

Thinking about retirement?

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Introduction

This is a guide to retirement options for those with personal pensions or company money purchase schemes. If you have any defined benefit pension arrangements, also known as final salary schemes, please contact us for further details.

Historically, the only option at retirement was to take a tax-free cash sum and utilise the rest of the pension fund to purchase an annuity. In recent years, the rules and choices for drawing pension benefits have been revised for example the requirement to purchase an Annuity by age 75 has been abolished. This all means that you have greater flexibility and choice in how and when you take your pension benefits.

This report explains and examines all the options that might be appropriate for your circumstances. We can only give specific advice after we have discussed your personal circumstances with you and considered the issues, options, and risks for your situation.

Before examining each of the options there are a number of issues that should be considered; these will help you analyse each option in turn, and decide upon its appropriateness. They are covered in the second section called 'Key Considerations'.

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Update On Recent Changes

The government have announced a whole raft of proposed changes to pension rules over the past few months.

The changes will provide increased flexibility, but exactly what has been announced? Who will benefit? What should you do now in preparation for the changes?

What has been announced?

The main headline was the removal of the requirement to purchase an Annuity at age 75, however there were also other significant changes including:

- The introduction of capped drawdown
- The introduction of flexible drawdown
- Changes to the taxation on lump sum death benefits

The scrapping of the requirement to secure a pension, most commonly via an Annuity, at the age of 75, has been removed.

This will mean investors can stay in Income Drawdown or continue to purchase Fixed Term Annuities past the age of 75, opening up the possibility of leaving surplus pension funds to family members.

The second major change is to the Income Drawdown rules with the introduction of Capped and Flexible Drawdown.

“Capped Drawdown” Once a fund is crystallised and any tax free lump sum (also known as Pension Commencement Lump Sum or PCLS) is paid out, the remaining fund can be used to purchase an Annuity or moved to Income Drawdown.

Capped Drawdown looks similar to Income Drawdown (also known as Unsecured Pension).

No minimum income must be taken, however there is a maximum amount of income which is available. The maximum annual income which can currently be taken is 120% of a single life, level Annuity based on the tables provided by the Government Actuary’s Department (GAD). This is being reduced to 100% from 6th April 2011. The income limits are also currently reviewed every five years before age 75. This will change to every three years before age 75 from 6th April 2011, or when the next five year review is due, whichever is later for existing Income Drawdown plans.

This means that going forward the amount of income that can be taken will be broadly similar for annuities and capped drawdown. At present the maximum income which could be taken from an Income Drawdown contract is generally higher than an Annuity.

Capped Drawdown will have no maximum age. Age 75 will however trigger a change in the frequency of maximum income reviews from every three years prior to age 75 and every year thereafter based on the individual’s age (the GAD tables will be extended). The increased frequency and use of actual ages will ensure there is less chance of fund erosion.

“Flexible Drawdown” Flexible Drawdown is a new introduction and will be available to individuals that have secure pension income equal to the Minimum Income Requirement (MIR) in the tax year that Flexible Drawdown commences.

The aim of the MIR is to prevent a member from exhausting their pension funds and falling back on the State.

Initially the MIR will be set at £20,000 a year and there is an intention that this will be reviewed by the Treasury every five years, it will not be index-linked on an annual basis.

Only particular types of pension income will count towards the MIR, such as income from:

- Lifetime annuities
- Scheme pensions e.g. from a defined benefit scheme
- State pensions

Drawdown income is excluded because it is not secure for life.

Where an individual satisfies the MIR they can enter Flexible Drawdown which will allow them to draw as much as they like from their arrangement without limit, but subject to tax at their highest rate.

To prevent abuse of the new rules in the year of commencing Flexible Drawdown no contributions can be made to a defined contribution scheme and the individual must cease to be an active member of any defined benefit scheme.

In addition once Flexible Drawdown has commenced, any further pension contributions will be subject to the annual allowance charge. For these reasons Flexible drawdown should only be used when an individual is sure that they have made all the pension contributions they wish to.

Alternatively Secured Pension (ASP) will cease to exist from 6 April 2011. Those individuals currently in ASP will transition to the capped drawdown rules at the next review as previously detailed.

The third major change relates to lump sum payments on death.

Lump sum death benefits are currently taxed on crystallised funds at a rate of 35% on death before the age of 75 and potentially up to 82% after age 75.

The new rules are simpler and certainly offer greater flexibility, although the rate of tax will rise on death before the age of 75.

From 6th April 2011 lump sum death benefits paid from crystallised funds will be taxed at a rate of 55%.

Lump sums paid from uncrystallised funds remain tax-free but only where death occurs before the age of 75.

For those who die before the age of 75 the new rules represent a tax increase, for those who die after age 75 the new rate is significantly lower.

Who will benefit?

The changes will be of most benefit to those that would like additional flexibility in how income is paid from their pension and what happens to any residual money when they die.

For those people who want a guaranteed income for life and have a low tolerance for risk then these changes will probably provide little benefit; an Annuity is still likely to be the preferred option.

Furthermore, for smaller pension funds an Annuity is likely to be the only practical option available.

However, if you want more flexibility in how you take your income or want additional options on death, the new rules may well help.

Although Flexible Drawdown will provide, as its name suggests, greater flexibility, it is likely that only a small number of people will qualify because of the £20,000 per annum MIR.

Capped Drawdown could help many more people who want income flexibility. For example those who have other sources of income, or who's working hours vary from month to month and year to year.

For those who disliked Annuities, because of the limited benefits available on death, using a Fixed Term Annuity or Income Drawdown plan in conjunction with the new rules will allow them to pass on unused pension funds to their beneficiaries. Although this will of course be subject to a 55% tax charge.

What should you do now?

This really is the \$64,000 question; it certainly cannot be answered here in full, as each individual's circumstances are unique to themselves; however it is possible to give some broad 'rules of thumb'.

Taking advice and speaking to a suitably qualified Independent Financial Adviser is a must now as the options have just got wider and more complicated.

The wrong thing to do is to wait, take no action and make decisions based on headlines and newspaper articles. Think over what you want, plan a cash flow showing your income and expenditure, think about what you want to happen on your death; it is only once you have done this can you start to think about how you achieve these goals with the pension you have worked so hard to build up.

Of course we can help you with all this planning, from an initial discussion; through to planning a cash flow and helping you make decisions that are right for you.

Key Considerations

Retired investors are exposed to a number of different risks. Typically when we talk about risk we are thinking about the risk linked to investments and how 'the value of units can go down as well as up'. However, when considering your retirement income structure, you need to consider a number of different risks that apply, these are

- [The risk of inflation](#)
- [The risk of annuity rate movements](#)
- [Longevity risk](#)
- [Investment risk](#)
- [The risk that your personal circumstances may change](#)

The risk of inflation

In recent years inflation has never been far from the news headlines, certainly at the start of 2011 there are fears that the relatively high levels of inflation we are currently experiencing will rise even further as the year progresses.

The impact of inflation is to devalue an investment, savings or income in 'real terms', which means a reduction in your spending power. You will be able to buy less in the future than you can today if the rate of return on your investment or savings does not match inflation. The same is true of your income.

If inflation were to return to target and was to run at a constant 2% per annum, which is the Government's target rate, then the real value of a £10,000 income today would be £7,386 in 15 years. That is more than a 25% reduction in real terms.

Many people are attracted to the higher income from a level Annuity and although in the short term this might meet their requirements, in the longer term they will see the spending power of their income reduce significantly because of the effects of inflation.

Risk of annuity rate movements

The timing of an annuity purchase can have a big impact on the level of income available. Annuity rates are priced in relation to the yields available on long dated gilts. Rates fluctuate from time to time and can have a significant impact on the level of income available between one month and the next.

Predicting annuity rate trends is becoming increasingly complex. Not only is it important to monitor changes in gilt yields but also to take into account changes in life expectancy.

Several retirement income options allow you to defer the purchase of a Lifetime Annuity to a future date. Whilst these options provide much needed flexibility, there is a risk that when you eventually purchase an annuity, rates may be lower than at present, of course, they may be higher.

Longevity risk

Longevity risk is effectively the risk of living too long! Life expectancy has significantly increased over recent decades. According to the Office for National Statistics, the average life expectancy in the UK for a male currently aged 65 is 17 years, and 19 years for a female (Source: Office of National Statistics).

Some options described in this report remove longevity risk by promising to pay an income for the remainder of your life, and that of your partner, where selected.

Other products leave you exposed to longevity risk, and the potential of a depleted pension fund with several years of income still required. In the worst cases, this will mean that income levels are reduced significantly in retirement. This risk is closely related to Investment Risk, and can be managed through appropriate investment strategies.

Your own health is closely related to longevity risk. There can be some advantages gained by deferring a Lifetime Annuity until later in life, as life expectancy becomes more predictable. In addition, as our health begins to fade, it may be possible to take advantage of enhanced annuity rates rather than the normal Lifetime Annuity rates.

Investment risk

Several of the options described later provide you with the opportunity to continue investing your funds for potential future growth. This will therefore continue to expose your fund to your chosen level of investment risk.

It is possible to invest these funds in a manner that is designed to limit the downside of any economic turbulence. However, you will need to consider the level of return required to make such a plan a success. Typically, as you target higher returns, you may need to increase the level of risk you are taking. This can mean that there is potential for a higher upside, which is matched by the potential for a greater loss on the downside.

Some contracts, such as Fixed Term Annuities offer a facility to limit the downside of investment risk. This works by providing an underpin of either a minimum income, and/or a minimum fund value.

The risk that your personal circumstances may change

Your circumstances have no doubt changed throughout your life, and it is likely that things will continue to evolve. It is important to consider how you see your retirement developing and the potential life changes that may occur.

Some options, such as a Lifetime Annuity, offer no future flexibility or possibility of change; others offer the opportunity to change at certain points in time; and others offer full flexibility.

Each option comes with its own set of risks, and compromises may need to be made in order to find the most suitable structure for you.

Options

Death benefits

How you provide for your spouse or partner, should you predecease them, is a very important consideration in selecting the most appropriate option for your retirement income provision. There are a number of ways you can provide income or a lump sum payment to your spouse, partner or family if you pre-decease them.

If you arrange a Lifetime Annuity, you can select to have a joint life option and/or a guaranteed income period which ensures that income payments continue to your beneficiaries. If the priority is to leave a lump sum on death, this option is available with contracts written under 'Unsecured Pension' rules. These include Income Drawdown, including both Capped Drawdown and Flexible Drawdown from 6th April 2011 and Fixed Term Annuities.

Further information on the death benefits of each option is contained within each section of this guide. Understanding and deciding on which option provides the most appropriate death benefit is one of the most important decisions that you will make.

The type of income

Many people concentrate on the amount of income that a particular option will pay, rather than the type of income.

The main types of income are:

- An income that will remain level meaning that the spending power is reduced by inflation over time
- An income that will increase in line with inflation
- An income that has the potential to grow
- An income that is paid for a fixed period of time
- An income that can be changed from year to year

The range of options

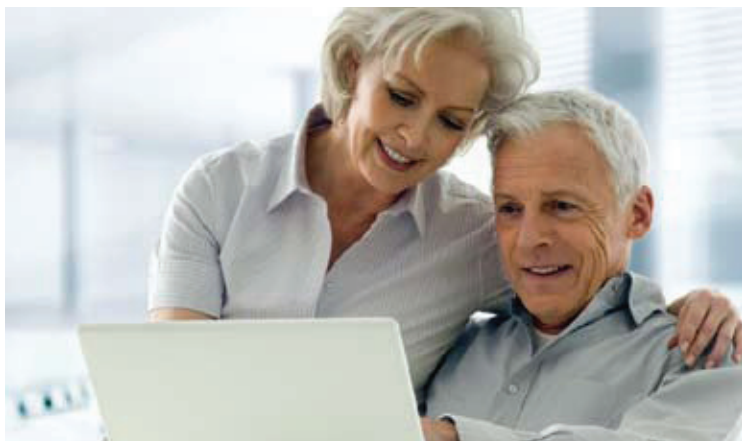
Over recent years, and as a result of recent changes in legislation, more modern and flexible alternatives have appeared, allowing you to take control over your future income needs, death benefits and the investment of your pension fund.

This report considers the different options in some detail to ensure that you understand the nature and significance of the advantages and disadvantages of these. It may transpire that, due to your personal circumstances and/or the size of your pension fund, some of the options may not be available or suitable.

The current main options available are:

- Deferral i.e. taking no income or tax free lump sum
- Buying a Lifetime Annuity
- Buying an Investment Linked Annuity, commonly known as Unit Linked or With Profit Annuities
- Buying a Fixed Term Annuity
- Income Drawdown, either in its Capped or Flexible form from April 6th 2011
- Phased Retirement

By considering each of these in turn, it is possible to firstly eliminate unsuitable options, and then to identify the most suitable choice for you and ensure that your retirement income will be tailored to meet your needs over the coming years.



Triviality Rule

If your total pension funds are currently worth less than 1% of the Lifetime Allowance (£1.8m in 2010/11 and 2011/12) you may be able to access all of the funds under the 'triviality' rules. This allows you to take the entire pot as a lump sum, with 25% available tax free and the remaining 75% subject to income tax.

The 'triviality rules' are not always straightforward, if you think you may be eligible then contact one of our advisers who can discuss your situation in more detail and confirm whether you qualify.

Deferment

It is important to consider the option of deferring your pension income payments to a future date if possible. Sometimes pension benefits are taken simply because we think they have to be taken. People are often still healthy and active at the age of retirement, and may actually want to continue to work.

It is often possible to defer 'crystallising' the pension fund and use other investments or income sources to cover expenditure requirements.

The investment strategy in deferment should be carefully considered to ensure that the fund is not exposed to inappropriate risk.

Should you die before age 75 your fund is uncrystallised it can generally be passed to your spouse or partner without deduction of tax. Death post 75 would attract a tax charge of 55% even if the fund is uncrystallised.

There are a number of advantages to deferment:

- The pension fund remains fully invested in a tax-efficient environment
- Lifetime Annuity rates generally rise for older lives, although this rise can sometimes be outweighed by falls in the general level of Annuity rates
- Deferring the purchase of a Lifetime Annuity purchase may allow you to take advantage of future worsening health or a change in personal circumstances
- An alternative income stream, perhaps from other investments, may provide greater tax-efficiency
- Social security benefits may still be available

There are of course a number of disadvantages to deferment:

- Future annuity rates cannot be guaranteed
- You will not receive the benefit of the income stream that would otherwise have been created
- If the funds remain invested in higher risk investments it could fall in value

It is also possible to defer your State Pension benefits. This results in a small increase to your weekly State Pension benefits, or the payment of a lump sum equivalent to the income that would have been paid, plus interest. The lump sum or the increase in State Benefits, are treated as income for tax purposes.

Lifetime Annuity

A Lifetime Annuity is now referred to as a Secured Pension and is the only option which can guarantee an income for the rest of your life, however long that may be. Historically, this is the most common way to take retirement benefits, taking the maximum tax-free cash sum available and using the balance of the fund to buy a conventional Lifetime Annuity. The income is provided as a level or increasing income for the rest of your life and is taxed as earned income.

Lifetime Annuities provide an income based on the Annuitant's age, gender, health, life expectancy and the level of gilt and fixed interest yields upon which annuity rates are based. Payments are made at agreed intervals, such as monthly or yearly, until your death.

You can buy your Annuity from the provider of your existing pension or shop about for a potentially better rate using the 'Open Market Option' facility which you have to be provided with.

There are different types of Lifetime Annuity, and a variety of options which need to be considered. Each of these options, or variations, will have an impact on the income paid. You can maximise income by limiting the number of additional options selected. An annuity with no options will stop when you die and never increase in value. Any options or features selected at outset cannot be changed once the contract has been set up. You must consider these options carefully and understand that a Lifetime Annuity income cannot be altered in the future to match changing circumstances.

Income frequency

Typically, Annuity income is paid monthly. However, it is possible to have income paid at a different interval, such as annually, half yearly, or quarterly. Income can also be paid at the beginning of each time period, or at the end, this is commonly known as 'in advance', or 'in arrears'. If income were to be paid annually in arrears, a higher level of income would be payable than annually in advance.

With and without proportion

This relates only to annuity payments which are paid in arrears. For example, if an annuity is paid annually in arrears and the annuitant dies at the beginning of the year, they will not have received their payment. 'With proportion' means that a proportional payment will be made for the percentage of the year in which the annuitant was living. Conversely, 'without proportion' means that no payment for that year will be paid. This has less of an impact where annuity payments are paid monthly.

Including a guaranteed period

A Lifetime Annuity guarantees to pay an income throughout your lifetime. However, including a guaranteed period means that if you die shortly after retirement, the full income continues to be paid to any beneficiary for the remainder of the guaranteed period. For example, after two years, the balance of the income due during a five year guaranteed period, i.e. three years, will be paid to your nominated beneficiary.

Typical options are to include a 5 or 10 year guarantee from the date of annuity purchase. Note that the guaranteed period does not start from the date of death.

Spouse's / partner's pension

If you are married or have a financially dependent partner, the annuity can be set up to continue paying them an income after you have died. This can be at the full rate, or at a reduced level, generally, two thirds or a half.

Selecting this option will reduce your starting income, and is irrevocable, i.e. if your partner predeceases you; your annuity terms will remain the same.

With and without overlap

This relates only to annuities which are set up with a guaranteed period and a spouse's / dependant's pension.

'Without overlap' means that if the annuitant dies within the guaranteed period, the annuitant's income is paid to the spouse / dependant, who will then receive their selected level of income from the end of the guaranteed period.

'With overlap' means that the selected spouse's income starts immediately within the guaranteed period and the annuitant's income also continues to be paid until the end of the guaranteed period. This means it is possible that more than 100% of the annuitant's income could be paid out.

Indexation

In order to protect the real value of your income, it is necessary to establish a plan with annual increases. This is normally set at 2.5% 3%, 5%, or at a level to match the Retail Price Index (RPI). Increases will take effect on the annual anniversary of the plan.

A level income is particularly exposed to inflation risk. This means that the buying power of your income will be impacted year on year, as the cost of goods and services rise.

Establishing an annuity with an increasing income will have a significant impact upon the level of starting income. There can be as much as a 30% reduction of initial income for including a 3% increasing income. This means that consideration should be given to the amount of time needed to catch up with the income that would have been paid from a level annuity.

Value protection

Value Protection can be selected at outset. This means that if you die before the total income payments received are at least equal to the original purchase price, the difference will be returned. From 6th April 2011 a 55% tax charge will apply, unless the money is reinvested in another appropriate pension product, in which case the tax charge does not apply.

For example, if you purchased an annuity for £100,000 and died after only receiving £40,000 worth of annuity payments, the difference of £60,000, less a tax charge of 55%, would be paid to your beneficiaries. This means the payout would be £39,000.

Value Protection is currently only available until age 75, however recent changes to pension legislation could change this.

Value Protection is a less attractive option for those aged over 65 because they could choose to have their pension guaranteed for up to 10 years instead. For example, someone aged 70 could guarantee that their pension would continue until age 80.

Value Protection and Guaranteed Periods are mutually exclusive. You can have one or the other, but not both.

Enhanced annuities

Overall, average life expectancy is increasing, but many people reaching retirement age are in poor health, and their individual life expectancy may be less than the 'average' used in traditional annuity calculations.

It is now possible to purchase enhanced annuities that take into account your health. Enhanced annuities are for those who have suffered health problems that are likely to have an impact on their anticipated lifespan. Typical conditions are the effects caused by long-term smoking, alcohol consumption, high cholesterol, high blood pressure, angina, and circulatory or breathing difficulties.

Where there is a clear expectation that a medical condition could substantially reduce life expectancy, for instance, if someone has suffered a heart attack, cancer or stroke, the rates offered can be even more favourable.

An enhanced annuity is a little like a life insurance policy in reverse. When you take out life assurance, the healthier you are, the cheaper the cost of cover. However, with a Lifetime Annuity the less healthy you are, the more likely you are to be able to enjoy a better annuity rate and higher income.

Once an individual is medically underwritten, accepted and the Annuity is purchased, the Annuity would then continue to be paid for the remainder of the individual's life. If they defeat their medical condition and live beyond their anticipated age, the annuity provider will continue to pay the Annuity.

It is therefore essential that when considering buying an Annuity you provide full details of your health, including any medication that you are currently taking.



Guaranteed Annuity Rates

Guaranteed Annuity Rates (GARs) are sometimes written into Retirement Annuity Contracts or Personal Pension Plans.

GARs provide potentially higher Annuity rates than are offered by today's marketplace. If you wish to benefit from a guaranteed Annuity rate via one of these older style policies, you may have to take your benefits in the structure dictated by the contract. Such terms are often very attractive and should be considered carefully.

Investment Linked Annuity

Advantages of a lifetime annuity

- You have immediate access to some or all of the tax-free cash available
- A choice can be made between a level or increasing income, for life, which is guaranteed
- No exposure to investment performance risk
- A surviving spouse's / dependant's pension can be included to carry on being paid after your death
- Income payments can be 'guaranteed' for a certain period so that they will continue to be paid for the remainder of the selected fixed period after your death. This cannot be used in conjunction with Value Protection
- The risk of you living a long time is transferred to the insurance company
- Depending on how long you live, you may get back more in income than you used to buy the Annuity in the first place
- They are relatively simple plans and usually do not involve on going planning and costs

Disadvantages of a lifetime annuity

- The pension you receive depends on Annuity rates at the time of purchase - which are currently low when compared to historical rates
- The level and structure of income is fixed at the outset. Once established it cannot be changed to take account of any changes in your personal circumstances, such as widowhood, secondary income receipts, or additional income needs
- Options selected at outset which will have reduced your starting income, may not be used in practice, e.g. if you choose a spouse's or partner's pension and your spouse or partner predeceases you, then the cost of this benefit has been lost
- You will not benefit from improved annuity rates in later life, which may be generated by worsening health and/or by the nature of becoming older
- Unless you include inflation proofing, you are exposed to the risk of inflation eroding the value of your pension income
- This option may represent poor value for money should you die early and do not opt for Value Protection or a Guaranteed Period
- The more features you choose, such as Guaranteed Periods, inflation proofing and spouse's benefit – the lower your starting income will be

Investment Linked Annuities typically invest in unit-linked investment funds or with profits funds and the levels of income received are linked to how well the investments perform. Good investment conditions may produce an increasing level of income. Poor investment returns are likely to have a negative effect on the level of future income. Investment Linked Annuities are like conventional Lifetime Annuities in many respects. You will need to make some decisions that are irreversible, such as whether you wish to include a spouse's pension or a Guaranteed Period.

The income that you receive each year is not guaranteed and will be directly influenced by investment returns. Investment risk means that your income could be less than that provided via a conventional Lifetime Annuity. However, potentially there may be sufficient investment reward to produce an income that is higher than a conventional Lifetime Annuity. As the Investment Linked Annuity provides the opportunity for increasing income benefits, comparison should be made against an increasing Lifetime Annuity as well as a level Lifetime Annuity.

In order to establish the starting level of income, it is usually necessary to make an assumption as to what future investment returns are likely to be (the bonus rate declared by the with profits fund and the growth rate achieved by the unit-linked funds). Depending on the assumptions made, the initial amount of income received from a with profits or unit-linked annuity may consequently be lower than that from a level Lifetime Annuity. The greater the level of assumed investment growth, the higher the starting level of income. However, the higher the level of assumed investment growth, the greater the risk that your future income may fall; if the assumed investment return is not achieved. The investor should be prepared to consider a lower income level if targeted investment returns are not achieved. This may be referred to as your 'capacity for loss'.

There are a range of contracts available in this sector with different variations in structure. Contracts often offer a mechanism to limit the level of downside. Some offer a 'worst case scenario' income level built in as well, which means that your income cannot fall indefinitely. This is normally significantly below the Lifetime Annuity income that you could have obtained.

With profits Annuities offer a smoothed level of investment returns and therefore a structure to limit the downside of the contract. The investment returns are typically declared each year by the with profits fund actuary. Investors should consider the strength of the underlying fund, and the ability of the investment managers.

Unit-linked Annuities operate in a similar way to with profits Annuities but have a higher degree of risk. They differ from with profits Annuities because the income is calculated based on the value of the unit holdings and there is no guaranteed amount of income.

Investment Linked Annuities offer the opportunity to remain fully invested and take advantage of long-term investment returns. These plans can continue for the rest of your life, although some do insist upon a disinvestment and the purchase of a Lifetime Annuity by the age of 90. Most Investment Linked Annuity contracts offer the opportunity to convert to a conventional Lifetime Annuity at any stage up to your 90th birthday.

Financial reviews

Investment Linked Annuities require regular reviews. As an investor it is important to both understand this type of product, and engage in the on-going review and management of investments.

Exit strategies

Although it is possible with most products to switch to a Lifetime Annuity at a future date, some restrictions may apply. It is important to understand the specifics of the product used in these circumstances.

Contract differences

Unlike Lifetime Annuities, Investment Linked Annuity contracts differ in structure and type. Advice and guidance with these contracts is essential.

Advantages of an Investment Linked Annuity

- You have immediate access to some or all of the tax-free cash available
- You can typically choose the level of income that you will receive, and can fluctuate it in line with investment returns
- If investment returns are above expectations you may have the opportunity to grow your retirement income
- In some contracts, you may vary your level of income allowing you to match income tax bands, offset other incomes, or take ad hoc income payments
- Subject to the risks outlined above income payments can be 'guaranteed' for a certain period so that they will continue to be paid for the remainder of the selected fixed period after your death
- Depending on how long you live, you may get back more in income than you used to buy the Annuity in the first place
- Most contracts allow the investor to convert to a conventional Lifetime Annuity at a future date. Some allow this on an Open Market Option basis

Disadvantages of an Investment Linked annuity

- Investment returns may be negative and can seriously impact the level of future income
- Investment risk must be fully understood
- Your income may fluctuate, as the income payable in any one year is dependent on the rate of investment return achieved and the initial assumptions made
- It is possible that you may not get back the amount of money you invested in the annuity if you die early
- This is a more complex type of plan and requires on going advice with regard to any changes that you may require
- On-going advice costs may be incurred

Fixed Term Annuities

Fixed Term Annuities provide a guaranteed level of income for a specific term. This approach enables people retiring to enjoy certainty with regard to their income payments, as they would with a Lifetime Annuity, but only for the term selected, rather than throughout life.

At the end of the term a Guaranteed Maturity Amount is provided, with which a further Fixed Term Annuity can be purchased. Alternatively, a conventional Lifetime Annuity or Investment Linked Annuity could also be purchased. Other options may also be allowable at this point dependent upon the pension legislation in force at the time.

At the end of the specified term of the Fixed Term Annuity, the income can be reset according to requirements at that time. The Fixed Term Annuity provides future flexibility by offering the ability to change the amount and shape of income at agreed intervals in retirement.

There is no minimum level of income that needs to be taken, which means you can take the tax-free cash alone and defer income to a later time.

A Fixed Term Annuity can be free of investment risk. The income payments are guaranteed, as well as the Guaranteed Maturity Amount available at the end of the term, which is known at the outset of the arrangement.

Value protection

As previously outlined under the Lifetime Annuities section, this means that if you die before the total income payments received are at least equal to the original purchase price, the difference will be returned less a tax charge. This charge is currently 35% although this will rise to 55% from 6th April 2011, unless the money is reinvested in another appropriate pension product, in which case the tax charge does not apply.

Spouse's / partner's pension

Again, as with a Lifetime Annuity, if you are married or have a financially dependent partner, the annuity can be set up to continue paying them an income after you have died. This can be at the full rate, or at a reduced level, for example two thirds or a half. However, this continuing income is only payable for the remainder of the fixed term, with the Guaranteed Maturity Amount then being available for reinvestment by the surviving spouse / partner.

Including a guaranteed period

In a similar way to a Lifetime Annuity, it is possible to structure a Fixed Term Annuity to ensure the income will be paid for a specified number of years from the start of the contract, even if the investor dies in the early years. However it is important to note that the guarantee period starts at the beginning of the fixed term, not from the date of death.

Selecting the appropriate structure for death benefits should be handled in conjunction with a professional retirement adviser.

Contract reviews

Fixed Term Annuities currently require a review of the maximum income levels every five years, from 6th April 2011 this will change to every three years if you are aged under 75 and annually if you are older than 75. If a plan term is fixed for longer than three years, a review of the maximum income is required. This may cause a reduction in the level of income that can be paid, particularly if the maximum permitted income levels have been selected. These limits are set by the Government Actuary's Department (GAD). However, whilst this could happen, it is not common because as you become older, GAD rates improve. Most Fixed Term Annuities have a standard 'default' income which is less than the maximum permitted, and annuity rates are currently at a historical low.

With some contracts, any income that cannot be paid because of the limit will be added to the maturity value of your plan to increase the Guaranteed Maturity Amount, thereby ensuring that its value is not lost.

Future advice

Financial advice will be required at the end of the fixed term to ensure that the most appropriate income structure at that time is selected.

Exit strategies

Fixed Term Annuity contracts expire at the end of the agreed term and offer the investor the opportunity to review and select the most appropriate income structure at the time. It is not possible to exit the contract during the fixed term.

Advantages of a fixed term annuity

- You have immediate access to some or all of the tax-free cash available
- You can choose to take just the tax-free cash and no income
- There is no exposure to investment risk
- Your income is guaranteed for the fixed term of the annuity, provided it remains within GAD limits
- The plan will also provide a Guaranteed Maturity Amount, known from the outset
- At the end of the fixed term, you can use the Guaranteed Maturity Amount to purchase any allowable form of pension income product suitable for you at that time. As such it provides considerable flexibility
- You may be eligible for an Enhanced Annuity if your health has worsened in the period between establishing the Fixed Term Annuity and the maturity date of the plan. This may lead to a significantly higher income

- The Value Protection death benefit, if selected, ensures that your spouse or partner and/or dependants, or estate, receive the full value of the original purchase price of the annuity, less the value of any income payments actually paid. This benefit will be subject to a 55% tax charge from 6th April 2011 unless reinvested in another appropriate pension product for the beneficiary
- Income payments can be 'guaranteed' for a certain period so that they will continue to be paid for the remainder of the fixed period after your death. However, this cannot be used in conjunction with Value Protection
- You can choose for a surviving spouse's / dependant's pension to carry on being paid after your death

Disadvantages of a fixed term annuity

- Your pension options are fixed for the term of the annuity, and cannot be altered to take account of changes in personal circumstances during the term
- The pension you receive is dependent upon Annuity rates at the time of purchase, which are currently low when compared to historical rates
- Whilst the Guaranteed Maturity Amount is guaranteed, the actual amount of income in the future will be dependent upon the prevailing Annuity rates at the time. Your future income may be lower or higher than the current level of income
- The maximum income you can take through a Fixed Term Annuity is restricted by GAD rates. It is therefore possible that your income level may have to be restricted at the review dates. There is a greater chance of this happening if you choose to take a high income above the default level
- Unless you include inflation proofing, you are exposed to the risk of inflation eroding the value of your income during the contract term



Income Drawdown

Income Drawdown allows you to take an income directly from the pension fund without having to purchase a Lifetime Annuity.

Until the recent changes to pension legislation were announced Income Drawdown could only be continued until age 75, when an income would have to have been secured, most commonly in the form of a Lifetime Annuity. However following recently announced changes from 6th April 2011 the requirement to secure an income at age 75 will be removed, allowing you to continue in Income Drawdown past the age of 75.

As discussed at the start of this guide from 6th April 2011 there will be two forms of Income Drawdown available:

- [Capped Drawdown](#)
- [Flexible Drawdown](#)

“Capped Drawdown” Once a fund is crystallised and any tax free lump sum (also known as Pension Commencement Lump Sum or PCLS) is paid out, the remaining fund can be used to purchase an Annuity or moved to Income Drawdown.

Capped Drawdown looks similar to the Income Drawdown (also known as Unsecured Pension) of today.

No minimum income must be taken, however there is a maximum amount of income which is available. The maximum annual income which can currently be taken is 120% of a single life, level Annuity based on the tables provided by the Government Actuary’s Department (GAD). This is being reduced to 100% from 6th April 2011. The income limits are also currently reviewed every five years before age 75. This will change to every three years from 6th April 2011, or when the next five year review is due, whichever is later for existing Income Drawdown plans.

This means that going forward the amount of income that can be taken will be broadly similar for annuities and capped drawdown. At present the maximum income which could be taken from an Income Drawdown contract is generally higher than an Annuity.

Capped Drawdown will have no maximum age. Age 75 will however trigger a change in the frequency of maximum income reviews; from every three years prior to age 75 and every year thereafter based on the individual’s age (the GAD tables will be extended). The increased frequency and use of actual ages will ensure there is less chance of fund erosion.

“Flexible Drawdown” Flexible Drawdown is a new introduction and will be available to individuals that have secure pension income equal to the Minimum Income Requirement (MIR) in the tax year that Flexible Drawdown commences.

The aim of the MIR is to prevent a member from exhausting their pension funds and falling back on the state.

Initially the MIR will be set at £20,000 a year and there is an intention that this will be reviewed by the Treasury every five years, it will not be index-linked on an annual basis.

Only particular types of pension income will count towards the MIR, such as income from:

- [Lifetime annuities](#)
- [Scheme pensions e.g. from a defined benefit scheme](#)
- [State pensions](#)

Drawdown income is excluded because it is not secure for life.

Where an individual satisfies the MIR they can enter Flexible Drawdown which will allow them to draw as much as they like from their arrangement without limit, but subject to tax at their highest rate.

To prevent abuse of the new rules in the year of commencing Flexible Drawdown no contributions can be made to a defined contribution scheme and the individual must cease to be an active member of any defined benefit scheme.

In addition once Flexible Drawdown has commenced, any further pension contributions will be subject to the annual allowance charge. For these reasons Flexible drawdown should only be used when an individual is sure that they have made all the pension contributions they wish to.

In both forms of Income Drawdown the income level is chosen by the investor, and can change according to personal circumstances. There is no minimum level of income that needs to be taken, which means that the investor can take the tax-free cash alone and defer income to a later time.

If you decide not to take the tax-free cash but take an income, the tax free lump sum cannot be withdrawn later.

Previously you had to take your tax-free cash by age 75 or the option was lost, this is not the case under new legislation from 6th April 2011.

As the pension fund remains fully invested, it is important to consider the level of investment returns required to meet the income being generated from the plan, and to cover the charges of the plan.

On death Income Drawdown contracts offer a number of options:

- [The remaining fund can be used by the surviving spouse or partner to purchase a Lifetime Annuity, or other income product, in his or her own name](#)
- [The remaining fund can be paid to the surviving spouse or partner, or the estate, as a cash lump sum, less tax charge. This charge is currently 35% although from 6th April 2011 it will rise to 55%](#)
- [The spouse or partner can continue to draw an income from the plan itself for a period of two years and then decide on the route to take](#)

Investment risk

Income Drawdown presents a number of risks for the investor. In particular investment risk, which could mean that the annuity available at age 75 is less than the Lifetime Annuity equivalent that you could have purchased at entry to the plan. On death there may also be less money in the fund than originally invested.

Mortality drag

Annuity providers set their rates by judging the life expectancy of their customers. This judgment determines how much capital they can afford to return each year to people who buy Annuities, along with interest. As older people are more likely to die, the provider can give a bigger capital boost to its older annuity customers.

That is why Annuity rates rise with age and this is known as mortality cross subsidy. In reality however, where Income Drawdown is chosen at outset, the residual fund will need to achieve a higher growth rate if it is to allow the pensioner to buy the same level of Annuity income as they could have received if they had purchased an Annuity at outset.

There are two reasons for this:

- The residual fund does not benefit from mortality cross subsidy until it is used to buy an annuity. People, who have used Income Drawdown and eventually purchase an annuity, receive less benefit from the deaths of people born at the same time because less of their capital is ever pooled.
- Life expectancy increases with age. For example, a man of 65 might on average expect to reach age 82, but if he survives to age 75 he can expect to reach age 85. This may at first seem odd. It happens because people who die younger have fallen out of the picture when the life expectancy for people at any given age is calculated. So the older someone is when he or she buys an annuity, the greater the age the annuity provider must expect him or her to achieve.

This effect is known as mortality drag and is reflected in the 'critical yield' growth figure that a full or phased income drawdown arrangement requires in order for the overall value of retirement benefits to match the value of benefits available from a traditional annuity.

If the critical yield is not achieved, your pension fund is likely to provide a lower overall level of benefits than those that would be provided through buying an immediate annuity and/or a lower level of income than you expected.

Financial reviews

Income Drawdown plans require a varying level of financial review dependent upon the investment complexity. As an investor it is important to both understand this product, and engage in the ongoing review and management of investments.

Income levels, as well as investment strategies should be reviewed on an annual basis. It may be appropriate to take a reduced income for a period of time to allow the fund to recover.

Exit strategies

It is possible with most products to switch to a Lifetime Annuity at a future date, although some restrictions may apply. It is important to understand the specifics of the product used in these circumstances.

Contract differences

Income Drawdown contracts differ in structure and type. In particular the level of investment structure and risk in the contract can vary significantly as can the charges levied.

- Advantages of income drawdown
- You have immediate access to some or all of the tax-free cash available
- Income Drawdown avoids the need to purchase a Lifetime Annuity
- Income may be taken from your plan between a minimum and maximum figure each year
- The minimum income is zero. This allows a high level of flexibility in income streams. Most plans will also allow you to change income levels, and even take ad hoc payments, subject of course to the overall maximum
- You can plan in advance the level of income you wish to take each year and influence the level of tax you pay on that income. You do not have to receive a fixed income and are able to vary it to suit your personal circumstances
- Your Pension Fund, less the plan charges and income taken from it, remains fully invested, allowing the potential for capital growth in a tax efficient environment
- The potential death benefit options are generally wider than under an Annuity
- Difficult decisions on the type of Annuity you need can be deferred until your personal circumstances/ objectives become clearer
- For those who qualify Flexible Drawdown will allow more income to be taken than has previously been the case

Disadvantages of Income Drawdown

- There is no guarantee that your income will be as high as that provided by an Annuity
- Future investment returns are unknown and the value of funds will fluctuate over time
- A combination of poor investment returns and high income withdrawals can reduce the value of your remaining fund. Withdrawing too much income in the early years may have an adverse effect on preserving the pension purchasing power or preserving the capital value of your fund
- The value of the remaining fund may not be enough to maintain income at the same level to that from an Annuity bought at the outset
- Death benefits payable as a lump sum will be subject to tax at 55%. However, the HMRC have advised that in most circumstances no Inheritance Tax will be payable
- Reductions in the Government Actuary's Department (GAD) rates in future could reduce the maximum income you are allowed to take
- Income Drawdown does not benefit from the mortality of others. This creates a 'mortality drag', which means that an additional level of investment return is required, over and above what is required to cover income and charges, to ensure that an equivalent Lifetime Annuity can be bought at age 75
- Income Drawdown can be a complex arrangement requiring annual reviews, and decisions to be made on desired income levels. Ongoing advice is needed, which is an additional cost to you or your fund

Phased Retirement

'Phased Retirement' is a process of 'crystallising' your pension fund in stages, rather than securing your retirement income all at once. This method uses only a part of the accumulated pension fund each year, and in particular uses the tax-free cash amounts for income purposes. This means that, particularly in the early years, it is possible to create a highly tax efficient income stream.

As only part of the pension fund is being used for income purposes, the remaining funds continue to be invested and remain under pre-retirement rules for death benefits, which are more tax efficient than post crystallisation rules.

Phased retirement can be conducted through sophisticated encashment processes, or alternatively by simply breaking down the pension fund into a number of segments.

By the nature of the arrangement, a series of small income streams are established each year. This can be through the purchase of an Annuity, or the transfer into Income Drawdown. The annuity can be lifetime, or investment backed, and will only be restricted by contract terms on minimum premiums. Normal annuity options will apply.

You can decide when you wish to phase in the value of your pension plan. Each element of phasing will provide the option of another tax-free cash lump sum, and will increase your pension income by the value of the Annuity purchased.

This will continue until your entire pension fund has been crystallised.

You may continue to make contributions to your plan to build up future pension income during this period.

Complexity

Phased Retirement can involve a complex series of contracts and should be understood by the investor.

Investment risk

Funds that have not been encashed remain invested and are exposed to normal investment risks.

Funds moved into Income Drawdown may also be invested.

Advice should be taken on the appropriate investment strategy.

Ongoing advice

This is a complex arrangement that will need annual management and advice, as well as ongoing reviews of the investment strategy.

Split funds

It is important to understand that the pension funds that have been used to generate an income, or tax-free cash, are treated as having been crystallised. These funds are treated differently than the remaining 'uncrystallised' funds in the event of death.

Advantages of Phased Retirement

- You can draw benefits from your Pension gradually with just some of the fund buying an Annuity or Income Drawdown plan in the earlier years
- As part of the 'income' is provided by tax-free cash, the level of income tax paid is minimised
- The balance of your fund continues to be invested in a favourable tax environment
- The older you become, the better the underlying Annuity rates are likely to be. However, the actual amount of Annuity income payable to you will depend upon the rates available at the time, and may be higher or lower than the rates currently available
- The uncrystallised pension fund can be returned to your beneficiaries on your death, and in normal circumstances this is free of inheritance tax
- You can vary the level of income each year according to your needs and tax position, although once you have bought a Lifetime Annuity this income will continue for the rest of your life

- You can choose to buy the type of Annuity which suits your personal circumstances on each occasion that you crystallise your pension fund, subject to the terms of each contract
- The lump sum death benefits can be higher with phased retirement than with Annuities or Income Drawdown
- You have the option to continue to contribute to your pension fund subject to the legislative limits applicable at the time

Disadvantages of Phased Retirement

- The tax-free cash lump sum entitlement is utilised for income purposes and is therefore not available for other expenditure. It is though still possible to encash the remaining funds in one event if required at a later stage, enabling you to benefit from a tax-free lump sum at that time
- Future investment returns are unknown and the value of units remaining invested in your pension plans will fluctuate over time, and this may not be to your advantage
- Annuity rates are not guaranteed and may be lower in future
- The value of your remaining Pension Fund when added to the Annuities you have already bought may not finally give you the same income as an Annuity would have given you at the outset
- They are complex arrangements usually involving annual decisions on what income is required
- Ongoing advice is needed, which is an additional cost to you or your fund, as agreed

Alternatively Secured

From 6th April 2011 Alternatively Secured Pension (ASP) will no longer be available.

Steps to consider leading up to retirement

Here at Investment Sense not only are we passionate about making sure you get the best possible result from your pension savings, we also like to offer practical help and ideas that actually make a difference.

We are specialists in what is known as the 'At Retirement' market, that is to say we help many of our clients convert their pension savings into income. As we have shown before, there are many ways to do this and we are proud members of the 'Offer More Options' Campaign.

However, we find that whilst more and more people are realising the value of advice and shopping about for the best option at the time of retirement, there are many things that could have been done in the years leading up to retirement that would have improved the income available.

Follow our six practical steps to help you maximise your income in retirement.

Take another look at how your pension is invested

We see many clients who have remained invested in equity based funds, that is to say they are invested in stocks and shares, right up until the day that they want to start taking an income from the pension.

There are countless times when we have seen an individual want to purchase an Annuity, for example, only to find that they are getting a lower income than they might have previously done because the stock market, and therefore the value of their pension, has fallen.

In the five years leading up to the time when you are likely to take an income from your pension, in whatever format you choose, take time to carefully consider how it is invested.

Remaining in equity based funds may be the right thing to do. However, as a general rule of thumb, the more likely you are to purchase an Annuity, perhaps because of the size of your fund or desire to avoid the risk associated with Income Drawdown, the more you should consider moving to safer investments.

Remember the State Pension

The State Pension can be an extremely valuable source of income, but we find many people do not know how much they will be entitled to until they reach the State Pension age. Even worse, some people don't even know what their State Retirement age is.

The State Pension may be derided by many; however it can form a significant part of your income in retirement and should be included in all planning.

It also makes sense to check that you have paid sufficient National Insurance to qualify for a full State Pension.

Of course you could just call us and we'll happily do the hard work for you.

Use the information you get about your State Pension carefully

So, you have found out what your State Pension will be, what next?

If you do not qualify for a full State Pension consider whether it is worth making additional National Insurance contributions.

Now consider how the amount of State Pension that you will be entitled to affects other income.

For example, we see many situations where a couple have a State Pension and other pensions, whether they be private or occupational, but these are all held by one of the couple, usually the husband, with the partner having no pension provision. This is not tax efficient, the partner with no pension will not use their Personal Allowance and the partner with the pensions will be paying more tax than is necessary.

Having pensions held by one person can be expensive. In the current tax year, the personal allowance i.e. the amount that can be earned without paying tax, is £6,475. Assuming a 20% tax rate, having all the pensions held in one person's name, with the other person's allowance going unused, would result in an extra £1,295 tax paid, and that's just in one year.

In an ideal world both husband and wife would use their full Personal Allowance, ensuring that income is arranged as tax efficiently as possible.

It is not possible to transfer pensions from one person to another (except on divorce). However there are ways, such as reallocating contributions from one person to the other, to try and equalise pensions so that your income in retirement is more evenly split and therefore more tax efficient.

Consider paying more into your pension

This might sound like an obvious piece of advice and not particularly imaginative, but take a step back and consider the benefits.

It's true that the closer to retirement the additional contribution is made, the less time it will have to grow, but consider the tax relief benefits. As you probably know, contributions to your pension are eligible for tax relief, meaning that for a basic rate tax payer, for every £80 personal contribution that is made; £100 is credited to the pension, the £20 difference being tax relief.

If you are a 40% tax payer even more can be claimed.

There are of course disadvantages to a pension, however the tax relief that contributions are eligible for can make them look very attractive, indeed, we see many people making quite sizeable contributions just on the strength of the tax relief that is available.

Further contributions could also be the answer to balancing up pension provision between spouses. If one spouse will not fully use their personal allowance in retirement, consider making pension contributions in their name. To obtain tax relief they will need to have earned income of their own; however serious consideration should be given to whose name pension contributions are made in.

Avoid any nasty surprises

If you decide that an Annuity, in whatever format, is the right choice for you, it can take some weeks to shop about for the best rate and put the Annuity in place, especially if you do it by yourself.

During this time, if you are invested in an equity based fund, we would strongly suggest that you consider switching into a Cash or Deposit based fund to minimise any nasty surprises. Who would have thought that the FTSE 100 would fall so much in the Spring of last year, who predicted the Greece crisis, the BP disaster, all things that will affect the value of your pension fund.

Most pension providers offer a Cash or Deposit fund, which will provide a short term safer haven for your money whilst you make up your mind about the best thing to do.

Yes, the market may increase whilst you are invested in Cash, but it could equally move downwards. A reduction in value is far more dangerous; after all, you are potentially stuck with the results of a fall in share prices for a very long time.

Plan, plan, and plan some more

All of the steps outlined above, along with making the right decisions when you do actually retire, will help you increase your income in retirement.

However, you need a coherent, considered strategy to get the best income possible in retirement and to work out exactly which of the steps outlined are right for you.

An Independent Financial Adviser can be invaluable when it comes to helping you plan your retirement strategy, and it needs just this, planning, the more planning you do, the better the result will be.



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