HAMPTON DEAN LTD

The Hampton Dean Guide to Pension Options

Introduction

When you get to retirement, depending upon the sources of your pension, you will be presented with a variety of options that need to be carefully considered before the big day. This is because they relate to important issues such as spousal pensions, inflation linked or level benefits and what happens to your fund when you die, as well as others.

There are risks attached to all these decisions because we do not know how long we are going to live and we do not know what is going to happen to our future health or the economy or any number of other imponderables. That is why understanding the choices and evaluating each risk is vital.

In some cases, such as Occupational Pension Schemes, your choices may be limited within the rules of the scheme, but we can help you to understand what these rules are and guide you through them nevertheless.

In other cases, such as Personal Pensions, Stakeholder Pensions, Self Invested Personal Pensions, Retirement Annuity Contracts, Additional Voluntary Contributions or others, the choices available can be a bit overwhelming.

Lump sum and income or larger income?

Under the new rules for pensions, introduced in 2006, every pension can pay up to 25% of its fund value out as a lump sum – currently, this lump sum is received tax free, although that could change in the future.

So, if the annuity rate is 6% pa and you have a £200,000 pension fund, you can decide whether you prefer £12,000 pa taxable income or a £50,000 tax free (currently) lump sum and a £9,000 pa taxable income. Or, any point in between. As a general rule of thumb, unless your circumstances are unusual, we would advise you to take the largest lump sum possible in most cases. However, we should talk this through because it is an important decision.

Annuity, Unsecured Pension or the Third Way?

In broad terms, there are 2 main options for your pension fund when you get to retirement. Each has its own set of advantages and risks attached. These main choices are to purchase an annuity or to leave your pension invested and draw directly from the fund. The main details, pros and cons of each are listed overleaf:-

Annuity purchase

An annuity is a guaranteed income for life, purchased with the remainder of a pension fund, after the lump sum has been taken. There are various ‘sub’ choices described in more detail in the ‘Hampton Dean Guide to Annuities’.

The main risks associated with this form of pension is that once you have made your choices and bought the annuity you cannot ever change your mind. Annuity rates are based upon interest rates and life expectancy, both of which are currently working against you. This means that, whilst a guaranteed income for life might sound attractive, in reality it might be less than you need. What is more, it could improve in the future if interest rates go up and you get older, but not if you have already bought an annuity.

The other major disadvantage is that, other than the choices for spousal pensions and guarantees, discussed earlier, once purchased, an annuity dies when you die. Whatever remains of your fund, stays with the annuity provider.

Unsecured Pension – formerly known as Drawdown

If you do not want to buy an annuity, because you feel that the rate being offered is too low and you’d prefer to wait to see if it improves or your life expectancy is such that you feel you are unlikely to get best benefit from an annuity, there is another option.

You can leave your pension fund invested, either with your current provider, or an alternative if there is an advantage in doing so and simply draw an income from the fund. There are limits on the level of income that you are able to draw, but as a maximum, they are generally better than the annuity rate.

The third way

For the past 10 years and more, annuity rates have reduced dramatically. In the 1990s, a £100,000 fund would have bought a male aged 65 an annuity of around £13,000 pa; this year, that has fallen to below £7,000 pa.

As is often the case when choices are stark and the possible disadvantages are unpalatable, whichever way you choose, the industry involved tends to come up with a third way. This is usually some form of hybrid that tries to address the major downsides of each option. The pensions industry is no different and there are a number of different types of hybrid options, generally centering around the idea of a temporary annuity.

Third Way Annuities are a halfway house between conventional annuities which offer retirees the chance of a guaranteed income for as little as 3 but more typically 5 years. Fixed-term annuities offer a guaranteed income followed by a return of a capital element which can be used to buy another income product that suits your circumstances at that time. In most cases, there are no ongoing charges such as annual management charges or explicit set-up charges and, uniquely, income and capital are guaranteed at the outset.