

# Pension Options at Retirement

## Introduction

When you near retirement you are faced with a number of decisions to make and **some of the most important will concern your pension provision**. These decisions are often so major that they can affect the rest of your life.

This Fact Sheet is **designed to assist those who are approaching retirement**. If this includes you, then you may have pension benefits in respect of **several occupational pension schemes** reflecting your work for different employers over the years. You may also have a **number of personal pension plans** and/or retirement annuity contracts to which you have contributed small, or large amounts at different times in your working life. Then there are your **State benefits** to consider.

## The Changing Face of Retirement

According to research by Paternoster, the **life expectancy of the average man in the UK**, who is retiring today at age 65, **has risen more quickly over the last decade** than in any other G8 country, that is, the United States, Canada, Britain, France, Germany, Italy, Japan and Russia.

The average UK man can now **expect to live for another 20 years after retiring at age 65**, a two year increase just in the last decade.

However, this hides the fact that life expectancy in parts of the country, most notably the North East and Wales is lower than the rest of the UK. **So the average man retiring today at age 65 in the South East of England** is more likely to be able to look forward to almost 25 years of retirement.

Although this research highlighted the increasing life expectancy of men, the average 65 year old UK woman can **expect to outlive the average man of the same age by a further 3 years**.

'When historians look back on the 20th Century, its defining characteristic may be neither its two world wars nor its explosion of technological innovation. Instead, what is likely to stand out most as the transforming element of the world we live in is the stunning rise in human longevity, particularly that enjoyed at older ages.'

Special Report - Financial Times - 17.11.2004

'Longevity is the 21st century's ultimate strategic issue. It effects every aspect of social and political life.'

Richard Jackson, Senior Fellow  
The Global Aging Initiative  
The Centre for Strategic and International Studies  
Washington

In 2001 there were 17.5million people aged between 50 and 80 in the UK, which represented 38% of the total adult population. It is projected that by 2031, 46% of the adult population will be in this range.

Government Actuaries Department 2001

'We are not facing a pensions crisis. What we face is a retirement crisis. Retirement should be a process, rather than an event, a journey, rather than a destination. Individuals could have a whole new phase of life that previous generations never envisaged: gradual and flexible retirement.'

Ros Altmann  
Specialist in Pensions Economics  
and a governor of the London School of Economics

## State Pension Benefits

Many people believe that there are no decisions to make concerning their State pension benefits but this is no longer true.

It is **important to know as accurately as possible** what your State pension entitlements are, so that **you can be aware of your overall tax rate** in retirement. This **will have a impact on choices** such as the benefits of part-time work and which spouse should hold most of the savings etc.

Having a clear idea of your State benefits will also help you decide **how much pension you need to produce** from your various occupational and private pension arrangements and **how much you can afford to commute** into cash within the limits imposed.

You can **obtain a forecast of your State pension benefits online** via the Pensions Service website ([www.thepensionservice.gov.uk](http://www.thepensionservice.gov.uk)).

From the same website **you can also print off the State Pension Forecast Form (BR19)** and then post it to the Pensions Service offices at Newcastle. Copies of BR19 are **also available from Post Offices**.

## Deferring State Pension Benefits

If you are **planning to retire gradually** because you are able to work part-time or carry out some consultancy work, **you may wish to consider whether you should defer** taking your State pension for a year or more.

The Basic State Pension (and any additional state pension) **does not have to be taken at state pension age**, it can be deferred indefinitely. If the basic state pension is deferred, the original amount of basic state pension due at state pension age **will be increased by 1% for every five weeks it is deferred**, equivalent to approximately 10.4% for each full year of deferred.

As an alternative to taking a higher pension after the period of deferment, **you also have the option of taking a lump sum**. To get a lump sum payment, the **pension must be deferred for at least a year**. The interest rate used to calculate the lump-sum entitlement will be **at least 2% above the Bank of England base rate**.

If you opt for an increased state pension, **it is payable for the rest of your life**. If you elect to take the cash sum, it is a one-off payment and your weekly pension is then paid at the normal rate.

It is important to note that **if you qualify for Pension Credit** any increased state pension you receive will be treated like any other income for the purposes of calculating the Pension Credit. If you elect to receive **a cash sum, on the other hand, it is ignored for Pension Credit**, Housing Benefit or Council Tax Benefit.

An increased state pension is **subject to income tax in the normal way**. The cash sum is also subject to tax but **you will not pay a higher rate on the cash sum than you will pay on other income you receive** in the tax year the cash sum is paid.

If you **die during the period of deferment** your spouse's pension would be increased or your spouse could receive a lump sum so long as you had deferred your pension for at least a year.

The simplest way to look at **whether deferral of your State pension is beneficial** is to look at the lump sum. In this case the lump sum created by the deferred pension amounts would currently be earning 7% pa interest (ie 2% above Bank Base Rate). **Can you obtain a better net return than 7% pa elsewhere?** Certainly not if you are a cautious investor.

An option for medium to higher risk clients could be to **take the State pension and to re-invest it into a personal/stakeholder pension plan**. You will pay tax on your State pension but your new pension plan will claim that back.

By investing the gross amount **you are taking the risk that your fund in 5 years will be more than the deferred fund offered by the Government**. You would currently have the advantage of being **able to take a 25% pension commencement lump sum** (ie tax free cash) from the new pension.

You should be aware that if there is a market downturn in 5 years time you would need to defer taking your pension.

Do not forget that **you may also have a separate personal pension plan that has been funded by national insurance rebates** if you contracted out of the previous State Earnings Related Pension Scheme (SERPS) or the current State Second Pension (S2P).

## Occupational Pension Schemes

If all, or part, of your pension provision has been built up through one or more occupational pension schemes **it is important for you to know what type they are**.




Such schemes may provide a known amount of pension and these are '**defined benefit**' schemes, more commonly known as 'final salary' schemes. That is, the pension that you can expect to receive is defined as a percentage of your 'final salary' for each year of membership in the scheme.

If you have benefits from a final salary scheme **it is usually in your interests to take the benefits provided by your employer** as these are not dependent on current annuity rates.

It is possible to take a transfer value to a private pension arrangement at, or prior to, retirement but you need to be very sure of what you are doing and **you may lose out financially if you do so**. This is a situation where obtaining advice from an independent pensions specialist is vital.

Unfortunately, many defined benefit pension schemes are **suffering from a shortfall of capital in the pension fund** compared to that required to fully pay the promised pension benefits. This could mean that your pension benefits are lower than you might have expected.

This 'shortfall' may have been caused by any number of things. Among them might be:

-  **poor asset allocation in the pension fund** (ie the overuse of equities prior to the market crash of 2000 to 2003 and the equally disastrous overuse of bonds as the markets moved ahead strongly from 2003 to 2006);
-  **poor actuarial advice** (ie not appreciating the impact on annuity rates of improving life expectancy and reducing interest rates);
-  **or too low a level of funding by the employer** over many years which was not appreciated because of the strong stock market growth in the 1990s.

Other occupational pension schemes **simply build up a fund which you convert into a pension at retirement**. These '**defined contribution**' schemes, more commonly known as 'money purchase' schemes.


That is, **the pension that you will receive depends on a number of unknown factors** such as the investment return on the fund, the charges that are applied and the level of annuity rates when you are due to retire.

If you have benefits from a money purchase scheme **it is in your interests to take independent pensions advice** to help you explore the full range of pensions offices to find the best pension that you can purchase with this under the **'open market option'**.


## Personal Pension Plans and Stakeholder Pension Plans


A personal or stakeholder pension plan is effectively a money purchase pension. When you near retirement, **the pensions office will provide you with various options** of annuity (ie a pension for life) and pension commencement lump sum (ie tax free cash).


Essentially you have the following main options:


 You may **purchase a 'secured pension'**, that is a conventional annuity (ie a known level of income for life). This could provide a level or increasing income. You could take a pension commencement lump sum and utilise the balance of your fund to purchase the conventional annuity.


You can either do this **with your current pensions provider** or **transfer the fund first to another pensions provider** (using the open market option) to obtain a more competitive annuity rate.

 You may **purchase an investment linked annuity**. These are usually described as a **with profits annuity** or a **unit linked annuity** to reflect the type of underlying investment fund that is to be used.

 You may **use what is called 'phased retirement'** (also referred to as 'staggered vesting') to convert your retirement fund in stages, over a number of years, into income.

 You may transfer the whole value of your pension fund into an **'unsecured pension'**, that is a pension drawdown product. This allows you to **vary future income levels to fit in with your overall financial plan**.

 You may also use a **combination of phased retirement and 'unsecured pension'** so that you have a 'phased income drawdown' plan.

 Certain people aged 75 may **purchase an 'alternatively secured pension'**. This is designed for people whose religious beliefs prevent them from buying an annuity at age 75. The Government has made it clear that they will monitor this closely.

## Summary of The Main Options

Secured Pension (Annuity)	Phased Retirement
<ul style="list-style-type: none"> <li>■ An annuity gives you a regular and secure income for your lifetime.</li> <li>■ Your pension fund is encashed to provide a pension commencement lump sum (tax free), with the balance used to buy an annuity from an insurance company.</li> <li>■ You choose a level or increasing annuity payable monthly, quarterly or yearly.</li> <li>■ You can also buy spouse's or dependant's benefits, but this will reduce your own annuity.</li> <li>■ Once you have bought your annuity, you usually cannot change your mind or change the benefits, even if your circumstances change.</li> </ul>	<ul style="list-style-type: none"> <li>■ Instead of using your whole pension fund to buy an annuity, only part is used.</li> <li>■ The balance remains invested with a view to providing higher future benefits.</li> <li>■ Your starting annuity is smaller, but is supplemented by the pension commencement lump sum which can be spent as income</li> <li>■ In future years, you encash further parts of your fund to provide more cash and purchase further annuities.</li> <li>■ Because you do not commit all your funds to buy an annuity immediately, you keep your options open.</li> </ul>
Unsecured Pension (Drawdown)	Phased Income Drawdown
<ul style="list-style-type: none"> <li>■ Instead of encashing your pension fund, it is left invested and you draw a single pension commencement lump sum and an income if you wish.</li> <li>■ The maximum income is roughly a fifth more than an annuity. There is no minimum income or indeed a requirement to draw any income.</li> <li>■ You choose the income you want, and when you want it, up to the maximum level up to age 75.</li> <li>■ If investments do well, you may benefit from higher future income payments, and vice versa.</li> <li>■ On death, the remaining fund is available to pay benefits to your family or dependants</li> </ul>	<ul style="list-style-type: none"> <li>■ Part of your fund is moved into an unsecured pension (income drawdown) to provide a pension commencement lump sum and income.</li> <li>■ The balance remains invested to provide future benefits.</li> <li>■ You can draw further pension commencement lump sums and additional drawdown income when you wish.</li> <li>■ Tailor benefits to changing financial and personal circumstances.</li> <li>■ If investments do well, you may benefit from higher future pension commencement lump sums and income, and vice versa.</li> <li>■ Death benefits are even more flexible than under an unsecured pension.</li> </ul>

## Conventional Annuity

Although this is **the most straightforward option** you should still use the services of an independent financial adviser to find the pensions office with the best annuity for you by using the 'Open Market Option'.

Other areas that you need to consider, **even if you are going to purchase a conventional annuity** with your pension fund are:

- A** Should you take **the maximum pension commencement lump sum** (ie tax free cash)?
- A** Should you purchase a single life annuity, or **an annuity based on the joint lives** of you and your spouse?
- A** In the event of your death **what proportion of your pension should continue** to your spouse?
- A** Should your pension **increase each year** and, if so, by how much?
- A** Should you build in a **guarantee period** of five years or ten years in case you die early on?
- A** Could you qualify for **an enhanced or impaired life annuity** because of your medical history or lifestyle?

All of these options affect the income you will receive. **You need to know how much each one costs** and find the right balance of benefits for your circumstances.

## A With Profits Annuity

A With Profits Annuity provides an income that is **linked to the investment returns of an insurance company's with profits fund**. As for all investment linked annuities, **the income payable can go down as well as up** in the future.

With Profit Annuities do however provide **smoothed investment returns**. Smoothed investment means, in poor years, your income will not necessarily go down as much as the underlying investments have gone down. It also means that in very good years, not all of the investment return is necessarily paid out (some is retained to cover the bad years). So, With Profit fund returns **should be less volatile than other investment funds**.

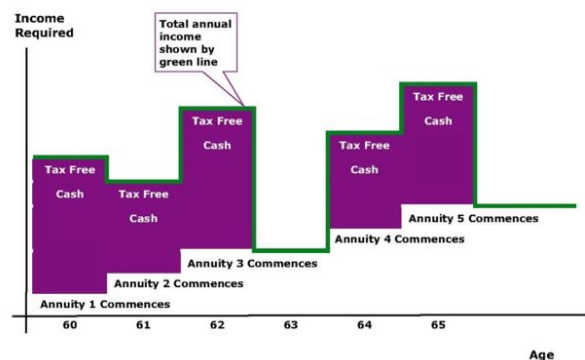
Typically, income is made up of two parts:

- A** **A minimum starting income** - This is set at a low level but, unless investment conditions are very bad, **you will usually get at least this much income provided you choose a 0% anticipated bonus rate**. Some with-profits annuities guarantee it.

- A** **Bonuses** - The insurance company usually announces bonus rates once a year. Bonuses can be both '**reversionary**' (usually announced once a year guaranteed to pay out for the duration of your annuity) and '**special**' – these only pay out for a year or so until the next bonus announcement. The amount of bonuses depends on many factors, the most important of which is stock market performance.

When you start a with profits annuity, **you normally select an anticipated bonus rate**. The minimum and maximum rates of anticipated bonus rate you can choose vary by provider, but typically, **the range is from 0% to 5%** and normally once selected cannot be changed.

**A very cautious person** wishing to use a With Profits Annuity **would choose a 0% anticipated bonus rate**.



Some providers **allow you to convert to a conventional annuity** (which must be purchased with the same provider) at given points in the future. This means that you can change your annuity to one which provides set income levels and no investment risk.

This **can be useful if your circumstances change** or standard annuity rates change.

## A Unit Linked Annuity

Your income in retirement will be **linked directly to the value of an underlying fund of investments**. Generally, you can choose the types of fund, for example:

- A** medium-risk **managed fund** where a fund manager selects a broad range of different shares and other investments;
- A** higher-risk fund where a fund manager selects shares and other investments in a **particular country or sector**;
- A** **tracker fund** (usually medium risk) which tracks the performance of a particular stock market index. Usually, these have lower charges than managed funds.

The more risky the underlying fund you choose, the more your retirement income may vary – both up and down.

**Some unit-linked annuities work in a similar way to with-profits annuities.** Your starting income is based on an assumed growth rate and if the fund grows at that assumed rate, your income stays the same. If growth exceeds the assumed rate, your income increases. If growth is less than the assumed rate, your income falls.

A few unit-linked annuities **let you invest in a 'protected fund'** which limits the fall in your income. Most unit-linked annuities do not guarantee any minimum income.

## Phased Retirement

Most personal pensions can be arranged not as a single plan, but **as a cluster of many separate plans, sometimes called 'segments'**. The segments can then be used to buy annuities at different times. **This process is called 'phased retirement'**.

Each time you convert a segment to an annuity, **you can first take part of the segment's fund as a pension commencement lump sum** of up to 25% of the segment.

Converting segments regularly means **you can effectively use the pension commencement lump sum as well as the annuity to provide your income.**

The drawback is that if you stagger the conversion of segments into annuities, **you will not be able to take all your pension commencement lump sum from your total pension fund at once** as a single lump sum. You must convert enough segments each time to buy an annuity.

Phased retirement **can be a very useful financial planning tool**, for example, if you want to ease back gradually on work and start to replace your earnings with pension income. It also provides **more flexible help for your survivors if you die.**

It is possible to **vary the type of annuity on each occasion** and it need not be on the same basis as the first or subsequent years.

Segments that have not yet been converted to annuities can provide a pension for your surviving dependants or a lump sum, depending on the terms of the pension plan.

**Phased retirement is generally suitable only if you have a fairly large pension fund**, or have other assets or income to live on. This is because the bulk of your pension savings remain invested, usually in the stock market, which may be more risky than buying an annuity straight away.

## Unsecured Pension (Drawdown)

Originally introduced in 1995 under the name of 'Pension Fund Withdrawal', an unsecured pension plan **allows you to take a pension commencement lump sum of up to 25%** and an income from your fund **whilst deferring the purchase of an annuity.**

Your **pension fund remains invested** and **you draw an income from it each year** if you want to. There is no requirement for a minimum income to be drawn.

The maximum limit (referred to as the '**basis amount**') is calculated by the Government Actuaries Department (GAD).

The basis amount is determined by your age and sex and is **120% of the yearly income which could be paid** if the pension fund were used to buy a level (ie non escalating) single life annuity.

The basis amount has to be formally **reviewed every 5 years**. At this time, **you may have to change the level of the amounts being drawn down** to fall within the new limit.

Importantly, the GAD factors **vary according to long term interest rates**, so if interest rates fall, GAD factors can fall too.

You have **considerable flexibility in setting the amount you draw** and can vary it (up to the maximum) from year to year to meet changing personal or financial circumstances. This system of drawing down income is **available until age 75.**

Because you do not buy an annuity at the outset, **you can keep your options open** on ancillary benefits and do not end up paying for benefits which might not be needed.

The **pension fund remains under your control**, so can be invested for growth or income, according to your objectives.

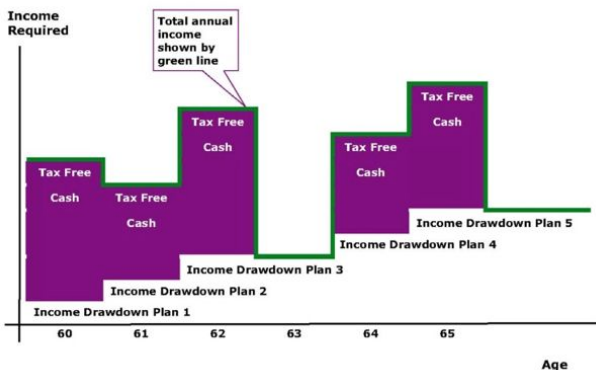
On death, the whole of your remaining pension fund, less a 35% tax charge, is **available to provide benefits to your family or beneficiaries.**

**Clients who are rather risk averse** and who need a high level of income in retirement **are unlikely to gain any benefit from an unsecured pension** and may end up with an inferior pension to that which they could have had simply by purchasing an annuity at the outset.

## Phased Retirement and Unsecured Pension Combined

This means you would start to draw an income from just part of your pension fund on one date, leaving the rest of the fund intact.

To increase your income at a later date, you could either increase the rate of withdrawal (provided you did not exceed the maximum limit) **or start to draw an income from a further slice of your pension fund.**



## Other Issues

Your pensions should not be looked at in isolation. You will need to consider **the level of income net of tax that your investment portfolio can provide.**

Many of your investments that were set up to produce capital growth **may now need to be transferred to investments or funds that are designed to produce a high level of income** rather than capital growth.

There are also some **tax planning opportunities** based around the benefits of equalising your estate with that of your spouse to reduce the overall level of Income Tax and eventual Inheritance Tax.

For example, although your pension can only be paid to you and taxed as your income, you could take the maximum pension commencement lump sum from your pension and **set up a 'purchased life annuity' in the name of your spouse** which would then be taxed as their income rather than yours.

## Pensions Advice

Certain areas of pensions advice **require the use of a pension specialist.** In general terms all competent independent financial advisers (IFA) should be perfectly able to advise you on funding for your retirement.

However, when you get to the point **where you need to consider your retirement options** it is essential to involve a pensions specialist.

This is particularly important **where you have 'defined benefit'** (also known as 'final salary') **occupational pension scheme benefits** or the total of your pension funds **is in excess of £200,000.**

Such a specialist will have passed the Chartered Insurance Institute's **G60: Pensions** exam, or be an Associate or Fellow of the **Pensions Management Institute.**

We currently have two such pensions specialists in our team of advisers.

## Risk Factors

- Information relating to Social Security benefits, is based on our understanding of legislation and practice in force at the date of this Fact Sheet.
- Whilst we believe our interpretation of current benefits and practice to be correct in these areas, we cannot be responsible for the effects of any future change in interpretation or treatment.
- In particular you are warned that State Benefits are subject to alteration and, in any case, the value of such benefits may depend on an individual's circumstances.
- These notes are intended as a guide only and do not replace the full product details that accompany any specific pension or investment recommendation.
- Tax relief depends on individual circumstances and tax rates and laws may change in the future.

In this Fact Sheet **references to 'spouse'** may also include 'partner' or 'civil partner'.

## For Further Info

If you would like to discuss your retirement options please ask your usual Arch adviser in the first instance or contact us via one of the following:

Tel: **01483 204600**  
 Email: **enquiries@arch-fp.co.uk**  
 Online: **www.arch-fp.co.uk**

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