

What Are My Options At Retirement?

The following notes do not apply to people who are in "Final Salary" pension plans. The purpose of these notes is to try and explain some of the common options open to clients when they come to take their retirement benefits.

1. TAX FREE CASH

As a generalisation, it is usually better for people to take their maximum tax free cash from a money purchase pension and to take no tax free cash from a final salary pension fund. This does, however, depend upon individual circumstances (the plan may have guaranteed annuity rates for instance) and should be fully assessed individually.

These notes refer just to money purchase pension plans. These fall into two legislation types:

1.1 Personal Pensions / Stakeholder

Usually a personal pension fund carries the option to commute 25% of the fund as a tax free lump sum. Personal pension buy out plans (and draw down schemes from company pension arrangements) will usually follow the rules of their original company pension schemes although they may well generate 25% tax free cash if this is more generous than the original rules permitted.

1.2 Company Pension Plans

Again tax free cash will usually be 25% of the value of your pension plan. Some people will have obtained protected tax free cash which is a greater percentage of the fund due to pre A-Day company pension scheme rules. We should always check the tax free cash position (which can be very complicated) if you believe your entitlement may be better than 25% of the fund value.

2. SCHEME PENSIONS

This is a pension provided by the pension scheme itself (ie, a big final salary scheme) or by an insurance company nominated by the scheme administrator along the lines of a traditional pension annuity mentioned below.

3. LIFETIME ANNUITIES

With a traditional annuity the annuitant (person receiving the pension) gives cash to an insurance company in exchange for a guaranteed income for the rest of their lives. Once the annuitant dies, the income ceases and the insurance company keeps the initial investment.

The big problem with annuities is that the rates keep dropping. This is due in part to the poor investment returns but also to the increase in longevity. Males born in 1901 could expect to live to age 45 whilst boys born in 2000 expect to live to 75. The figures for women are 49 and 80 respectively. These average expectations are expected to rise by a further 2 years within the next 20 years. (National Office of Statistics 2002).

3.1 Single Life

This type of pension would be paid for the annuitant's life alone. If the annuitant dies one month after starting the pension, the annuity ceases and the insurance company pockets the cash. On the other hand, if the annuitant lives to 125 the insurance company will keep paying.

3.2 Joint Life

Here the annuity is paid until the last annuitant dies so a couple (ie, husband and wife, civil partnership or unmarried couple) take out the pension which continues at the same level throughout their joint lives.

3.3 Reversionary Annuity

This is often referred to as a "joint life/last survivor" annuity. With a reversionary annuity the pension is payable in full for the lifetime of the annuitant and then on their death a reduced pension will be payable to their dependant.

Typically the annuity reduces by 1/3 or 1/2 on the annuitant's death ie, the full pension is £10,000 pa, when the annuitant dies this reduces to £6,667 or £5,000 pa for the remainder of the life of the dependant.

Reversionary annuities often have the misnomer of widow(er)'s benefits. In reality, if you can prove a dependency then anyone can have the annuity ie, a same gender partner is acceptable. Please note that whilst HMRC are fairly reasonable, some pension fund trust deeds are not. You may, therefore, be restricted as to who qualifies under this rule.

With any annuity which makes provision for a survivor (eg, a widow), it is usual to name that person at outset. However, it is possible, by special arrangement, to have the definition of a survivor include people who are not yet dependent. A good example would be where a wife predeceases a husband who then remarries. When he dies, the annuity could be paid to the new wife so long as special provisions are made.

3.4 Guarantee Period

It is possible to establish a guarantee period on the annuity (typically 5 or 10 years). By way of example, with a 5 year guarantee if the annuitant were to die after 12 months' payments had been made, their estate would receive the value of a further 48 payments. After the first 5 years of the plan no further guarantees apply.

3.5 Escalation

Post A-Day escalation is optional. All figures quotes are for a male and female aged 65 in March 2006 with a net fund of £100,000.

3.5.1 Level

This provides the highest annuity rate, but the income remains level for the rest of the annuitant's life. A £10,000 pa annuity paid now will be worth £7,300 in real terms after 10 years, or £6,300 in real terms after 15 years at an average inflation rate of 3% pa

3.5.2 Fixed Escalation

Typically, escalation can be fixed at 3% or 5% pa. Recent quotations have shown that 5% fixed escalation can give a lower pension than Retail Price Index (RPI) linked payments.

3.5.3 RPI Escalation

As the name suggests, the pension increases each year in line with RPI. It is not generally possible to obtain escalation by the All Earnings Index (AEI) which is, of course, the real level necessary to maintain the earning power of a pension.

3.5.4 LPI Escalation

Limited Prices Increase (LPI indexation) is an increase in your pension by RPI, but with a cap of (usually) 5% pa maximum. In this way the insurers know that if high inflation returns their risks are reduced.

3.5.5 With Profit Or Equity Escalation

This concept can be a little difficult to grasp, however, the basic principle is that the annuity will rise if the insurance company's investments out perform agreed parameters. By way of an example, an annuity may be taken out which will remain level as long as the insurance company's pension fund grows at 6% or more each year. If the pension funds grow at more than 6% in any year then the annuitant will get a higher pension. If the funds grow at less than the 6% figure then the pension may fall.

4. DRAW DOWN OR INCOME DRAW DOWN (IDD)

As an alternative to using your accumulated pension fund to purchase a conventional annuity, it is now possible to purchase an unsecured income draw down. This income can continue until age 75 at which time you can maintain your income in the form of an Alternatively Secured Pension (ASP).

As part of the investment choices within an IDD you can buy a short term (say 5 year) annuity. Unsecured income must cease by the age of 75. The maximum income is the equivalent of 90% of the best rate available on the Financial Services Authority (FSA) published comparative rate tables.

Unsecured pensions must be actuarially reviewed every 5 years (and in practice they need reviewing from an investment perspective at least every year).

The initial income available from a draw down scheme is broadly based on an annuity that could otherwise be purchased. In other words, if the maximum annuity that could otherwise be purchased was, say £10,000 pa, then it would be possible to draw down from the fund any sum between £12,000 and £0 each year.

The sum that is drawn down is taxed in the same way as an annuity, ie as income. The fund that is not drawn down remains invested in a tax free environment and will ultimately be available (after tax) for beneficiaries when the pensioner dies.

Unlike a purchased annuity where the future income level is certain, there is no guarantee that the fund remaining will grow sufficiently in the future to maintain the level of income.

A draw down scheme can be useful in certain circumstances. These might include an active interest by the member in continuing to manage their pension fund. Annuitants in ill health may prefer the ability to pass on remaining assets to their estate (after tax). Some people may prefer to take their tax free cash and no annuity now in the hope of receiving a higher pension when they are older, likewise some may take the opposite view and want the maximum annuity now when they are young enough to enjoy it.

Naturally, the expenses associated with a draw down scheme will be higher (because of ongoing management and monitoring) and it is our view that under normal circumstances they are best suited to substantial pension funds.

On a like for like basis IDD will never match a guaranteed annuity as it cannot benefit from the mortality bonus. Where a pension is undertaken with a pension company the actuary of that company will assess the likely lifespan of the applicant. Life expectancy increases to older you get so at age 65 a male is expected to live to around 15 years. The actuary will then assume everyone lives for this period thus creating a rate which (after allowing for his profit) uses up the annuity purchase price over 15 years. This means of course that if you live for 20 years you are getting a much better deal that could be the case if you managed your own fund. On the other hand if you die young, clearly the IDD is better for your dependants.

5. ALTERNATIVELY SECURED PENSION (ASP)

ASP comes in where unsecured income ceases ie, at age 75. It is in effect unsecured income but in a much more restricted form so income has to be checked against assets each year. With effect from 6 April 2007 individuals in ASP must take a minimum of 65% of the Government Actuary's Department (GAD) rate for a 75 year old, with a maximum withdrawal of 90% of the Financial Services Authority (FSA) published comparative rate tables for someone aged 74 and 364 days so if the annuitant is 95 the annuity rate is still for that of a 75 year old.

6. TRIVIAL BENEFITS

If the value of all pension (or dependants) benefits is less than 1% of the Lifetime Allowance (LTA) (£16,500 in 2008/09) the benefits can be commuted for a lump sum. 25% of the lump sum will be tax free, 75% taxed as earned income.

7. PROTECTED RIGHTS

The Department of Work & Pensions (DWP) have announced (December 2005) that protected rights funds can also choose from all the new alternative pension options.

8. IMPAIRED LIFE ANNUITIES

It is now possible (and common) to obtain underwritten annuities for individuals in ill health. One obvious form of enhanced annuity, which can sometimes pay dividends, is for cigarette smokers. In the same way that smokers can now pay 25% more for their life cover, smokers could obtain up to 15% to 20% better annuity rates.

Whilst we would always look to underwriting any medical problems, severe ill health is sometimes better dealt with via a draw down or high level reversionary annuity.

9. PAYMENT FREQUENCY

It is usual for an annuity to be paid monthly in arrears. However, it is possible for it to be paid at other frequencies such as quarterly, half-yearly or annually. There should be a reasonable return on leaving your fund with the annuity provider so that it is paid say, annually, rather than monthly. Thus, if you felt it was more convenient to receive a single annual payment this could be achieved.

10. SUMMARY

Clearly, everyone would like the maximum pension with minimum risk. Unfortunately, this utopia is unavailable. At the end of the day, the type of annuity received will be a compromise between security and immediate income requirements.

A pension fund of £100,000 (August 2006) might purchase an annual pension of for a male and female both aged 65 as follows:

Level pension for the male life alone £7,000
Level pension for the male life, 5 years guaranteed £6,900
Level pension for the female life alone £6,400
Level pension for male, 66% for female £5,500
Level joint life pension, 100% to survivor £5,000

RPI pension for the male life alone £4,800
RPI pension for the female life alone £4,200
RPI pension for male, 66% for female £3,500
RPI joint life pension, 100% to survivor £3,200

The above will be out of date **immediately**, however, the figures can be used to indicate the costs of each option. For instance, if inflation averages at 3% each year it will take the annual pension received from an RPI escalating pension around 12 years to exceed the level of the non-escalating pension.

Using the same example for a male aged 65, the cumulative income received from the RPI pension does not exceed the total level pension received until 22 years into retirement. Of course, the compounding effect of the escalating pension increases the amount received quite dramatically thereafter.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. 9th September 2006.