Original Article

Making the most of retirement

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ABSTRACT This article aims to prompt those who design and promote Defined Contribution pension schemes to think beyond encouraging use of the Open Market Option and consider other things that can be done to help their scheme members receive a better retirement income. The article suggests seven areas where actions can be taken to achieve this aim.

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Over the past few decades, there has been an accelerating move in the United Kingdom from Defined Benefit to Defined Contribution pension provision. Under a Defined Benefit arrangement, pension savers know what their retirement income will be and do not have many decisions to make for themselves.

Pension savers with Defined Contribution pension savings have to make a number of decisions for themselves to achieve a fulfilling retirement income. Recent events have conspired against the pension saver in this respect. Consider the impacts of poor investment markets, an increasing State Pension Age and low gilt yields are having on those who are moving into retirement. At this point of time, the outlook does not look good.

It is important that pension savers get the best outcomes from their pension savings. If they are not satisfied with their retirement income, permanent damage could be done to the pension savings brand.

Much has been written about the need to shop around to make full use of the annuity open market option. This has been driven in the main

by the ABI consultation paper on its proposed code of conduct. However, the use of the Open Market Option is only one aspect of what needs to be done to achieve better retirement outcomes.

I will describe below the seven steps a pension saver needs to go through to achieve the best possible retirement outcome. Using the open market option is only one step along the path, although for many, an important step.

BEGINNING THE JOURNEY INTO RETIREMENT

The journey into retirement starts today. Many will have several pension pots all aligned to retirement plans when they were active members of employer sponsored pension arrangements, which have not been reviewed since they left those employments.

Mary is a case in point. She is 56 and has built up several pension pots aligned to when she expected to retire. Until a few years ago, she was expecting to retire when her state pension became payable. She understood this to be 60 (the message that her state pension age would move from 60 to 65 by 2020 never reached her). Now, she anticipates continuing in work to age 66 when her state pension becomes payable. Her pension pots are in lifestyle funds, based on a retirement age of 60. If left untouched, her

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retirement outcome will in all probability be far worse than it would otherwise be if she adjusted the investment strategy of those pension savings to what her retirement plans currently are.

Step 1: Review current pension savings to see ensure they align with current retirement plans

A recent NAPF report on the annuity market draws attention to the effect of cliff edge changes in annuity rates. It is a general rule that the larger the amount applied to purchase an annuity, the better the terms that will be obtained.

A pension saver with more than one pension pot should therefore consider consolidating their pension pots in one place. The advantages of this are:

1. easier management of the pension pots;
2. potentially a better retirement outcome.

However, the pension saver must consider some downsides, for example:

1. loss of valuable guaranteed annuity rates;
2. penal encashment charges; and
3. loss of Protected Tax Free Cash and early retirement options deriving from pre 6 April 2006 rights.

Step 2: Consolidate pension pots in advance of retirement wherever this is a sensible option

The move to retirement income

One of the effects of the Bank of England's Quantitative Easing (QE) programme has been a reduction in gilt yields. One commentator has pointed out that this has the effect of reducing annuity rates by up to 20 per cent. The reduction in maximum income from Capped Income provision is just as transparent. This raises the question as to whether now is a good time to designate pension pots to provide retirement income. Pension savers may expect that as the economy improves and the impacts of QE are reversed, gilt yields will increase with resulting

changes to annuity rates and maximum Capped Income limits to come through over the next few years.

This is fine, but what if income is needed now?

In this situation, our pension saver should look at their non-pension savings. Income from non-pension savings can often be received tax free. If income can be received tax free, only the net amount required has to be realised. This preserves more of an individual's total savings for use later in retirement. A 20 per cent taxpayer who wishes to generate £10 000 gross income only has to extract £8000 net from his savings. For higher rate taxpayers, the effect is even better. It should also be noted that the Government reclaim age allowance, from those over age 65, once taxable income reaches £25 000. This can therefore be a valuable step for many to take.

Tax free income can be generated from:

1. funds held within ISAs;
2. funds held within Insurance Bonds by taking maximum advantage of the 5 per cent capital withdrawal rules; and
3. realising assets within the Capital Gains Tax allowance.

Step 3: Consider realising non pension assets to produce tax free income

Step 3 is fine if our pension saver has realisable savings outside his pension pots. For many, this will not be an option. They should therefore consider phasing into retirement. That is designating only that part of their pension savings that is necessary to generate their tax free cash and income requirements over the coming year. This would avoid being locked into poor annuity rates or income drawdown rates, leaving the opportunity to review the situation, as gilt yields improve.

A benefit of not designating all of the pension savers pots to provide pension income is that if the pension saver dies prematurely, any payment of a lump sum for his residual pension savings will normally be tax free. Any lump sum from funds that have been designated to provide pension income be it through an

annuity or capped income will be subject to tax at the rate of 55 per cent. Therefore, by designating just what is required to provide necessary retirement income affords greater protection to dependants.

Step 4: Consider phasing into retirement

However, producing the best outcome for the pension saver depends upon the pension saver themselves. An increasing number of people are not stopping work altogether at one time. Either through necessity, or out of choice, many continue to work part-time much beyond their expected retirement age.

For pension savers who go down this route, are they going to defer their pension income until they retire? Will they use part of their pension savings to supplement their reduced employment income? Will they defer their state pension until they fully retire?

Drawing on their pension savings should be considered in conjunction with all these factors.

Step 5: Consider impacts of ongoing employment income on pension savings

Following on from the above, what does the consumer expect their income needs to be during retirement. It is becoming more apparent that retirement income needs are not linear. These needs follow more of a U shape. In the early years of retirement, additional leisure time creates more spending opportunities. It is a fact of life, especially as we live longer towards the ends of our lives, that more will have to be spent to fund high care costs. Many can expect a dip in income needs in between these two extremes. What products does the pension saver need to meet his income requirements?

Annuities are often represented as investments and get a bad press. This does not help the pension saver going into retirement. How many commentators refer the percentage rate of return available in the annuity market? A fairer representation would be to consider annuities as an insurance of a continued income

stream should the annuitant live longer than expected.

However, annuities do not provide the flexibility required for the unpredictable U shaped income requirements described above.

That said for those who can access Enhanced Annuities and Impaired Life annuities they may be the perfect solution. For other pension savers having their retirement income 100 per cent backed by an annuity will also be the solution.

At the other extreme, initially, 100 per cent use of income drawdown solutions will be the solution they require. For many, the best outcome will be delivered by a combination of both.

Step 6: Understand what the income needs in retirement may be and use the best products to meet those needs. always shop around

Any action in accordance with Steps 3, 4, 5 and 6 should all result in a review of the overall retirement objectives and the pension savings to ensure they are aligned.

Step 7: Continually review retirement plans and pension pots

Call to action

Early in this article, I highlighted Mary. Mary will not get the best from her pension savings unless she is made aware of what she should be doing. There are many headwinds preventing those who are coming up to retirement from getting the maximum value from their savings. The danger is that her generation will tell their children and grandchildren that making pension savings is not worth the sacrifice. This is a message from trusted individuals that will do permanent damage to the pension savings brand.

This is a wake up call for all of us in the pension savings industry.

Unfortunately, many cannot afford or appreciate the value of good Financial Advice. Those who can and do must be pointed in that direction.

There are therefore two challenging areas that need to be tackled. These are:

Communication

1. How do we get the valuable information as described above to pension savers at the right time?
2. How do we avoid giving advice but at the same time ensure that the information is clear and understandable?
3. How do we point them to information sources that will enable them to make the correct decisions for themselves?

Barriers

- What unnecessary barriers do we have in place that prevents our pension savers from accessing the flexible products and solutions from which they may benefit?

If we are going to help our pension savers achieve the best possible outcomes, we must start tackling these challenges now.

A successful retirement outcome is dependant on more than just shopping around for an Open Market Option.

The 7 steps

Step	Action
1	Review current pension savings to see ensure they align with current retirement plans
2	Consolidate pension savings in advance of retirement wherever this is a sensible option.
3	Consider realising non-pension assets to produce tax free income
4	Consider phasing into retirement
5	Consider impacts of ongoing employment income on pension savings
6	Understand what the income needs in retirement may be and use the best products to meet those needs. Always shop around
7	Continually review retirement plans and pension savings