

## **PERSONAL PENSION FUND WITHDRAWAL**

Pension Fund Withdrawal (PFW) is a fairly new innovation providing a real alternative to Personal Pension holders when they come to take benefits. The traditional way of providing a regular income at retirement has been to purchase an annuity whereby the value of the pension fund is paid to an insurance company and in return the insurance company guarantees a predetermined level of pension for the policyholder's lifetime.

Purchasing an annuity commits you to decide, at outset, which features to include. The number and type of features built into the annuity affect the level of pension payable for the rest of your life. For example, you must decide on whether the pension will increase, if a dependant's pension is to be included, if a minimum guarantee period is to be included and the frequency of payment of your pension. These features can significantly affect and possibly reduce the income available from an annuity and if your circumstances change after you have bought your annuity, you normally cannot change any of these features. For example, you may choose to include a dependant's pension, payable to your spouse if you die first, and this reduces the pension payable in your lifetime. If your spouse predeceases you a dependant's pension will not be paid and your pension will not increase to take this into account. The starting income from an increasing pension is significantly lower than the income from a non-increasing pension and it takes a number of years for the income from an increasing pension to truly match the income received from a non increasing pension. This means that an increasing pension will only be good value if you prove to be long-lived. Both of these examples highlight the fact that, due to unforeseen circumstances, an annuity may prove to be poor value for money.

Whilst annuity products continue to evolve and improve, when coupled with the fact that many individuals object to exchanging large sums of money merely for the right to an income for the rest of their lives, it can be seen that an alternative was overdue.

This alternative, now called Pension Fund Withdrawal, enables you to withdraw an income from the invested fund on a regular basis and avoids the necessity to purchase an annuity.

PFW allows a great deal of flexibility in the level of income payable. At the point benefits are taken, you are obliged to take income each year between a maximum and minimum threshold calculated by the Government Actuaries Department (GAD). The maximum income is broadly 120% of the available from a single life, non-increasing annuity. The maximum level of withdrawal is therefore calculated with reference to age, sex and the yields available on long-dated gilts at the time the calculation is made. During any 12 month period, the pension paid can be anywhere up to the maximum and nothing at all. The amount paid can vary each year if required but every 5 years it is necessary to recalculate the maximum pension to ensure benefits are not being over paid. At this point the maximum income can therefore be less or more than it was at the start.

While income flexibility is one reason people elect to use PFW and this can be particularly useful for tax planning purposes, another reason people go down this route is for the potentially superior benefits payable on death.

On the death of the plan holder, a surviving spouse has the following options.

1. Continue with income withdrawals based upon his/her GAD rates (provided this is not any more than the maximum income payable to the policyholder).
2. Buy an annuity
3. Take the accumulated fund value as a lump sum less a 35% tax charge (a surviving spouse who initially chooses to continue with income withdrawals may choose this option up to two year's following the death of the planholder ( a lump sum can be paid to a person(s) other than the surviving spouse if required).

If there is no surviving spouse, the value of the fund less a 35% tax charge is payable to your estate or a beneficiary nominated by you.

The above rules apply on the death of the member before age 75. To this point, the Government are happy with the concept of PFW and although they abolished the requirement to purchase an annuity at age 75 when new pension rules were introduced on the 6th April 2006, they now say that PFW post age 75 is only for those with a strong principled religious objection of the concept of annuitisation. To discourage PFW post age 75, they have introduced a draconian tax regime.

Upon the death of a member post age 75 whilst in PFW, initially, their residual fund must be used to provide a spouses pension. If there is no spouse or, upon their eventual death, the residual funds can be left to the member's nominated charity with no tax consequences. The third alternative is for the distribution of these funds to the deceased member's estate, subject to tax charges which could reach 82% of the fund. In reality, in all but a few cases, clients will purchase annuities with their residual funds close to their 75th birthday.

Having said that many people will view the superior death benefits and income flexibility (pre age 75) as a major step forward from the traditional route of buying an annuity. However, there are some very serious drawbacks that every plan holder needs to consider before electing to take PFW.

Firstly, part of the return from an annuity is a return of capital and this amount is calculated by the insurance company taking into account the fact that some annuitants in the 'annuity pool' will die earlier than expected. Therefore if you bought an annuity today, you would benefit from this extra return, in the form of a cross subsidy from other annuitants and this increases the income the insurance company can pay to you without taking investment risk and is why the insurance company can guarantee your income.

If, however, you put off buying an annuity and instead utilise PFW you will not benefit from this cross subsidy. This means that while you are in PFW, you cannot achieve the

same return as an annuity without taking investment risk because the returns available from safe investments, such as cash and gilts will not be enough to match the income you could get from an annuity.

Therefore it is vital that you are comfortable with taking on board this investment risk which necessarily means that the fund can fall as well as rise. It follows that, if the investments have not achieved the returns required, your income may be reduced in the future, whether at the point the income limits are recalculated on each third anniversary of starting withdrawals, or when you eventually buy an annuity.

This investment risk is very real and you must understand this before moving into Pension Fund Withdrawal.

The second risk factor is the level of annuity rates, which can move up and down. If annuity rates move down (for example, if yields on gilts reduce and/or life expectancy continues to increase) then the maximum income payable under PFW will be lower than it otherwise would be. You should not assume that annuity rates will rise as you get older, as rates generally may fall if yields on gilts fall.

Again, this is a very real risk, which you must understand before moving into PFW.

**Therefore, in summary, under PFW the value of your fund and your income is not guaranteed in any way and your income may reduce if:**

- 1. Investment returns are lower than required and/or**
- 2. Annuity rates in the future are lower than they are now**

This risk is higher if you take anywhere near the maximum level of withdrawals. While this risk is reduced if you lower the income taken through PFW, it should be noted that, whatever level of income you take, there is no guarantee that your income can be maintained at a particular level and no guarantee as to the level of annuity you may be able to purchase in the future.

It should also be noted that it is possible to opt out of PFW and purchase an annuity at any time and this is a decision that will be reviewed with you on a regular basis.

Finally, we would like to summarise the risks of PFW using wording recommended by our regulator, the Financial Services Authority;

- High income withdrawals may not be sustainable during the PFW period;
- Taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income when the annuity is eventually purchased;
- The investment returns may be less than anticipated
- Annuity rates may be at a worse level when annuity purchase takes place.

These notes will be given to any clients of Greyfriars Asset Management who elect to move into PFW and individuals will be asked to sign a letter confirming that the risks have been fully explained to them.

These notes are for information only and no action should be taken on reliance of these notes without taking suitable individual financial advice.

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Greyfriars Asset Management LLP.