Pension Matters
Advice without compromise

# A Guide to Your Retirement Options

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**This guide provides a general outline of the various options available to those with Pension funds approaching retirement. It is therefore of relevance to anyone approaching a significant milestone in their lives and is designed to provoke thought and discussion as to the optimum route for your heard earned funds. It is not intended to be definitive or provide advice but will hopefully help you understand what is on offer and be the next step towards a happy and fulfilling retirement.**

**Best Wishes,**

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# 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 loosely 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 are low 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 now Annuity rates have been correspondingly low and are considered to be poor value.

However there is nothing to say Annuity Rates 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, but if rates fall you are left with a lower income for life than you might have had. It is worth noting that generally underlying Annuity rates have been falling steadily since 1995.

**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 you so 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 because as a population our average life expectancy continues to rise. This means Annuity rates will fall correspondingly as pensions 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, although

this gender bias will end in December 2012 when EU legislation will require unisex rates to be applied, so good news for women, not so good news for men!

**D. Health & lifestyle**

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. Your Pension can be payable only to you for your lifetime, or it can continue to be paid to your spouse or Civil partner 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 against rising prices as the table below demonstrates how inflation can reduce your spending power over time. This does come at a price and you have to make a decision whether the additional cost is worth the benefit and look at your Annuity in relation to your other assets and alongside the State Pension which is protected against inflation.

The effect of inflation on £1,000 - reducing your spending power

| 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 to your Annuity which means that should you die your pension would continue to be paid at the same level to your dependants for the guaranteed period. This is normally for 5 or 10 years. Depending on the options selected at outset your husband or wife may continue to receive a Pension or the remainder of the guaranteed instalments may be paid as a lump sum. 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 (subject to tax) for death prior to age 75.

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, 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 at outset had you elected not to take any of the additional benefits 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 to 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 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 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 purchase a guaranteed period if you wish.

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 can 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 your entire 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 your benefits
5. If you die soon after the plan has started the payments you have received may not represent the amount in the fund
6. Lack of certainty of future income

## 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 income 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.

Variable Annuities are essentially a 'halfway house' between a Conventional Annuity and Income Drawdown potentially offering the best of both worlds, but they are not without constraints

**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 income requirements in the future
4. Avoids 'once in a lifetime' commitment of conventional Annuity purchase
5. Potential to leave your fund as a lump sum (subject to tax) to beneficiaries other than your Spouse.

**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 due to charges
3. Charges and early surrender values can be prohibitive
4. Variable annuities are relatively new and some designs are a complex proposition
5. Your starting income will be lower than a Conventional Annuity
6. 
7. Without investment growth your income may never reach the level of a Conventional Annuity

## 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 provide an income. 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. You can continue doing this until your entire Pension fund has been utilised.

**What happens if you die?**
As far as the Phased Pension, (those segments you have already accessed) income can continue to be paid to your spouse. The Pension fund which has not been Phased 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 to your estate intact upon death providing you are under 75.

**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.

## Income Drawdown

Income drawdown (or unsecured Pension as it is sometimes 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 but 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 which is taxed as earned income. The income taken must fall between set limits which are between 0% - 100% 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 three years (every year after age 75) and amended in line with 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, so should you choose to take nothing this tax year you cannot take twice the amount next year.

**Flexible Drawdown**

If you have sufficient guaranteed pension income of £20,000 per annum, known as the Minimum Income Requirement (M.I.R) it is possible to transfer your pension fund into "Flexible Drawdown" which permits you to take unlimited amounts of income from your pension (you are not restrained by the government imposed limits of regular Income Drawdown which is known as "Capped Drawdown"). This will be subject to income tax at your marginal rate but could be a useful way of accessing your pension fund and using the capital.

**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 55% (Protected Rights must provide a spouse's pension if you have one)
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 Income Drawdown**

1. Allows you to receive part or 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, indefinitely if you so wish
5. On your death your family can benefit from the value of your Pension fund, although a 55% tax charge will be payable on any lump sums payable

**Disadvantages of Income Drawdown**

1. There is no guarantee that your income will be as high as that offered under the Annuity route
2. Annuity rates 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 you 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 an ever reducing 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. If your fund falls you may have to take increasingly uncomfortable levels of investment risk to have any hope of meeting your longer term income needs
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. Income Drawdown plans do not benefit from Mortality Gain.
8. A combination of high withdrawals and poor investment performance could reduce your fund and income to virtually nothing.
9. The Government Actuary's Department which determines income rates from Drawdown plans may reduce the rate at which you can take income from your plan so your pension income could be reduced at each 3 year review even if your fund has increased in value.

## 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, or combination best suits your longer term financial objectives taking into account your personal circumstances.

The decisions you make will affect the rest of your life so it is important you have as much information as possible before seeking Professional Advice and deciding upon the optimal course of action for yourself.

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 cover of this brochure. Thank you for taking the time to read our guide we hope you found it of value.