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A Quick Guide: Your Retirement Income Options

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Introduction

Many people are under the impression that on retirement their pension fund will automatically produce an income, when in fact there are a number of choices that must first be made.

When you reach the age at which you are going to draw your benefits from your pension arrangements, under “money purchase” schemes, such as Stakeholder and Personal Pension Plans, you have to make choices regarding the type of income you draw. After a series of legislation updates, the number of options available to generate an income from your accumulated schemes have steadily increased. The main driving force behind these changes has been the seismic changes to life expectancy with retirement periods now lasting over a number of decades.

The initial decision is how to go about changing your pension fund into a regular income. The most common option is to purchase a conventional annuity. Alternatives include options such as Income Drawdown and Phased Retirement, which offer the chance to defer purchasing your annuity. However, it is not always suitable to take up one of these plans and it is always best to take professional financial advice.

Some people have been reluctant to invest into pensions (despite the major tax breaks) because of the previous restriction of having to purchase an annuity by age 75. Consequently, more recent changes have removed this requirement and therefore allow more flexibility and freedom on how to access the accumulated funds within a pension arrangement.

In today’s climate, annuity rates are historically low. Investors are concerned that with what in most cases is their largest investment apart from their home, they are being forced to buy a low 'income' over what could be a 1/3rd or more of their lifetime.

However, there are sound reasons why an annuity may form all or part of the picture in providing a retirement income. An annuity provides a strong basis for underpinning a retirement income and offers a guaranteed income for life, on which other sources of income can be added.

The uncertainty of inflation in the future means that a combination of solutions to meet short and long term requirements is increasingly forming the basis of people’s ‘at retirement’ planning. The aim of this guide is to give you information of the various options available.

Different Types of Annuity

An annuity is a simple investment that provides an income payable for the rest of your life. The income is generally paid to you by an insurance company in exchange for your accumulated pension fund.

A Compulsory Purchase Annuity (CPA) or Pension Annuity is one that is purchased with the capital sum from a pension plan. Normally, up to 25% of the pension fund can be taken as a tax free cash lump sum and the remainder must be used to provide a taxable lifetime income.

Things That Can Affect the Level of Annuity That You Receive

There are a number of factors that influence the return you will get from your annuity, which include:

- The size of the pension fund. Obviously the larger your fund, the higher the annuity income will be.
- Mortality. This is the calculation of the age to which you are expected to live. In general women tend to live longer than men and therefore women usually receive lower annuity rates than men of the same age, as they will have to be paid for longer. European legislation may lead to unisex annuity rates in the coming years.
- Health. If you have an illness that is expected to shorten your life, you should be able to achieve a higher annuity level as you will be classed as having an 'impaired life'.
- Smoker? If you smoke you may also be able to achieve a higher annuity income as it is thought that your life will be shorter than that of a non-smoker.

Other than these factors, Gilt yields will impact annuity rates, as will the profit margin required by the annuity provider.

Options

The most secure of all annuities is a conventional annuity. A conventional annuity is one that removes the risk of a fluctuating income. The income payable will not reduce during your lifetime; however the real purchasing power of the annuity will typically diminish over time due the effects of inflation. It is possible to opt for an annuity that will increase each year, often by a set amount of say 3%pa, or in line with the Retail Prices Index (RPI).

Alternatively, you can elect to have an annuity that that is linked to an underlying investment fund. The income provided by one of these "investment linked" annuities will vary over time, depending on the performance of the underlying investments, though often will have a minimum income that will be payable.

Some annuities provide the option to preserve the underlying capital, less income paid out and a subsequent tax charge. These are known as Value Protected Annuities.

A with profits annuity links your income to an underlying with profits fund. The income can therefore move down as well as up but the aim of with profits is to produce a steady investment return. A unit linked annuity can be a relatively high risk strategy as the income is linked directly to the performance of a stock market fund. The type of annuity that you choose will depend on the level of risk that you are willing to take.

When you initially purchase your annuity you have a variety of options. The first thing to consider is how do you want to receive the income?

- Monthly, Quarterly, Bi-annually or Annually?
- In arrears or in advance?
- Do you want a level income or an income that increases by 3%, 5% or RPI? Or even a with profits or unit linked annuity?
- Do you want there to be an income for your spouse if anything happens to you?
- Do you want a guaranteed period? This means that there is an income paid for say 5 or 10 years from the date you buy the annuity even if you die.

All of these decisions are extremely important because once the annuity has been bought, you cannot change the way that the income is paid to you.

Maximising Annuity Income

What most investors are unaware of is the fact that they do not have to purchase their annuity from the company that they held their pension fund with. There is an option called the 'Open Market Option', which means that you can purchase your annuity or 'income' from an alternative provider. This means that you can 'shop around' and go with the provider who will supply the highest level of income, given your age, size of fund and state of health. Recently, the Financial Services Authority (FSA) has insisted that insurance companies make it more prominent that it is the right of the investor to shop around for their annuity. The difference between the highest and lowest annuity provider can be as large as 30% or more.

This is excellent news as it will increase awareness amongst the public and means that many pensioners will end up with a higher level of annuity income that they would have otherwise settled for.

It is also important to note that there are a number of insurance companies that offer 'enhanced annuities'. These are conventional annuities that take in to account medical and lifestyle factors, which could have a negative effect on life expectancy. These types of annuity will be underwritten and an enhanced rate may be offered to reflect the likelihood of the annuity being paid for a shorter length of time.

Other Options – Capped Drawdown

Under this method, your tax free cash entitlement is paid up front as a lump sum, with the balance of the fund remaining invested. Each year, you draw down an income from the residual fund depending on your income requirements at that time.

The maximum income you can take is broadly equivalent to the annuity that could be purchased with the funds available. There is no minimum income level and effectively you could choose to stop income withdrawals in the future (or not to take them). You can vary your income each year up to the maximum level, and every three years the maximum rates are re-set based on your age and market conditions at the time (this reduced to every year post age 75).

The advantage of Capped Drawdown is that it allows you to take your tax free lump sum up front, and vary your income from year to year depending on your own requirements and tax position.

If you die whilst taking drawdown there are broadly two options:

- 1) If you are survived by a spouse or financial dependant they can continue to take drawdown or buy their own annuity.
- 2) The fund can be paid out either to your nominated beneficiaries or a trust as a lump sum, less a special tax charge of 55%.

This is a significant advantage over the annuity route – if you are married there is no need to buy expensive benefits for a spouse as they would be able to continue to enjoy the residual fund if you pre-decease them. In addition, if you are not married, you are able to pass a part of your pension on to your beneficiaries; an option that is not available with annuity purchase.

The disadvantage is that the fund remains invested and there is an element of investment risk, with no guarantee that your income can be maintained indefinitely.

Phased Retirement

Under this type of arrangement, your fund is typically split into 1,000 identical segments/arrangements. Each segment is made up partially of tax free cash (25%) and you encash segments as and when income is required.

As each segment is encashed, it will provide you partly with a tax free cash lump sum, with the balance then being used either to purchase an annuity, or it can be transferred to a flexible drawdown account to provide you with a regular income.

The balance of your fund which is not used to provide an income remains invested.

This option is likely to prove a much more tax efficient income than any of the other options, since part of it is made up of part of your tax free cash lump sum each year. However, the lump sum is spread over the period up to age 75 and is therefore not available at your retirement age.

'Third Way' Options

A relatively new development in the retirement options space is the introduction of a number of products that are collectively known as 'third way' options. This route offers a lifetime income with some of the advantages of Capped Drawdown, in that some products give flexibility over the level of income that can be taken, though with some underlying guarantee to either investment returns or income. In addition, the fund remains invested giving the opportunity for a rising income. Some of these products provide the attractive death benefits that Capped Drawdown offers.

Short-Term Annuities

These also come under the third way option, in that instead of purchasing an income for life with your entire pension, all or part is used to purchase a fixed income via an annuity, for a period of up to 10 years. At the end of the period, your options are to either purchase another fixed annuity, a lifetime annuity or enter into Capped Drawdown. In essence, you have all your retirement options available to you again. This is useful when certainty of income is required, however, you do not wish to make a 'one-off' decision with an annuity purchase. An advantage is that it allows for changing personal circumstances, such as deteriorating health or changes to marital status.

Flexible Drawdown

For those with larger pension funds, Flexible Drawdown may provide the opportunity to increase the amount of income you draw from your pension fund.

Essentially, as long as you have a fixed lifetime income of £20,000pa from other sources (such as annuities, state pensions and final salary pension schemes) you can draw an unlimited amount from your remaining fund. Of course, Income Tax is payable at your marginal rate of tax, but this may present some valuable financial planning opportunities.

In particular, this could be a useful means of increasing your pension income in the early years of your retirement (these are the years in which your income requirements are likely to be highest and you are most able to enjoy a higher income). You could also draw a higher level of income to fund a series of regular gifts to your family, which could be a very powerful option from an estate planning point of view.

Advice

Of course, all of these options will only add to the confusion that many people have with pension funds and their retirement options. It is therefore vital that you take advice from a professionally qualified firm of financial planners before making what for many people will be one of the biggest financial decisions of your life.

Please contact retirement@LIFT-Financial.com for more details of the advice and guidance we can provide, as well as our other retirement services.

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