



Retirement income options

Whether or not you've reached retirement age, you'll need to know what your options are to generate an income from the pension funds that you've built up. In part one of this two-part feature, Ray Prince discusses personal pension plans

So, picture the scene... You've reached that point when it is time to retire: it might seem as though you have done all the hard work in building up a pension pot, but converting this to income will be the one of the most crucial financial-planning decisions of your life.

Unfortunately, many people miss out on thousands of pounds worth of income by not researching all the options available.

How and when you take income depends on your retirement goals. You will probably have high-income requirements in your 50s, 60s and perhaps early 70s. Usually in your 70s your income requirement decreases (although you may then need to think about planning towards long-term care costs).

Take the tax-free cash

The golden rule to maximising retirement income is to take the maximum tax-free cash (known as pension commencement lump sum) from your pension fund. You do not have to take this lump sum, but it can be very advantageous to do so. The maximum you can take is usually 25 per cent of the underlying fund value.

The only exception relates to the NHS Pension Scheme and final salary schemes. With these, taking cash might not be such a good deal as it could reduce your final-salary income too much.

Once you have taken your tax-free cash, this money is no longer considered to be 'pension money'. If you want to generate income, you can do so more effectively and tax-efficiently if the funds you use are not deemed to be 'pension'.

You could, for example, invest up to £7,200 a year in an ISA to generate a tax-free income. Therefore, couples can invest £14,400 jointly.

Alternatively, you could buy a purchased life annuity. These are similar to conventional annuities but have extra tax advantages. People don't tend to use them because it means your capital is committed to the annuity and cannot be 'reclaimed'.

A third option is to invest in life insurance bonds. This route allows you to take five per cent income from your investment, tax deferred. In effect, what you are doing is deferring the income-tax liability. If you encash the bond after, say, 20 years

there will be a further income-tax liability if you are a higher-rate taxpayer. If you are a basic-rate taxpayer, (after encashing the bond) there will be no further tax liability. As a higher rate taxpayer, you need to gross up the five per cent income withdrawal from the bond to calculate the equivalent gross return that you would need from an alternative type of investment, such as a deposit savings account.

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Therefore, the rate you would need is 8.33 per cent. If you don't want to take any risk with the bond investment you can actually invest the money into a deposit account within the bond wrapper. Do take care which bond you decide to in-

vest in, as the deposit rates fluctuate between the providers of these types of products.

Annuities

The traditional way of turning your pension pot into retirement income is to use the capital to buy an annuity, which is an annual income from an insurance company. Annuities are one of the oldest financial contracts and date back to Roman times.

In 1811, Jane Austen in *Sense and Sensibility* observed: "People always live forever when there is an annuity to be paid to them. An annuity is very serious business; it comes over and over every year, and there is no getting rid of it".

Once purchased, an annuity contract cannot be changed. There are two important ways to boost your annuity income that many retired people miss out on.

1. The open market option

Seven out of 10 people, according to annuity provider Just Retirement, make the mistake of buying their annuity from the company with which they invested their pension. This can mean you miss out on a huge chunk of extra retirement income.

David Cooper, group marketing director of Just Retirement, says failing to shop around for the best annuity rate might undo much of the effort made in selecting the right fund and pension scheme in the first place. "With so much focus on selecting the right fund managers to add value, allowing funds to roll over into an annuity with the holding provider might be equivalent to throwing away additional returns of 2.5 per cent a year over 10 years before retirement".

2. Enhanced Annuities

Annuity provider Just Retirement claims seven out of 10 people are unaware their health or lifestyle might qualify them for an increased annuity. If you smoke or have a serious medical condition you may be able to get a higher value annuity as insurers recognise these factors can affect your life expectancy.

Just Retirement estimates up to 40 per cent of people could receive a higher income at retirement thanks to enhanced or impaired annuities. You don't have to be a particularly heavy smoker – 10 cigarettes a day for the past 10 years will qualify you for enhanced rates. Illnesses that qual-



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'The golden rule to maximising retirement income is to take the maximum tax-free cash from your pension fund'

ify for enhanced annuities include diabetes, liver impairment, heart conditions and many types of cancer, whether or not you are in remission.

If your spouse is also on your annuity, don't forget to take his or her health into consideration as this could also improve rates.

Other annuity options

How you maximise income from a pension fund really depends on what your fund is worth. More money means that you may be able to take more risk, and vice versa.

Anyone with the average pension pot of £30,000 to £40,000 should secure a guaranteed income. But if your pot is £100,000 or more (which many dentists will have), you may be able to take on additional risk to generate extra income.

Conventional annuities offer the security of a set level of income for life. There are several options under the 'conventional' umbrella. For example, how often you want income and whether to secure an income for your spouse when you die.

Most couples choose an annuity that benefits the surviving spouse, so that when you die, an income is paid to your survivor for life. The higher the amount paid, the lower the original annuity will be.

An alternative (and addition) to a partner's pension is using a guarantee period. This ensures payments continue generally for five or 10 years, even if you die within that time. Using a guarantee period can be a good way of providing for financial dependants, but will also reduce annuity income.

Most importantly, you need to choose between an income that is fixed for life or one that rises each year. With inflation proofing, this could make a real difference to your retirement income.

Choosing an escalating annuity will give you a lower starting income than a level annuity (one that doesn't increase). On the other hand, if you opt for level income, your annuity will provide no protection from inflation.

Intuitively, most people go for level annuities because you get a higher initial rate of income. Someone with a pension pot of £100,000 would get around £2,000 a year more from a level annuity than from an escalating one. An escalating annuity can be

linked to the Retail Prices Index (RPI), in which case your income will change in line with inflation. Alternatively, you can opt for a fixed percentage of escalation, say three per cent a year.

An interesting study has been carried out to find out how long it takes for an escalating annuity to catch up with a level annuity. If the annuity increases at three per cent a year and inflation is three per cent it takes more than 30 years for the cu-

mulative payments from the increasing annuity to overtake the total payout from the level annuity. However, if inflation is one per cent higher at four per cent per year, the break-even point is brought forward by nearly 10 years.

Higher-risk investment

If you can afford to take some risk with your retirement income, perhaps because you have a large pension fund, consider an

investment-linked annuity. This gives you the opportunity to beat inflation while keeping your income at a reasonable rate. But bear in mind that there is a risk that if markets perform poorly your income could drop.

The annuity is linked to a unit-linked or with profits fund. You still get a regular income, but the pension fund you use to buy the annuity is invested with the goal of achieving a higher level of income.

You are normally required to assume a future rate of growth for the underlying funds. Under a with profits annuity you have to assume a future level of bonus rate. The higher the selected rate, the higher your initial income will be. If investment performance exceeds the assumed rate, your income will increase. If not, your income will decrease.

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A combined strategy

Those who are concerned about inflation but don't like the idea of escalating annuities might consider splitting their pot to buy some level and some increasing annuities, plus perhaps an investment-linked annuity.

If you have enough money in your pot you could buy a level

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guaranteed annuity income of say £10,000 plus an RPI-linked income of £6,000, which will increase in payment. Use the rest to buy a unit-linked annuity, which will give you an income

that fluctuates. You won't be able to do this if you have a pension fund of £30,000 to £40,000, but with £100,000 or more it could make sense to split it.

The key point

It goes without saying, make sure you conduct research into all your options when you take your retirement income from a personal pension (or 'old' FSAVC) pot. As you can see, there are various combinations when purchasing an annuity so choose from all the providers in the market and you should end up with the best deal available at the time.

Take some action

Whether you purchase an annuity direct from a provider or through a registered financial adviser, you will end up with the same level of income. The typical commission paid to an adviser is one per cent of the total purchase price. If you purchase direct, the provider simply keeps the commission that they would have paid to the adviser.

If you want to do your own research, utilise the many services available online to see which provider is offering the best income. Then use an adviser to organise all the paperwork for you and to double-check that you've definitely got the best rate.

Free audio CD

To learn more about your retirement planning options, you can request a free copy of one of Rutherford Wilkinson's Audio CDs: 'How To Avoid The Three Most Common Retirement Planning Mistakes'. Just call Catherine Lowes on 0191 217 3340 and a copy will be posted to you (please quote ref: DT).

About the author



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