estate in tact on death.

Disadvantages of Phased Retirement

- 1 Money in your Pension fund is still invested and therefore can fall as well as rise.
- 2 If the value falls you may receive a lower income in future years.
- 3 You cannot take all of your tax free cash at outset.
- 4 There are no guarantees that ultimately your income will be as high as the income offered by a conventional Annuity at outset.
- 5 You must still purchase an Annuity to provide income whenever you draw part of your tax free cash sum and Annuity rates at that time may not be favourable

Unsecured Pension (Income Drawdown)

Income drawdown (or unsecured Pension as it is now known) works differently to other retirement options. Up to 25% of your Pension fund can be taken as a tax free cash lump sum at outset. Instead of purchasing an Annuity with the remainder of your Pension fund your money remains invested.

You must take an income directly from your Pension fund each year. This is taxed as earned income. The income taken must fall between set limits which are between 0% - 120% of

the amount you would have received had you purchased a Conventional Annuity. These limits and therefore the amount you may take as income are reviewed every five years and amended in line with Annuity rates at that time. Your income can vary within these set limits, so you need not take an income unless it is advantageous to do so. If you elect not to take your income in a particular year it cannot be 'rolled over' to the following year, e.g. you take nothing this tax year you cannot take twice the amount next year.

What happens if you die?

If you die your spouse has three options:-

- 1 Taking a cash lump sum, the value of the Pension fund (subject to a tax charge of 35%)
- 2 Buy an Annuity with the remaining fund.
- 3 Continue to take income drawdown. If this is to continue the income limits are recalculated to fit your husband/wife's own circumstances.

Advantages of Unsecured Pension

- 1 Allows you to receive all of your tax free cash lump sum at outset
- 2 Income can be increased and decreased within the set income limits which may assist in tax planning
- 3 Your fund remains invested and therefore with good investment performance your ultimate Pension income could be greater
- 4 Purchase of an Annuity can be delayed until age 75 (perhaps indefinitely if you enter Alternatively Secured Pension - see below)



5 On your death your family can benefit from the value of your Pension fund, although a 35% tax charge will be payable on any lump sums payable

Disadvantages of Unsecured Pension

- 1 There is no guarantee that your income will be as high as that offered under the compulsory purchase Annuity route
- 2 Annuity rates are not guaranteed and may increase or decrease in the future making Annuity purchase expensive compared to today's rates
- 3 Future investment returns are unknown and the value of funds remaining invested in your Pension will fluctuate over time. If the value of your Pension fund falls you could receive a lower income in future years.
- 4 You may withdraw too much income in the early years. If your Pension fund does not grow sufficiently your income in the future may have to reduce and your fund could be eroded over time leaving you with very little or even no income
- 5 There are increased costs involved as ongoing reviews of your plan will be needed to ensure that your retirement needs are being met as your circumstances change
- 6 Under current legislation you will have to make a decision at age 75 whether to buy an Annuity regardless of Annuity rates at the time, or enter into Alternatively Secured Pension which may not be appropriate

7 The level of income you get from a conventional Annuity is based on the average life expectancy of someone your age. A life company when fixing an Annuity rate will take into account that the funds of those people who die early will remain in the pool to effectively subsidise those who live longer. This is known as "Mortality Gain". Unsecured Pension plans do not benefit from any subsidy. When you invest in one of these plans the income you take is not subsidised by anyone else. If you are not to lose out in comparison to the Annuity you could have bought your plan must earn extra returns to make up for not benefiting from the mortality gain

8 A combination of high withdrawals and poor investment performance could reduce your fund and income to ZERO

IMPORTANT

(RISK WARNINGS FOR INCOME DRAWDOWN PLANS - PLEASE READ CAREFULLY)

- A. High income withdrawals may not be sustainable
- B. Taking withdrawals may erode the capital value of the fund, especially if the investments returns are poor and a high level of income is being taken. This could result in a lower income when the Annuity is eventually purchased.
- C. The investment returns and projected future Pensions may be less than those shown in the illustrations.
- D. Annuity levels may be at a worse level when Annuity purchase finally takes place.



E. Taking high levels of income could exhaust your fund and leave you with no income in the later years of retirement.

F. The returns you require to satisfy your income needs may demand a higher risk investment strategy than you wish to take at this stage.

Alternatively Secured Pension

After the 6th April 2006 it was no longer compulsory to buy an Annuity at age 75, your fund can remain invested with any income taken to be known as 'Alternatively Secured Pension' (this is very similar to Unsecured Pension, although death benefits are different) and this can be continued for life.

The amount of income that can be drawn down is once again linked to Annuity rates and can be set at anywhere between 55%-90% of the prevailing prescribed Annuity Rates for a 75 year old at that time. Please note, regardless of your increasing age your income will always be based upon the Annuity Rate for a 75 year old.

You can of course elect to buy an Annuity at anytime. The advantages and disadvantages are largely the same as those for Income drawdown and I would draw your attention to the Risk Warnings above.

The most significant difference is the payment of death benefits which are as follows;

I Your fund must provide an income for spouse/dependents If there is no spouse or dependents you may

2 Leave the money to a registered Charity (If no charity is chosen this will be selected by the Scheme administrators)

3 Leave the money to another member or members of the same Pension Scheme subject to a 70% tax charge on transfer and Inheritance Tax (an effective tax rate of 82%)

However due to the complexity of Option 3 above, many Pension provider do not offer this route and for the vast majority of people purchasing an Annuity by the time they reach 75 will be the preferable option, particularly as the market in Variable Annuities matures and the range of options and guarantees within them broadens.



Conclusion

Pension planning and the numerous options available to you are inevitably complex and if you are like the vast majority of people it is rare to find a case where it is 100% conclusive for any option. It is therefore usually the case of establishing which option best suits your longer term financial objectives taking into account your personal circumstances, income I realise that the above is somewhat lengthy but feel it is important to ensure you are in receipt of as much information as possible to assist you in your decision making. If you would care to make a note of any questions you may have or points which you feel require clarification I will be happy to go through them with you.

Should you want a confidential appraisal of your situation simply complete our enquiry form on our website **www.pensionmatters.net** or call direct **FREEPHONE 0800 612 4541**.

Alternatively you may wish to contact us via post at the address shown on the front cover of this report.

Thank you for taking the time to read our guide which we hope you found useful

