Funded Personal Pensions - Choices at NRA

Background

All early personal pension schemes including Retirement Annuity Policies, Top Hat Schemes, Executive Pension Plans and the like had, at retirement, to use the accumulated funds to buy an annuity. This requirement arose for a number of reasons including recovery of tax relief and discipline on the pensioners. However in recent times professional and public pressure has enabled some liberalisation of this regime and more choice in the manner in which benefits may be taken is now available. But the essentials remain the same in that the accumulated fund must be used to provide income in retirement. Only a fraction, usually 25%, may be commuted into a tax-free lump sum.

Essentially there are six options as follows:-.

(i) You may leave your existing pension fund with the existing providers and after taking a tax-free cash sum if you wish, utilise their annuity rates to purchase a Compulsory Purchase Annuity which allows them to pay you a guaranteed lifetime income,

(ii) You may exercise a transfer (Open Market Option) of the whole value of your pension fund to another provider who may offer a better annuity rate. Again you may decide to commute part of your pension income for a tax-free cash lump sum payment,

(iii) You may exercise the Open Market Option in order to take a Unitised or With Profit Annuity from your existing pension manager or a third party provider,

(iv) The whole value of a pension fund may be transferred into a Phased Retirement Account with your existing provider(s) or externally to another provider. By using this facility future income levels may be varied to fit in with your overall financial plan.

(v) The whole value of your pension fund may be transferred into an Unsecured Pension Scheme (Drawdown arrangement) and this vehicle is then used to provide you with variable income. This section includes Alternatively Secured Pensions. See section 5, (a) and (b) below.

(vi) The whole value of your pension fund may be transferred into a scheme combining the features of (iv) and (v) above.

Please note, payments received under Options (V) are not income, but withdrawals of capital, which may have the effect of reducing your pension fund.

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1. Compulsory Purchase Annuity

Advantages

- You receive a guaranteed level of gross income for life. (Note, the guarantee does imply that the annuity provider will stay in business for the duration of the annuity).
- Your pension can be guaranteed for a certain period of time (e.g. 5 years).
- You can configure the annuity to provide the benefits you need, for example a residual spouses pension.
- You will be able to take a tax-free cash lump sum immediately, in return for a lower pension, to invest for additional income or spend as you wish.
- There is only a minimum of paperwork needed to start the payment of benefits.

Disadvantages

- The level of income is fixed at outset and cannot respond to changing personal financial circumstances.
- Inflation proofing of the income by buying an index linked annuity can be very expensive, in other words the annuity payments are significantly les than a level annuity.
- The level of income is fixed at outset and will depend upon the level of annuity rates available at that time. These may not be favourable depending upon such factors as interest rates and the returns available on medium to long term gilts.
- There is no possibility of future investment growth on your pension fund, although an implicit rate of investment growth has been assumed when setting the annuity rate to provide your income.
- In the event of death, depending upon the type of annuity you have purchased, benefits to your dependants could be lower than those enjoyed under some of the other options available to you and briefly explained in this briefing note.

Comment

Taking the annuity rate offered by your existing pension fund manager is very frequently extremely poor value. It is most often best to at least search the market just in case another provider is offering a better rate. Do not forget, you will, hopefully, be in receipt of the payment for a long time.

However we always check to ensure that your plan does not have any useful guaranteed annuity rates built in. These were very fashionable in earlier times (the late 1970's to the early 1990's approximately) and were often, optimistically, set at better rates than currently are available in the market.

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2. Open Market Option Annuity

Advantages

- You receive a guaranteed level of gross income for life.
- Your pension can be guaranteed for a certain period of time (e.g. 5 years).
- You can configure the annuity to provide the benefits you need, for example a residual spouses pension.
- You will be able to take a tax-free cash lump sum immediately, in return for a lower pension, to spend or invest as you wish, or to repay the mortgage on your home.
- As we will only advise this if there is a financial advantage so your income will be higher than under Option I.
- We may advise this if we have reasonable doubts regarding the financial sercurity of your existing manager.

Disadvantages

- The level of income is fixed at outset and cannot respond to changing personal financial circumstances.
- The level of income is fixed at outset and will depend upon the level of annuity rates at that time. These may not be favourable depending upon such factors as interest rates and the returns available on medium to long term gilts, etc.
- There is no possibility of future investment growth on your pension fund, although an implicit rate of investment growth has been assumed when setting the annuity rate to provide your income.
- In the event of death, depending upon the type of annuity you have purchased, benefits to your dependants could be lower than those enjoyed under some of the other options available to you and briefly explained in this report.
- An annuity is an income purchased by a lump sum. It is normally paid monthly for the rest of your life and can continue to a dependant such as a wife or husband after your death (possibly at a lower level). It can be for a fixed amount or can increase each year, for example in accordance with changes in the cost of living. It provides certainty and security, compared to the flexible but unknown future benefits available under the Phased Retirement Account and Unsecured Pension Scheme options detailed elsewhere in this briefing note.
- When comparing the advantages and disadvantages annuities with other options contained in this note, you must remember that you may receive a tax-free cash sum at outset which may be reinvested to generate additional income in retirement. You may choose to buy a "Purchased Life Annuity", to provide additional income. Part of the income generated by the Purchased Life Annuity can be paid tax-free

Comment

It is always best to at least research the open market for a better rate.

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3. Unitised and With-Profits Annuity

This alternative seeks to mitigate the principal weakness of the Compulsory Purchase/ Open Market Annuity by giving the annuitant a defence against erosion of purchasing power by exposing him to some investment risk. These schemes work by making an assumption about future investment growth, and sharing these potential gains with you. The provider will set a maximum growth assumption of usually about 5%. In practice we would usually recommend a lower growth assumption to create the prospect of taking an increasing income as the real return exceeds the assumed growth rate.

A proportion of investment risk has to be accepted by the annuitant, and the initial income level will usually commence at a discount to the regular Compulsory Purchase/Open Market Annuity.

Advantages

- A tax-free cash lump sum can be taken up to the maximum in the usual way;
- The annuity can be configured as required by your circumstances, for example residual spouses benefits.
- The purchase decision does not need to be made just on the basis of prevailing annuity rates.
- Client can chose the level of risk he is prepared to accept and hence either a higher income now or the prospect of some growth in income in the future.
- Purchase possible for most fund values as for a CPA.

Disadvantages

- The level of income is not fixed at the outset and can go down as well as up;
- The initial income level will be influenced in the usual way by annuity rates prevailing at the time of purchase;
- Death benefits are more akin to those under a CPA and consequently less advantageous than under other options listed below.

Comment

The underlying investment portfolio in the With Profit Annuity Fund will need to be equity based to provide for growth, mixed with a fixed interest component for a certain measure of stability and income. With pure unit linked annuities you are able to select alternative funds for different risk/reward assumptions. For instance the younger an annuitant the more risk could be assumed.

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4. Phased Retirement

Phased retirement (sometimes known as 'staggered vesting') is another method of taking retirement benefits from a personal pension plan. Phased Retirement allows greater control of your retirement fund and converts it gradually over a number of years into income (an annuity must be taken at age 75). In operation this works in much the same way as with the segmentation of pension policies themselves. Your income each year is made up of part tax-free cash and part annuity. The annuity provides ongoing income for life.

Although the income level may not be readily comparable to that from a CPA/OMOA its main aim is flexibility through enabling the un-utilised fund to grow in a unit linked or with profits pension fund and take advantage of annuity rates improving with age.

Advantages

- Tax-free cash can be used as "income" and thus, for a given level of income, reduce your overall liability to income tax;
- Compared to a CPA with fixed income, this allows flexibility according to need;
- Over time the comparative value of a CPA is eroded because of its' fixed nature;
- Low early payments allows fund growth for greater future income;
- As you age there is the prospect of annuity rates rising and providing you with higher income (the insurance company's potential time risk is reduced);
- Allowances can be made for spouses facing greater or lesser longevity.

Disadvantages

- Loss of the benefit of the tax-free cash in one lump sum;
- There is no guarantee that at any stage your income will be as high as that offered under the compulsory purchase annuity;
- Annuity rates may not be any more favourable over time;
- Deferring the purchase of the annuity does not guarantee a higher level of future income, as the continued investment of your pension fund may go down as well as up.

Comment

Phased retirement can only be properly considered by anyone with a fund over £100,000. We consider that below this level the administration charges have an excessively negative effect on returns. It reality phased retirement is a hedge against low annuity rates. Essentially the pensioner is taking the view that current rates are low, but will rise in the future, and not just because the annuitant is aging.

This choice has rather fallen out of favour in recent times. To date we have never set up one of these schemes.

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5(a). Unsecured Pension Scheme (Income Drawdown or Capital Withdrawal)

(i) Background

Of all the alternatives available to the Compulsory Purchase Annuity an Unsecured Pension Scheme (or perhaps more accurately, capital drawdown) is often appealing to clients. Unsecured Pensions are a complicated and involved subject and clients should be very sure of themselves before considering it, especially as an alternative to an annuity.

(ii) General Description

In essence the contract is very simple. Instead of buying an annuity your fund remains invested in a pension fund and you withdraw capital which you use as income. Effectively it is an investment fund contained within a pension plan wrapper. You are able to take the maximum tax free cash available immediately at outset and you do not need to take an immediate 'income'. There is also a choice in the level of income you can take. This is set with reference to special tables published by the Government Actuaries Department (GAD). The minimum income is 0% of the 'GAD rate'. The maximum is 120% of the 'GAD rate'.

(iii) Risk

In our view this is the key feature of these plans that clients must fully appreciate. When using a USP plan clients retain <u>all</u> the investment risk, as opposed to an annuity where all the investment risk is taken by the insurance company. An appreciation of this is crucial otherwise clients will either take too much or not enough risk with the underlying funds. It also means that regular investment reviews are essential to ensure that the appropriate risk profile and asset allocation of the scheme is maintained.

(iv) Costs

Drawdown schemes are not cheap to run. They require professional investment and pensions management as well as the interpretative and co-ordinating skills of an adviser. These costs have a direct and visible affect on performance. Mitigation and control of these costs is therefore vital, but not spending enough would also be very short sighted. This is not the place to discuss specific fees and costs as they vary considerably from situation to situation. Suffice it to say that we have worked hard to get client's access to the best value funds available, usually on institutional, that is wholesale, terms.

(v) Death Benefits

These schemes offer a range of Death benefits that may be attractive to clients. Essentially on the death of the pensioner, there are three choices available to the surviving beneficiary, these are:-

1. To withdraw the whole fund, subject to a 35% tax charge.

2. To continue to withdraw income from the fund. Income levels will be reset, based on the survivors age or GAD rates applying at the time. If chosen, an annuity must be bought by the earlier of what would have been the pensioner's 75th Birthday or the survivor's 75th birthday.

3. To buy a conventional pension annuity with the whole fund.

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(vi) Advantages

- Ability to boost future income by keeping payments low;
- Any other sources of funds available may decrease reliance on the income;
- You will be able to take a tax-free cash lump sum immediately to spend or Invest as you wish (this is not available through the phased retirement option but is through the compulsory purchase annuity and transfer options mentioned earlier);
- Residual funds have a tax benefit if the recipient is subject to higher than 35% tax;
- Acceptance of investment risk enables understanding of the potential for growth;
- You may be able to use Flexible Income Plan as part of your Inheritance Tax planning by using varying levels of income (within prescribed limits) and using all or part of the income to make gifts to take advantage of annual exemptions;
- Individual circumstances such as where a partner is not in good health or is unmarried can benefit from using a drawdown scheme.

(vii) Disadvantages

- Very much as for the previous Phased Retirement section, but the following should be noted;
- There is no guarantee that your income will be as high as that offered under the compulsory purchase annuity or transfer routes referred to earlier,
- There is no guarantee that annuity rates will improve in the future;
- Accepting risk means that the value of your pension fund may go down as well as up. You may not have a sufficient fund available to purchase an annuity equivalent to the amount you would have received at outset. Safe investments may not grow sufficiently;
- After drawdown commences transfer or further contributions are prevented;
- You may feel that the prospect of future higher income does not compensate you for being able to enjoy a guaranteed and secure level of income today and for the rest of your life.
- High levels of income withdrawal are unlikely to sustainable.

Once again this option is usually restricted to fund levels of anything over £100,000 because of the high level of administration required.

(viii) Actuarial Calculation and Mortality – Annuity Drag/Profit

Annuity providers make a profit from the fact that some individuals die sooner than is expected. They utilise some of this "mortality profit" to enhance current annuity rates. By delaying the purchase of your annuity the benefit of this potential profit, which can be significant, may be lost. This is especially true the longer you defer the purchase of an annuity. This effect is called "annuity drag".

Investors in USP do not benefit from annuity profit. This is a very significant cost and must be assessed in every case to check the viability of an USP.

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5(b). Alternatively Secures Pension

This is a form of USP, supposedly brought in to satisfy the demands of minority faith groups whose beliefs do not permit the pooled sharing of risk implied in annuity purchase. Essentially it permits the continuation of the unsecured pension arrangement post age 75, subject to more stringent tax and benefit rules, especially in regards to inheritance. This briefing note is of a general nature and we are not discussing the minutiae of the schemes. We will be preparing a briefing note on this subject in due course. In any event the best thing to do if you want to know more is to ask us.

Comment

We receive a great deal of interest in these schemes. However when the full report we prepare is discussed with the clients we often find that the annuity route is still preferable. These schemes are relatively expensive to run – even though we use very low cost providers – and the client has to accept all the risk.

In our view it is more likely that these types of schemes will be chosen when the pensioners priority is not income but other financial planning considerations, for example inheritance tax mitigation, or capital transfer to succeeding generations.

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Generally

Recent pension's legislation was trumpeted as being intended to 'simplify pensions. This may have been the intention but in practice it has had limited success, mainly due to persistent political tinkering and the dead hand of the Inland Revenue rule makers. Certainly the reduction in tax regimes from eight to two and the modest additional flexibility available is welcome. But the post A Day changes to investment property in SIPPS, ASP's and Pension Term Assurance have done nothing to give us confidence that Government has any real idea what it is doing with the legislation that governs personally funded pensions or other money purchase schemes all of which are just essentially glorified regular investment savings schemes with special rules.

The really pernicious effect of all these changes and amendments are that it makes it even more complex for clients to understand and makes the average pension investor even less confident of pensions as a reliable means of saving for the long term. In other words Government cannot be trusted with our money if it keeps changing the rules.

Ultimately these pensions changes do present clients with more choices and in our opinion require more advice. Clearly this is to our advantage. But if you know us you will also know that we do not welcome more work than we think is necessary, especially if it is driven by arbitrary 'rules' rather than logic and common sense.

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