Your Retirement Options

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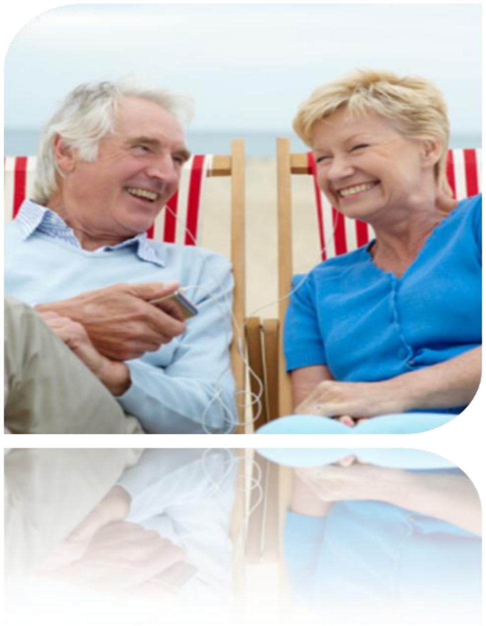
Introduction



This is a guide to retirement options for those with company money purchase or personal pensions. 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 to use the rest of the pension fund to purchase an annuity.

A lifetime annuity is a contract with an insurance company that pays you a guaranteed income for life no matter how long you live. Whilst this contract is suitable for many people it is important that you are aware of other options that provide more flexibility and choice. These are explained in more detail in this document.

This report explains and examines all the options that might be appropriate for your circumstances. It is for guidance purposes only. This report is not making any specific recommendations. Specific advice will be given only 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, as these will help you analyse each option in turn, and decide upon their appropriateness. These are covered in the first section called 'Key Considerations'.

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 "units can go down as well as up". However when we are considering your retirement income structure we need to consider a number of different risks that apply to this particular investment, 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

Although in 2009 we saw the rare occurrence of deflation in the economy, it is far more common for us to experience a constant level of inflation. The Government sets a target inflation rate for the economy and tasks the Bank of England to manage interest rates and other economic factors to meet the target.

The impact of inflation is to devalue an investment in 'real terms'. When we consider income this means a reduction in the spending power of the annuity. You will be able to buy less in the future than you can today if inflation is maintained through this period.

If inflation was to run at a constant 2% per annum then the real value of a £10,000 income today would be £7,386 in 15 years' time. 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 a lifetime annuity purchase can have a big impact upon 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 and the effect of more sophisticated pricing models.

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 a lifetime annuity rates may be lower than at present.

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 currently for a male at the age of 65 is over 17 years, and over 20 years for a female.

(see: http://www.ons.gov.uk/ons/rel/lifetables/interim-life-tables/2008-2010/sum-ilt-2008-10.html)

Some options described in this report remove longevity risk by promising to pay an income for the remainder of your life, and that of you 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 impaired or enhanced annuity rates rather than the normal lifetime annuity rates.

Investment risk

Several of the options described provide you with the opportunity to continue investing your funds for 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 we will need to consider the level of return required to make such a plan a success.

Typically as we target higher levels of return we may build up a higher level of risk on the fund. 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 offer a facility to limit the downside of the investment risk. This works by providing you with an underpin of either a minimum income, and/or a minimum fund value. Where these are available we will discuss this with you. Where such an option exists it will come with additional charges. We will need to consider whether the payment of such a charge is worth the potential benefit this provides.

We have tried to make it very clear in this report where investment risk applies. In the formal advice process we will be very clear with you about the level of investment risk we believe you are taking onboard.

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 and there is still the chance of dramatic changes in life.

It is important to consider how you see your retirement developing and life changes that may occur. Managing our finances during this time is very important.

Understanding how the decisions you are about to make with your retirement income will impact the way your income is structured is also very important. Some options offer no future flexibility or possibility of change; others offer the opportunity to change a certain points in time; and others offer full flexibility. However 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.

△ **It is important for you to understand these options and for us to understand your needs. Our advice process will start by discussing your objectives in retirement and any specific needs you may have.**

❖ Death benefits

How you provide for your spouse, or partner, should you pre-decease them is a very important consideration in selecting the most appropriate option(s) 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, and provide your desired peace of mind.

If you arrange an annuity you can select to have a joint life option and or a guarantee 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 'drawdown pension' rules such as drawdown pensions, guaranteed drawdown pension and fixed term annuities.

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

❖ 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 but where the spending power is reduced by inflation
- ✓ 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 change from year to year

The range of options

Over recent years, as a result of changes in legislation, more modern and flexible alternatives have appeared - alternatives that allow you to take control over your future income needs, death benefits and the investment of your pension fund. You now have a number of different options. This report considers these 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:

1. Deferment
2. Buying a lifetime annuity
3. Buying an Investment linked annuity
4. Buying a fixed term annuity
5. Phased retirement with lifetime annuities
6. Scheme Pension
7. Drawdown Pension
8. Guaranteed Drawdown Pension

By considering each of the options in turn, we will be able 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.

△ Things you should also be aware of:

If you are a member of an occupational pension scheme and can control/influence how your pension benefits are taken you may have an additional alternative to the above options. Please contact us for further information.

Triviality – if your TOTAL pension funds are currently less than £18,000 (2012/2013 tax year) you may be able to access all of the funds – subject to income tax on 75% of your fund value.

1. Deferment

We should always consider the option of deferring your pension benefits to a future date if this is possible. Sometimes pension benefits are taken simply because we think they have to be taken. People are often still healthy and active at the normal age of retirement, and may actually want to continue to work. It is often possible to defer 'crystallising' (by which we mean drawing some or all of your pension fund benefits) the pension fund and use other investments or income sources to cover expenditure requirements.

Pension funds are highly tax efficient investment vehicles. Monies invested in a pension fund are largely tax free. The investment strategy in deferment should be carefully considered to ensure that the fund is not exposed to inappropriate risk.

Should you die before your fund is 'crystallised' your pension fund monies can generally pass to your spouse, partner, or indeed your estate without inheritance tax being applied. This allows a surviving spouse for instance to use the whole fund to secure a lifetime income, or invest these monies for income purposes.

Advantages of deferment

- The pension fund remains fully invested in an appropriate environment.
- At any point in time, annuity rates are better for older lives.
- Deferring annuity purchase may allow you to take advantage of a future fade in health.
- An alternative income stream may provide greater tax efficiency.
- Social security benefits may still be available.

Disadvantages of 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 the fund could fall in value in the deferment period.

△ **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. This lump sum, or the increase in State benefits, are both treated as income for tax purposes.**

2. Buying a lifetime annuity

Historically, the most common way to take retirement benefits is to take the maximum tax-free cash sum available and use 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 simply provide an income based on the your age, normal life expectancy and the level of gilt and fixed interest yields upon which annuity rates are based.

This annuity gives you payments at agreed intervals (such as monthly) until your death.

You pass your pension fund either to the pension provider with which you have built up your funds or to another on the open market, to purchase as large an income as possible. 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 levels payable. These are discussed below

An impaired or enhanced annuity:

An impaired or enhanced annuity offers you a potentially higher rate than normal, based upon your own health and lifestyle. If you are on any medication, or for example smoke, it can be possible to gain a higher income than normal. It is necessary to complete a simple health questionnaire to proceed on this basis.

An impaired life 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 for the cover. However, with an annuity, the less healthy you are the more likely you are to be able to enjoy a better annuity rate; which ordinarily means that more income will be payable. The annuity provider is expecting you to have a shorter period in retirement than the average person of the same age in the UK and is therefore prepared to pay you a higher level of annuity income.

Maximising lifetime annuity income

After considering your personal health and lifestyle, we can maximise income by limiting the number of additional options we select when purchasing your annuity. An annuity with no options will stop when you die, and never increase in value. It is therefore very likely to erode in real terms as the years progress. i.e. YOUR SPENDING POWER WILL DECLINE.

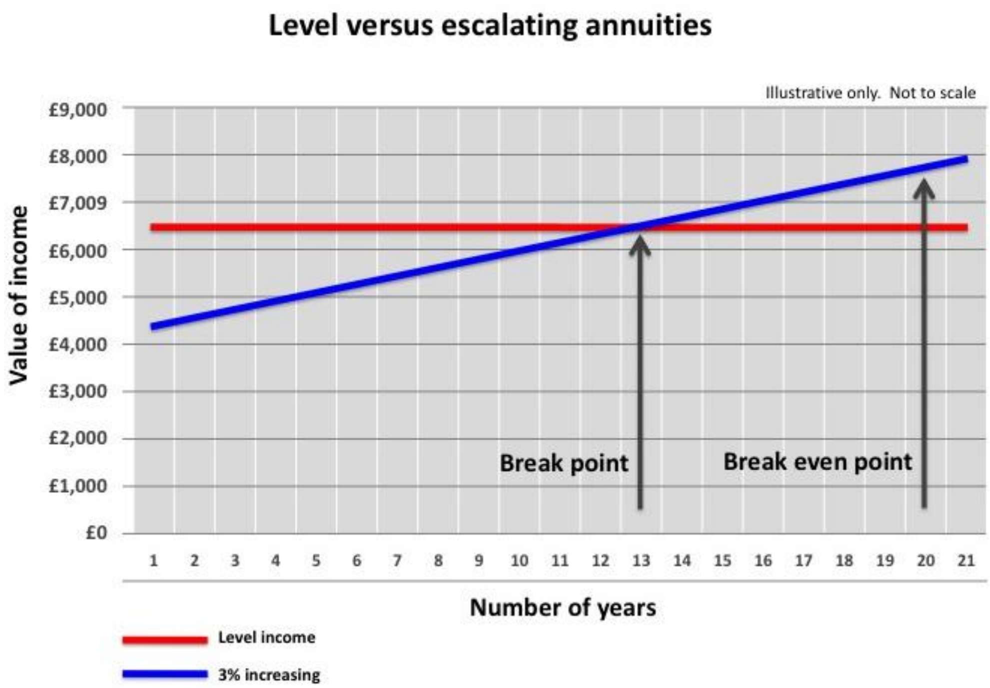
Guaranteeing your income payments

Lifetime annuity income is already guaranteed, however this simple option guarantees the income payments in the event of your early death. Income will continue to be paid at the full amount for the given period. This is normally 5 or 10 years from the date of annuity purchase. Note that the guarantee period does not start from the date of death. For example, if a pension was taken in January 2012 with a 5 year guarantee and death occurred in January 2014, income would be received until January 2017 – i.e. the guarantee would end 5 years after the income was started.

Increasing your Income year on year

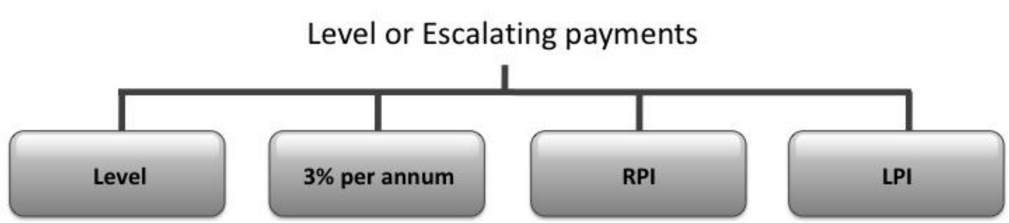
In order to protect the real value of your income, it is necessary to establish the annuity with annual increases. This is normally set at 3%, 5%, or at a level to match the Retail Prices Index (RPI). Increases will take effect on the annual anniversary of the plan.

Establishing an annuity with an increasing income will have a significant impact upon the level of starting income offered. This can be by as much as a 30% reduction for 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, see chart below:



A level income is particularly exposed to inflation risk. This means that the buying power of your income will be impacted as each year progresses and the cost of goods and services rise. The above chart shows a level annuity income compared to a 3% escalating income.

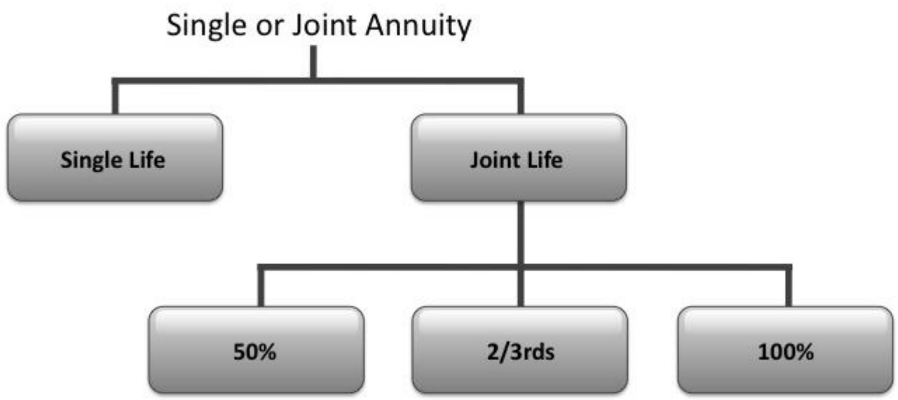
You will firstly see that the starting income is much lower for the escalating income. This takes approximately 13 years to catch up with the level annuity, at the break point. It takes approximately 19 years in total before the same amount of total income has been paid. This makes no account of interest that could have been earned on the difference in income if it had been saved.



- RPI is the Retail Prices Index and is an accepted measure of inflation.
- LPI is Limited Price Indexation, and follows RPI up to a cap of 5%. An LPI annuity has a higher starting income than RPI because of this limitation.

Joint Life/Spouses Pension

If you are married or have a financially dependent partner, the annuity can be set up to continue paying the income to your names dependant after you have died. This can be at the full rate, or a reduced level of say, two thirds, or a half. Selecting this option will reduce your starting income, and cannot be changed so if your partner predeceases you, your income will remain on the same basis.

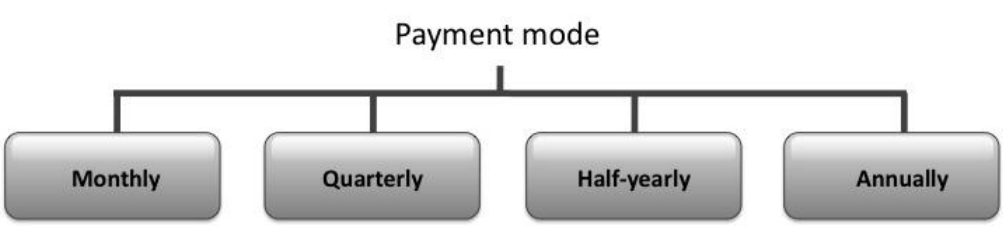


Value Protection

Some annuity contracts offer, upon your death, to pay back to your estate the value of your original investment less the total of any gross income paid to date. This ensures that overall you, or your estate will at least receive your money back over the contract period, subject to a potential tax charge of 55%.

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.



△ IMPORTANT POINTS TO NOTE WITH LIFETIME ANNUITIES

Irrevocable choice

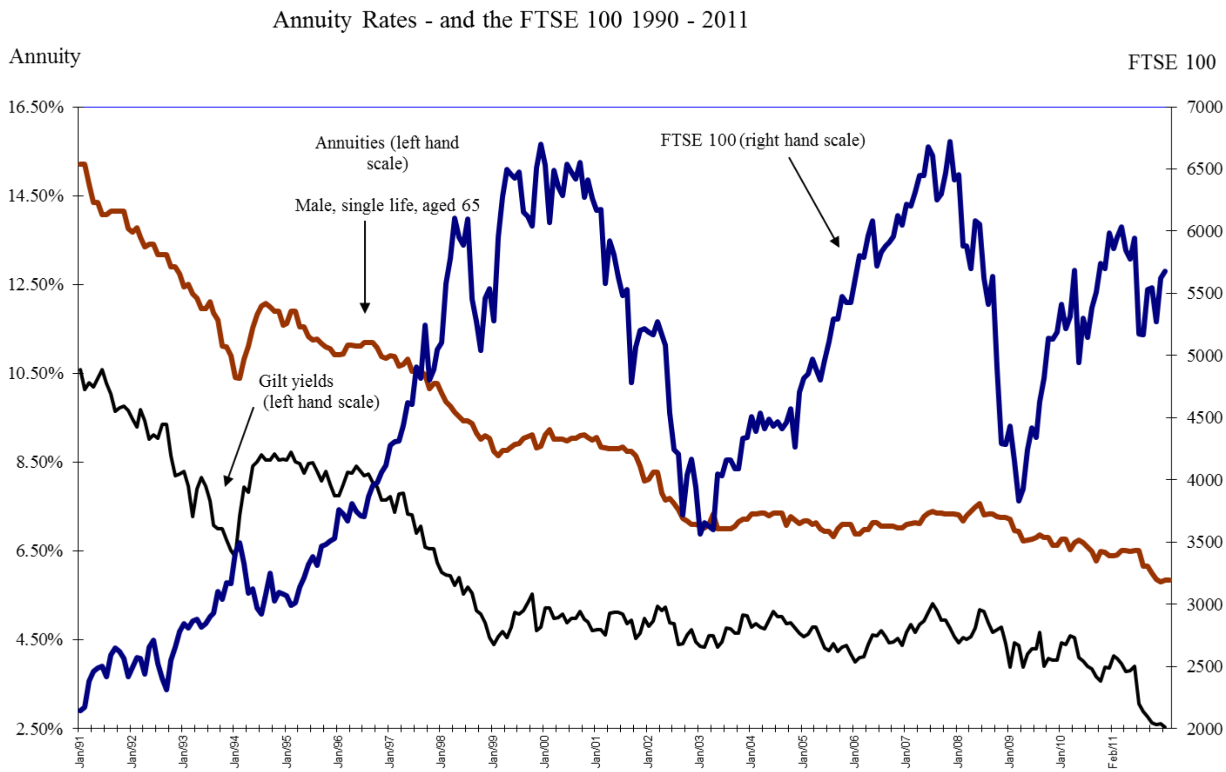
These options are available at outset only, and cannot be changed once the contract has been established. You must consider these options carefully and understand that a lifetime annuity income cannot be altered in the future to meet your changing circumstances.

Guaranteed Annuity Rates

There are 'Guaranteed Annuity Rates' that are written into some older Retirement Annuity and Personal Pension Plans that provide potentially higher annuity rates than current terms available. You may have to take your benefits in the structure dictated by the contract. Such terms are often very attractive and we will consider these closely.

Prevailing rates

Annuity rates fluctuate. Annuity rate levels affect the amount of pension that can be bought. Your pension fund will buy a larger pension if annuity rates are high than if they are low. Annuity rates have fallen along with interest rates and gilt yields over the last few years and this has resulted in a reduction of the purchasing power of annuity contracts. This is illustrated in the chart below.



Source: www.retirement-partnership.co.uk | Fund of £100,000 for a man aged 65, level pension, payable monthly in advance.

These figures go back to 1990 and give you an idea about the long-term trend in annuity rates.

This chart also shows the level of the FTSE 100 index. There is no relationship between the stock market performance and annuity rates, however the value of your pension fund may well be linked to the stock market, so the timing of an annuity purchase is important.

Advantages of a lifetime annuity

- You have immediate access to all of your tax-free cash.
- You can choose between a level or increasing income for life, which is guaranteed. This means you have no exposure to investment performance risk.
- The income is guaranteed to be payable for at least the rest of your life and is protected as a long-term contract of insurance under the Financial Services Compensation Scheme.
- The risk of you living a long time is transferred to the insurance company.

- Your income can be guaranteed for a certain period so that your income will continue to be paid for balance of the fixed period after your death.
- Depending on how long you live, you may get back more than you used to buy the annuity in the first place.
- They are relatively simple plans and usually do not involve ongoing planning and costs.

Disadvantages of a lifetime annuity

- Annuity rates may not be favourable when you buy your annuity. The pension you receive is dependent upon the value of your fund and annuity rates at the time of purchase.
- The level and structure of income is fixed at outset. Once the shape of income is established it cannot be changed, regardless of future eventualities. Income cannot be altered to account for changes in your personal circumstances, such as death of spouse or partner, inheriting money or additional income needs.
- You will not be able to benefit from improved annuity rates in later life, which may be available due to fading health.
- You are exposed to the risk of inflation eroding the value of your pension income. A level annuity presents the greatest risk. The real value of a level annuity can reduce by 25% over 15 years with just a 2% level of inflation.
- This option may represent poor value for money should you die early and do not opt for value protection, or a spouse's or partner's pension as explained above.
- 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 option and your spouse/partner predeceases you, then the cost of this benefit has been lost.
- The more features you choose, such as: guarantee periods; inflation proofing; spouse's benefit - the lower your starting income will be.

3. Buying an investment linked annuity

Investment linked annuities typically invest in unit-linked investment funds or with profit 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 available.

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, and establishing a guaranteed income period.

The income that you receive each year is not guaranteed and will be directly influenced by investment returns achieved. The negative impact of investment risk means that your income could be less than would be provided via a conventional annuity. Nevertheless, potentially there may be sufficient investment reward to produce an income that is higher than a conventional 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 annuity.

Some investment linked annuities are also marketed as ‘flexible annuities’. These contracts are fundamentally the same, however may offer you an increased level of flexibility on the level of income available, and when and how this can be paid. In the most flexible, income frequencies can be changed, and the level of income drawn from the contract can sit between a wide band of income levels, equivalent to 50% and 120% of prevailing annuity rates. This allows considerable flexibility in setting the appropriate income levels for each year.

In order to establish the starting level of income it is often necessary to make an assumption as to what the investment returns achieved are likely to be (the bonus rate declared by the with profit 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 return achieved, the higher the starting level of income. The higher the level of assumed investment return, the greater the risk that your future income may fall, if the assumed investment return is not achieved.

There is a range of products available with different variations in structure. Some 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 secured.

With profit backed annuities offer a smoothed level of investment returns and therefore a structure to limit the downside. The investment returns are typically declared each year by the with profit fund actuary, or is calculated by a sophisticated formula based process. Investors should consider the strength of the underlying fund, and the ability of the investment managers of the same fund.

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 by the age of 90. Most investment linked annuity contracts offer the opportunity to convert to a lifetime annuity at any stage up to your 90^{th} birthday.

Establishing the initial income level and the appropriate assumed return on investments must be considered carefully. A high income that is not matched by the appropriate investment returns will have a negative impact on future income levels. You 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’.

△ IMPORTANT POINTS TO NOTE WITH INVESTMENT LINKED ANNUITIES

Investment risk

Investment risk should be fully understood. The value of funds can go down as well as up

Financial reviews

Investment linked annuities 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.

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.

Product differences

Unlike lifetime annuities, investment linked annuity products differ in structure and type. Advice and guidance with these contracts is essential.

Advantages of an investment linked annuity

- You have immediate access to all of your tax-free cash.
- You can typically choose the level of income that you will receive, and this can fluctuate it in line with investment returns.
- Investment linked annuities offer the opportunity to grow your retirement income in line with investment returns.
- You may be able to vary your level of income allowing you to match income tax bands; offset other incomes; or take ad hoc income payments.
- Your pension income payments can be ‘guaranteed’ for a certain period so that your income will continue to be paid for the balance of the fixed period after your death (subject to the risks outlined above).
- Depending on how long you live, you may get back in income more than you invested in the annuity in the first place.
- Some products provide the benefit of ‘mortality credits’.

- Most allow you to convert to lifetime annuity a future date. Some allow this on an open market basis giving the advantage of future changes in personal circumstances.

Disadvantages of an investment linked annuity

- Investment returns may be negative and this could seriously impact the level of future income available.
- Your income may fluctuate on occasions, since 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.
- They are more complex plans and require ongoing advice with regard to any changes that you may require.
- Ongoing advice costs may be incurred.

4. Buying a fixed term annuity

Fixed term annuities provide regular income payments, as with a lifetime annuity, but this time only for the term selected, rather than for life.

At the end of the term a guaranteed maturity value is provided. This can be invested in another pension income product which could include a further fixed term annuity), a conventional lifetime annuity, investment linked annuity, enhanced annuity or income drawdown. Other options may also be allowable at this point dependent upon the pension legislation in force.

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.

A fixed term annuity is usually free of investment risk as the income payments and the level of maturity value available at the end of the term are guaranteed. However the annuity rate available at the maturity date is not known and presents the key risk to future income levels.

At the end of the fixed term, should your health have changed, it may be possible to purchase an impaired or enhanced annuity. This may mean that a much higher level of income is available at this stage. Some fixed term annuity providers allow for you to switch to an impaired life annuity during the term, should your health deteriorate to such an extent that you qualify for an impaired life annuity. In such instances medical evidence may be required and a transfer value is calculated.

There are two types of fixed term annuity:

- A standard fixed term annuity which is not investment linked and has a guaranteed income and guaranteed maturity value. The amount of income received from the point of retirement is likely to be comparable to that of a conventional lifetime annuity and the income will cease at the end of the term. At this point, the guaranteed maturity value will be available for you to reinvest in another product. The guaranteed maturity value is free of any investment risk and is known at the outset of the arrangement. If you choose the default income it is set at the level that aims to provide you with a comparable level of income for the rest of your life, assuming that underlying annuity rates do not change.

- An investment linked fixed term annuity which is similar to the lifetime investment linked annuities described earlier but only for a fixed term. Once again at the end of this term the maturity value becomes available for reinvestment in a new fixed term annuity or alternative retirement income product.

Fixed term annuities are available for terms of three or more years and at the end of the fixed term, should your health have changed, it may be possible to purchase an impaired or enhanced annuity. If you are in good health at present there may be a benefit in seeking to delay the purchase of a conventional lifetime annuity until a later age in order to seek to capture the benefits of health fade.

You are more likely to contract a medical condition that results in your health fading (whether this be to a very limited or significant extent) between now and age 75 than in the years leading up to this point. Impaired or enhanced annuities can provide a significant increase in annuity income. The availability of such annuities in the future is dependent on the willingness of providers to offer them.

Death benefits

A range of options can be included at the outset to provide death benefits should you die within the term these include:

- **Value Protection:** This returns the original purchase price to your estate or nominated beneficiary less the monetary value of any gross income paid to date. This effectively provides a ‘money back’ structure to the contract. This lump sum will be subject to a 55% tax charge unless it is reinvested in another appropriate pension product, in which case the tax charge does not apply.

- **Return of current fund value:** This returns the current fund value at the time of death as a lump sum. This lump sum will be subject to a 55% tax charge unless it is reinvested in another appropriate pension product, in which case the tax charge does not apply.

- **Dependents Pension:** It is possible to continue the same level of income payments for the remaining term of the contract. The guaranteed maturity value is then available for reinvestment by the surviving partner in their own name.

- **Guaranteed Income Payments:** In a similar way to a lifetime annuity it is possible to structure the fixed term annuity to ensure that the income will be paid for a specified number of years from the start of the contract, even you die in the early years.

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

△ IMPORTANT POINTS TO NOTE WITH FIXED TERM ANNUITIES

Annuity rate risk:

Future annuity rates are an unknown. The rate available at the future maturity date may be lower, or higher than current rates.

Income reviews:

Fixed term annuities are written under drawdown pension rules that require a review of maximum income levels every three years. If your plan term is fixed for longer than three years a review of the maximum income is required by legislation. This may cause a reduction in the level of income that can be paid, particularly if the maximum income levels have been selected, though you will usually receive any 'held back' income at the end of your term.

These limits are set by the Government Actuary's Department (GAD).

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 annuities expire at the end of the agreed term and offer you the opportunity to review and select the most appropriate income structure at that time. It is not usually possible to exit the contract during the term though some providers offer a switch or transfer should you qualify for an enhanced/ impaired life annuity when qualifying conditions are met.

Advantages of a fixed term annuity

- You can receive all of your tax-free cash lump sum at outset
- You receive a fixed income for the duration of the term of the plan, which cannot fall provided that it remains within Government Actuary's Department limits.
- You have no exposure to investment performance risk, unless you choose an investment linked fixed term annuity, as your income, and maturity amount is guaranteed for the term of the annuity.
- At the end of the term you can use the maturity value available to purchase the amount and shape of income that is appropriate to you at this point, subject to the prescribed limits and depending on the underlying annuity rates available to you.
- You may be eligible for an enhanced or impaired life annuity if your health has faded in the period between establishing the fixed term annuity and the maturity date of the plan. This may lead to a significantly higher income.
- Should you die within the fixed term period a number of options are available for the payment of benefits, or investment value.
- The Value Protection death benefit, if selected, ensures that you or your spouse and/or dependents receive the full value of the purchase price of the annuity, by the repayment of the amount originally invested, less the value of any income payments actually made (although this benefit will be subject to a tax charge of currently 55% unless reinvested in another appropriate pension product).
- The alternative death benefit structure can ensure that the income continues to be paid to your surviving spouse and the guaranteed maturity value is made available at the end of the fixed term to provide an annuity income based on your partner's own requirements and circumstances.
- This style of annuity enables you to reinvest the guaranteed maturity value in any form of allowable pension product (i.e. a conventional lifetime annuity, another fixed term annuity, an investment linked annuity, or a drawdown pension. As such it provides considerable flexibility.

Disadvantages of a fixed term annuity

- Your income options are fixed for the term of the annuity at outset and cannot be altered to take account of changes in personal circumstances, during the term.
- Your pension income cannot be altered in value during the term (except for any contractually agreed increases in payment) to take account of fluctuations in supplementary sources of income or to take account of the effect of inflation.

- The income you receive is dependent upon annuity rates at the time of purchase or the on-going investment performance. Annuity rates are currently low when compared to historical rates –see previous chart.
- Whilst the maturity value of the plan may be 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 income can be exposed to inflation risk for the term. This means that the spending power of the income received can be reduced by the increasing cost of living.

5. Phased retirement

'Phased retirement' is a process of 'crystallising' your pension fund rather than a particular product type.

This method uses only a part of your 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.

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 a drawdown pension. The annuity can be lifetime, or investment backed, and will only be restricted by contract terms on minimum premiums. Normal annuity options will apply.

It is possible to use fixed term annuities and the process to construct this will be the same as using an unsecured pension, with partial transfers being made from the personal pension fund. So for example a series of fixed term annuities can be used, allowing consolidation of income contracts at a later date.

You can decide when you wish to phase your pension plan. Each crystallisation will provide a 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.

△ IMPORTANT POINTS TO NOTE WITH PHASED RETIREMENT

Complexity

Phased retirement can involve a complex series of contracts and should be understood by you.

Investment risk

Funds that have not been encashed remain invested and are exposed to normal investment risks. Funds moved into 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 pensions gradually with just some of the fund buying an annuity 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 pension fund continues to be invested in a favourable tax environment. This allows you to take advantage of investment opportunities as they arise with the possibility of a higher future income.
- 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. You are exposed to annuity rate risk.
- The uncrystallised pension fund can be returned to your beneficiaries on your death, and are 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 drawdown (described later).
- 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 possible to encash the remaining funds in one event if required.
- 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 decrease in future in line with yields on Gilts and other fixed interest investments and changing life expectancy.
- 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.

6. Scheme pension

Scheme pensions have been available for many years, although typically only through occupational pension schemes. This is now a more widely available option but is a complex option, which needs both initial and ongoing advice.

A scheme pension is unlike other forms of annuity, in so far as the pension income is drawn directly from the fund, in a similar way to a drawdown pension.

The pension fund remains fully invested, typically in a self invested environment and will therefore carry the associated risks involved. This also allows you to explore a range of investment opportunities in the future.

The income payable is agreed with the scheme actuary and set according to your personal circumstances. This may change over time to reflect changing health and circumstances. A key principle of the scheme pension is to allow the fund erode over time.

A scheme pension offers a bespoke pension income, payable from your own pension fund.

This is not a guaranteed income, although some guaranteed investments could be built into the investment strategy.

△ IMPORTANT POINTS TO NOTE WITH SCHEME PENSION

Complexity

A scheme pension is a complex proposition and requires ongoing advice.

Investment risk

The funds can continue to be invested in a wide range of assets. An appropriate investment return will be required to cover the income and charges from the plan.

Risk of longevity

Income levels are established having made certain assumptions on life expectancy. Living longer than these assumptions may mean that incomes have yet to be reduced in the future.

Advantages of a scheme pension

- Income levels are set according to personal circumstances.
- Income can be higher, particularly post 75.
- Fund depletion is a factor of the assumptions.
- Income payments can be guaranteed for a predetermined 10 year period, and are reviewed every three years to ensure sustainability.
- Spousal benefits can be paid up to previous income levels.
- The client continues to remain invested and can benefit from excess returns.

Disadvantages of a scheme pension

- Investment returns may be negative and can seriously impact the level of future income available.
- Your income may fluctuate on occasions, since the income is dependent on the rate of investment return achieved and the initial assumptions made.

- These are more complex arrangements and they will require ongoing advice and review.
- You are not participating in the mortality pool available under annuities.
- Ongoing advice costs may be incurred.

7. Drawdown pension

A drawdown pension allows income to be taken directly from the fund, as with a scheme pension, however the level of income to be paid can be chosen by the investor. The actual income levels can change, and vary according to needs and personal circumstances. There is no minimum level of income that needs to be taken, which means that you can take the tax-free cash alone and defer income to a later time.

When income is to be taken there are two types of income drawdown being capped drawdown and flexible drawdown.

Under capped drawdown the maximum income limit is set by the Government Actuary's Department (GAD). Your maximum income is set at the start of your plan, and reviewed every three years before age 75 and annually after. The maximum is set to roughly equate to a single life annuity without any increases. There is no minimum income that must be taken.

Flexible drawdown is only available for those who can demonstrate a minimum level of secured income. Those who meet the Minimum Income Requirement (MIR) of £20,000 p.a. from a combination of certain scheme pensions, lifetime annuities and State pensions, can use flexible drawdown for the remainder of their pension funds. This allows them to take uncapped levels of income from the fund.

The pension fund remains fully invested while in drawdown so 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. Drawdown plans which provide a guaranteed income are covered in section 8.

In addition to this an additional level of growth is required if, at say age 75, the same level of annuity were to be purchased as at the entry date. This is caused by the 'mortality drag'. In a lifetime annuity the purchase premiums are all pooled together to provide the annuity incomes. When an individual dies, part or all of their fund is used for the provision of other incomes. An investor in a lifetime annuity therefore gains from the mortality of others. In order to make up for this advantage, the drawdown pension fund needs to achieve an additional level of investment return over and above the level to cover income and charges.

On death the drawdown pension fund can be used to provide death benefits in a number of ways:

- The remaining fund can be used by the surviving spouse/partner to purchase a lifetime annuity, or other income product including a drawdown pension, in their own name.
- The remaining fund can be paid to the surviving spouse/partner, or any other nominated beneficiary, as a cash lump sum, after a 55% tax charge.

Drawdown presents a number of risks. In particular investment risk, which could mean that the annuity available at say 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.

Product options have now been developed to mitigate some of this risk. Please note that it is now possible to build in guarantees in relation to your death benefits, and income levels within drawdown plans. These guarantees do increase the charges on the plan, however may provide the peace of mind required to be able to take advantage of the investment opportunity, income flexibility, and death benefits otherwise not available through a lifetime annuity. This is covered in section 8.

△ IMPORTANT POINTS TO NOTE WITH DRAWDOWN PENSIONS

Investment risk

Investment risk should be fully understood. The value of funds can go down as well as up. The impact of underperformance can mean that there will be insufficient funds at a later age to buy the same level of lifetime annuity that could have been purchased at the entry to the plan.

Financial reviews

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.

Contract differences

Drawdown plans differ in structure and type. In particular the level of investment choice and therefore risk in the contract can vary significantly.

Advantages of drawdown pensions

- Immediate access to all of your tax-free cash.
- Drawdown avoids the need to purchase a lifetime annuity.
- Income may be taken from your plan each year. The minimum income is zero and the maximum (for capped drawdown) is set for you as mentioned above. This allows a high level of flexibility in your income. Most plans will also allow you to change income levels, and even take ad hoc payments.
- 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 between prescribed limits to supplement other sources of income.
- 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 benefits are generally better than under an annuity (but usually not as good as phased retirement).
- Difficult decisions on the type of annuity you need can be deferred until your personal circumstances/objectives become clearer.
- The full remaining fund value is available to a surviving spouse/partner on death to provide an income based on their circumstances. Or the remaining fund can be paid as a lump sum (less tax) to any nominated beneficiary.
- Future legislation changes may benefit you.

Disadvantages of drawdown pensions

- 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 remaining invested in your plans will fluctuate over time.
- A combination of poor investment returns and high income withdrawals can reduce the value of your remaining pension 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 your remaining pension 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 in most circumstances no Inheritance Tax will be payable.

- Reductions in Government Actuary's Department (GAD) rates in future could reduce the maximum income you are allowed to take. In this respect the allowable maximum and minimum income levels are recalculated every three years (before age 75).
- A drawdown pension 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.
- Drawdown pensions can be complex and require 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.

8. Guaranteed drawdown pension

It is now possible to buy protection against falling investment values, in the form of drawdown pension plans which include explicit guarantees. With these products, you are guaranteed to receive a guaranteed income for life irrespective to the ongoing performance of the investments. There are often guaranteed death benefits as well.

These guarantees allow you to retain control of your pension fund in terms of where it is invested but with a guaranteed income. The fund can go down as well as up but the fund can benefit from strong markets that give as larger fund for use in the future, while at the same time insuring you always have an income for life if markets do not perform well.

By insuring at least part of your pension income you can protect an element of the income you receive from your pension fund from falling below a minimum level in the future. The provider will promise to pay you at least a certain guaranteed amount every year until you die. Additionally, if your investments perform well, that income may go up over time, but if they perform badly, your income is still fixed at a minimum guaranteed level.

At any point in the future, the fund value of the pension (less any charges outstanding at the time) is still available. This means that if an annuity or other suitable pension solution is more appropriate for your circumstances you can move the fund. Speaking to a financial adviser to do this is recommended.

Some providers use a sophisticated risk management program to buy assets which will match changes in the underlying investments so there are always sufficient assets to provide you with the guaranteed income regardless of market conditions.

As these plans are effectively drawdown pensions, many of the advantages and disadvantages and important points are the same but there are some key differences:

△ IMPORTANT POINTS TO NOTE WITH GUARANTEED DRAWDOWN PENSIONS

Investment risk

Investment risk should be fully understood. The value of funds can go down as well as up. The impact of underperformance can mean that there will be insufficient funds at a later age to buy the same level of lifetime annuity that could have been purchased at the entry to the plan.

Financial reviews

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.

Contract differences

Drawdown plans differ in structure and type. In particular the level of investment choice and therefore risk in the contract can vary significantly.

Advantages of a guaranteed drawdown

- Immediate access to all of your tax-free cash.
- Drawdown avoids the need to purchase a lifetime annuity.
- Income may be taken from your plan each year. The minimum income is zero and the maximum (for capped drawdown) is set for you as mentioned above. This allows a high level of flexibility in your income. Most plans will also allow you to change income levels, and even take ad hoc payments.
- With guaranteed drawdown, you know in advance what your minimum income will be over the period of your investment and have certainty. If you take higher than the guaranteed income, future income payments may be less.
- 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 between prescribed limits to supplement other sources of income.

- 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.

- You can continue to invest in higher-risk assets and can benefit from any returns whilst having downside protection.

- Gains are usually 'locked in' periodically (generally annually), and cannot be taken away. These gains will increase the level of income that can be taken.

- The full remaining fund value is available to a surviving spouse/partner on death to provide an income based on their circumstances. Or the remaining fund can be paid as a lump sum (less tax) to any nominated beneficiary.

- The potential death benefits are generally better than under an annuity (but usually not as good as phased retirement) and with guaranteed drawdown death benefit guarantees are usually included which could enable guaranteed income to continue or a minimum amount of lump sum to be paid.

- Difficult decisions on the type of annuity you need can be deferred until your personal circumstances/objectives become clearer.

- Future legislation changes may benefit you.

Disadvantages of a guarantee

- There is an additional cost involved in such contracts and as you will be paying an additional charge for the guaranteed income, your fund will grow at a slower rate than if you had invested in the same product without the guarantee.
- 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 remaining invested in your plans will fluctuate over time.
- A combination of poor investment returns and high income withdrawals can reduce the value of your remaining pension 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 your remaining pension 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 in most circumstances no Inheritance Tax will be payable.

- Reductions in Government Actuary’s Department (GAD) rates in future could reduce the maximum income you are allowed to take. In this respect the allowable maximum and minimum income levels are recalculated every three years (before age 75).

- A drawdown pension 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.

- Drawdown pensions can be complex and require 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.

Risk warnings and important information

All the alternatives to conventional lifetime and fixed term annuities involve some investment risk. You should be aware that:

- The value of your invested pension fund can fall as well as rise.
- Past performance is not a guide to future investment performance or returns.
- High income levels may not be sustainable.
- Taking withdrawals may erode the capital value of your fund and result in lower income in the future.
- The level of maximum withdrawal is reviewed every three years and annually after age 75, and this could result in the level of income you receive being reduced in the future.
- When and if you eventually purchase an annuity, the actual annuity rates may have reduced to a lower level than at present.

This document is based on our current understanding of legislation, which may be subject to changes in the future. This document is for information only and should not be taken as advice or acted upon. We recommend you take advice before making an important decision.

All income is treated as earned income and subject to income tax at your highest rate.

Where we have referred to tax in this document please note:

Tax treatment depends on individual circumstances and may be subject to change.

Updated April 2012

△ Recommended additional reading

- The Financial Services Authority – FSA – have produced useful publications such as:
- 'Retirement Options' 'Income Withdrawal' 'Managing in Retirement'

  These may be downloaded from the following web address:
  http://www.moneymadeclear.fsa.gov.uk/tools/publications/publications.html