For use with your Financial Adviser

Pensions: Time for change

New approaches for a new retirement reality

A special report by Dr Ros Altmann

MetLife


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Who should read this report?

This is MetLife's second collaboration with Dr Ros Altmann, following on from her earlier report on the importance of retirement planning in 2009. Her latest report, based on the extensive experience and expertise she has built up as a policy adviser and investment manager, has been written primarily as a tool for Financial Advisers to help them in their discussions with clients. It provides new insights for the pensions industry and will also be a valuable read for everyone interested in retirement incomes including advisers, providers, regulators, policy makers and ultimately, of course, savers.

Reasonable efforts have been made to ensure the accuracy of the content of this report, but accuracy cannot be guaranteed and neither the author nor MetLife make any warranties or representations as to its accuracy. The intention of this report is to highlight issues facing the pensions industry. Nothing contained in this report constitutes investment advice on the part of MetLife or the report's author.

About the author

Ros Altmann is the leading independent expert on pensions policy, long-term savings and later life income. She is an economist and pension fund manager with extensive experience of all areas of pensions and savings, including state pensions, annuities, investment management, pension protection and retirement.

Before her City career, Ros was an academic at University College London, London School of Economics and Harvard University, researching and publishing on UK pension policy, occupational pensions and retirement. After this, Ros managed institutional investment portfolios for many years, including pensions, insurance and mutual funds, as well as advising central banks and private client fund managers. She was Head of Equities at Chase Manhattan's International Investment Operation in London and a Director at Rothschild Asset Management and NatWest Investment Management.

Her policy advisory work specialises in pensions and investment-related issues. She was a consultant to the UK Treasury on the Myners Review of Institutional Investment and worked on pensions policy with the Number 10 Policy Unit. She successfully spearheaded a long-running campaign to achieve compensation for 150,000 workers who lost their final salary company pensions as a result of flawed legislation. She is a frequent media commentator and a renowned consumer champion. She regularly writes articles and speaks at conferences on pension reform.

Ros has a first class honours degree in Economics from University College London, a Ph.D. degree in Economics from the London School of Economics, an honorary Doctorate from the University of Westminster and was a Kennedy Scholar at Harvard. She is a Governor of LSE and the Pensions Policy Institute and a non-executive member of the Investment Advisory Boards for the Public Trustee, Official Solicitor and Office of the Accountant General.

About MetLife

MetLife Europe Limited is proud to have worked with Dr Ros Altmann in developing this report. We understand that planning for retirement is one of the biggest financial considerations of anyone's life and that the role of financial advice is crucial. We are committed to developing innovative solutions for retirement planning and retirement income.

MetLife Europe Limited is affiliated with US-based MetLife, Inc. a leading global insurance and financial services organisation which counts the US's largest life insurer among its subsidiaries. The organisation is renowned for its stability, financial strength and security, and had approximately $846.3 billion of total assets as of September 30, 2012.

MetLife, Inc. is a leading global provider of insurance, annuities and employee benefit programs, serving 90 million customers. Through its subsidiaries and affiliates, MetLife holds leading market positions in the United States, Japan, Latin America, Asia Pacific, Europe and the Middle East. For more information, visit www.metlife.com.

Introduction

Improving retirement income is a goal we all want to achieve. In today's uncertain world, can this goal be guaranteed?

The launch of workplace auto-enrolment in October 2012 is designed to tackle the lack of pension saving in the UK. Initial results have been encouraging and the Pensions Regulator has talked about auto-enrolment making a "promising start".

Increasing retirement saving is certainly important if people are to avoid long-term poverty in old age. However, encouraging pension saving is only part of the answer. Most savers are now having to rely on defined contribution (DC) pension schemes where the amount of pension income they will receive generally depends on the risk of investment, interest rates and annuity markets. Around 3.6 million UK workers are already saving into such schemes and around £500 billion is invested in defined contribution funds, according to the National Association of Pension Funds.

All that is known in advance with DC schemes is the level of contributions. Workers can no longer rely on employers to predetermine their pensions. The ultimate retirement income will depend on investment market performance and also on how savers turn their pension funds into income - with low annuity rates a particular problem in recent times.

Pension risks are now borne almost entirely by individual pension savers themselves and those risks need to be understood. As life expectancy is rising and working lives are lengthening, the demands on pensions and retirement income are evolving. Pensions need to adapt to the new realities. This report highlights some of the inadequacies of the current system and suggests new approaches to pension planning that can help achieve the goal of improving later life incomes.

MetLife is focused on encouraging debate and new thinking on retirement income which is why we are working again with the leading independent pensions expert in the UK, Dr Ros Altmann.

"As life expectancy is rising and working lives are lengthening, the demands on pensions and retirement income are evolving. Pensions need to adapt to the new realities."

Chapter 1: Employers no longer guarantee pension outcomes

The world of pensions has changed dramatically in recent years, leaving people struggling to keep up with developments.

No employer guarantees: Employer pensions are no longer offering the kinds of guaranteed payouts that UK workers previously relied on. The good old days of a guaranteed employer pension, which even offered generous facilities for 'early retirement,' are all but over.

Financial crisis and scandals have caused disappointment, uncertainty and confusion: Many types of private pensions have suffered a series of scandals and disappointments as investment markets and annuities have failed to live up to expectations. The financial crisis has left people fearful for their financial future and savers have suffered a succession of setbacks as interest rates have plummeted. At the same time, with an aging population, pension ages are rising. Retirement prospects are more uncertain than ever before and millions of workers are finding themselves exposed to risks they do not understand.

New responsibilities for individuals in uncertain DC pensions: The new world of pensions places much more responsibility on each of us to manage our money to try to achieve a decent income in later life. Defined Contribution (DC) pensions, where all that we know is how much money is going into the fund, entail unprecedented risks which most of us feel ill-equipped to deal with. There is no certainty over how much our pension fund will be worth in future and how much income it will provide.

State pension is being cut, no more earnings-related state pension: The Government is, at the same time, struggling to regain control of public finances. In the face of increasing numbers of older citizens and rising longevity, policy makers plan to reduce pension costs and shift extra responsibility for later life finances away from the state and onto individual taxpayers.

The state pension will be cut for future retirees and the state pension age is set to rise. The state will no longer provide an earnings-related pension, there will be just a flat-rate basic state pension, worth around £144 a week in today's money, and anything extra has to come from private sources of income.

But private pension scheme membership is at record lows: Many people have contributed to private pensions in the past, but the latest figures and surveys show that pension membership has fallen sharply in recent years. Private sector scheme membership is now at its lowest ever level.

Auto-enrolment aims to address the pensions crisis as state and employer pensions fall: This lack of pension savings represents a pensions crisis that needs to be urgently addressed. Having recognised that people are not saving enough to provide sufficient extra income for a decent later life lifestyle, now that employer guaranteed pension schemes are nearly all closed and the state second pension is being abolished, a nationwide initiative is underway, to automatically enrol all workers into an employer pension scheme. They can choose to opt out, but only once they have joined. This is designed to ensure more people will have private pensions and that their employers will help them build up extra savings for their future.

> The Office of National Statistics (ONS) Pension Trends Survey shows employee membership of private sector pension schemes fell from 46% in 1997 to just 32% in 2012. Private sector membership of defined benefit schemes fell from 34% in 1997 to just 8%.

Is auto-enrolment the solution?

Will this policy achieve its aim? Are DC pensions currently fit for purpose to ensure both a good pension fund will be accumulated and then also ensure a good income? I believe the answer is a resounding 'No'.

Auto-enrolment will increase coverage but not adequacy of pensions: This 'auto-enrolment' programme is seen as a solution to the pensions crisis. Auto-enrolment will ensure more people are contributing to pensions, but won't ensure that these pensions deliver decent retirement outcomes. In other words, auto-enrolment will increase coverage of pension saving, but will not ensure adequacy of later life income.

Auto-enrolment schemes place risks on individuals and do not ensure good outcomes: The typical auto-enrolment pension scheme will place the risks of retirement provision squarely on individual workers. They will have to rely on financial markets delivering good returns, reasonable charges and fair value annuities when they need to take income from their investments in later life. These DC schemes are being relied on to meet future retirement income challenges and are supposed to increase pension incomes sufficiently to more than offset reduced state pension payments.

Individuals do not understand pension risks: The problem with this new approach - cutting state pensions and leaving it to private pension saving to fill the gap - is that it requires individuals to be able to cope with risks that they do not really understand.

Many may be lulled into a false sense of security: Around 11 million extra workers are expected to start saving into an employer pension scheme as a result of auto-enrolment. These workers are being led to believe that this will help them achieve a comfortable retirement income to supplement their state pension. But, financial literacy is low and pension saving is complex. Most people do not understand the important issues relevant to retirement saving. There is, therefore, a significant risk that relying on current thinking and standard DC pension schemes will not achieve good enough pension outcomes to deliver decent incomes in later life.

Standard DC pension products not fit for purpose: In fact, the current DC pension products, both for building up a fund and then taking an income out of it, do not fit with many people's lives. The whole framework is too inflexible and based on old-style notions of retirement.

People's lives have changed but pensions have not kept up. The standard products provided by most private sector pension schemes are designed for the past, not the future. This has dangerous implications for us all.

> Pensions are not just about money, they are about people and their lives. As auto-enrolment proceeds, pensions of the future need to fit in with people's changing lives, to ensure pensions can accommodate changes in both investment and retirement realities. The next chapter looks at how retirement is changing.

Risks of rising pensioner poverty

Saving significant sums is difficult given consumer behaviour and the pressures in society today. But it is important for all of us that long-term savings increase. If we fail to address these issues, there will be millions of older people struggling to cope financially in later life or in poverty. Failing to ensure adequate later life incomes will place extra burdens on younger members of society too.

So what are the challenges and risks that need to be addressed?

Delayed start: Firstly, there is the risk that young people will not start saving, or will decide to prioritise current spending over saving for their future. The later you start saving, the harder it can be to accumulate enough money for retirement. Auto-enrolment may help here, however it is only a start.

Adequacy of contributions: Second, there is the risk that, even if you are saving, you are not saving enough to deliver the kind of income you will want or need in later life. Providing decent pensions is expensive.

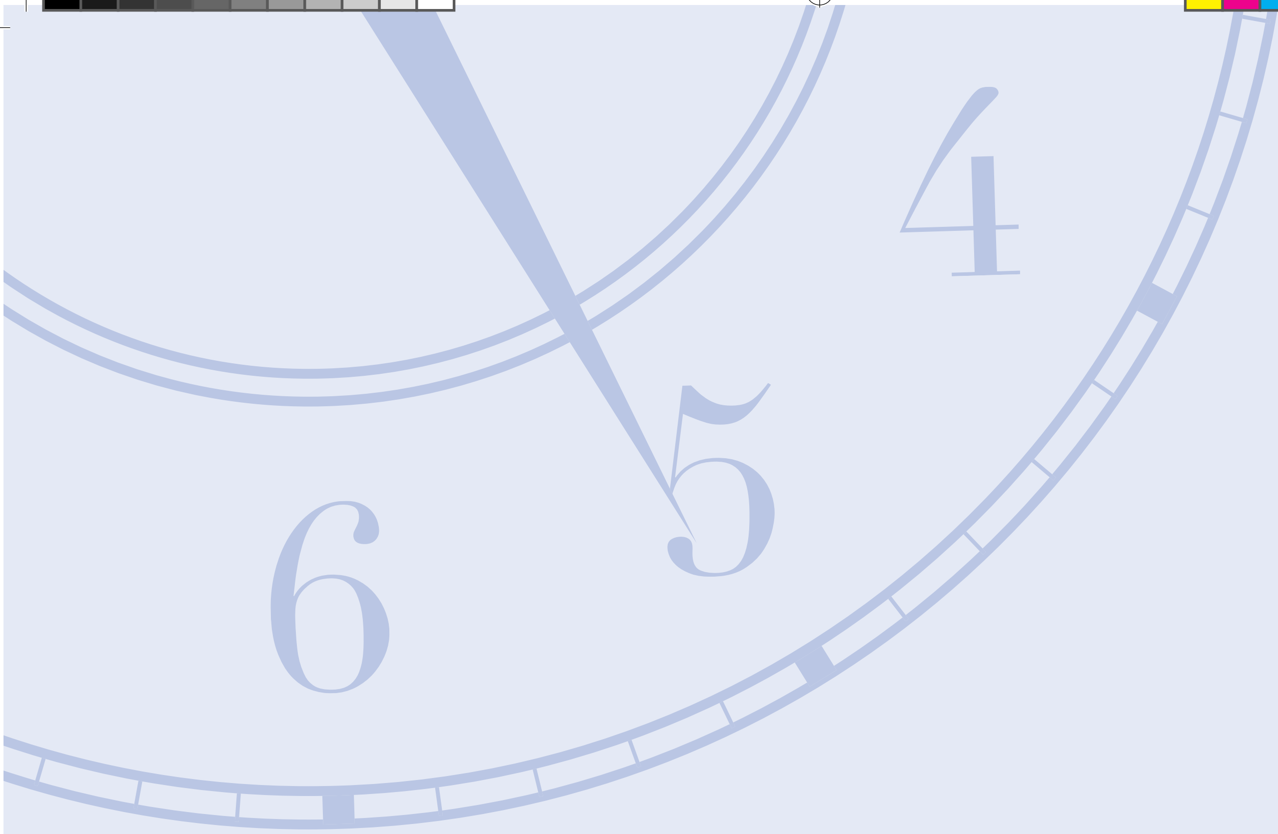
Choice of investments: Third, you must choose investments wisely and ensure you give yourself the best possible chance of making money in the markets. This will entail investing in a range of assets, including stock markets, that can deliver good returns. But investing is complicated and is best handled by professionals. Most people do not have the skills required to manage their money independently. Some do, but most do not. This increases the need for professional investment management approaches to help pension investors achieve better later life income outcomes. In this regard, it is not clear that today's DC pension products are fit for tomorrow's retirees.

Managing investment risks requires flexibility and adjustment over time: Fourth, you will need to be prepared to make adjustments over time. Many people used to believe that returns from investment markets could be relied on and that the longer you invest, the higher those returns. This has resulted in many investors experiencing disappointment relative to their expectations. In reality, there are no absolute guarantees that taking investment risk will be rewarded. The old idea that one can just start investing in a pension fund when young, either in equities or perhaps in a balanced or with-profits fund, and leave the money to grow and deliver good pensions in later life is simply not applicable any longer. Successful investing usually requires a 'hands-on' rather than a 'head in the sand' approach. Investment markets are volatile and there is no 'loyalty bonus' for holding 'risky' assets. Investors may hope to achieve higher returns, and many have done so in the past, but that does not mean each individual investor will succeed. DC pension investments need to be monitored over time, to check how they are performing and perhaps make adjustments as circumstances change.

Risk of failing to have a financial plan: Fifth, you are unlikely to be able to manage later life income planning by yourself, when your pension relies on investment markets. You actually need to make a financial plan and decide how you can move along a good path to provide adequate later life income, rather than crossing your fingers and hoping for the best. In an ideal world, everyone would have professional help to plan their finances. Seeing a financial planning adviser, who can help assess your current and future income prospects, is more likely to ensure good outcomes than trying to manage such complex decisions alone or just relying on industry-wide default funds.

Poor value income options at retirement - annuity risks: Sixth, there is a real risk of not receiving good value when you take income from your accumulated pension savings. Even if you have saved diligently and have made good investment choices, the dramatic drop in annuity rates has resulted in much lower pension incomes for today's retirees. Not only that, but most people buy annuities which stay fixed in money terms, with no protection against inflation. The earlier you buy your annuity, the more your income will be debased by inflation and the poorer you will become throughout the course of your retirement. Even with inflation at just 3% a year, a £10,000 annual pension income will lose more than a quarter of its value after just 10 years. The risk of buying at the wrong time, choosing the wrong annuity or failing to find the right rate could increase the number of poorer pensioners by many millions.

DC pensions not well-suited to cope with retirement risks: DC pension plans are not set up to cope with recent developments in people's lives and often fail to offer appropriate options to address retirement risks properly. For example, they will not protect against inflation, deteriorating health or paying for care.



Chapter 2: The new retirement reality

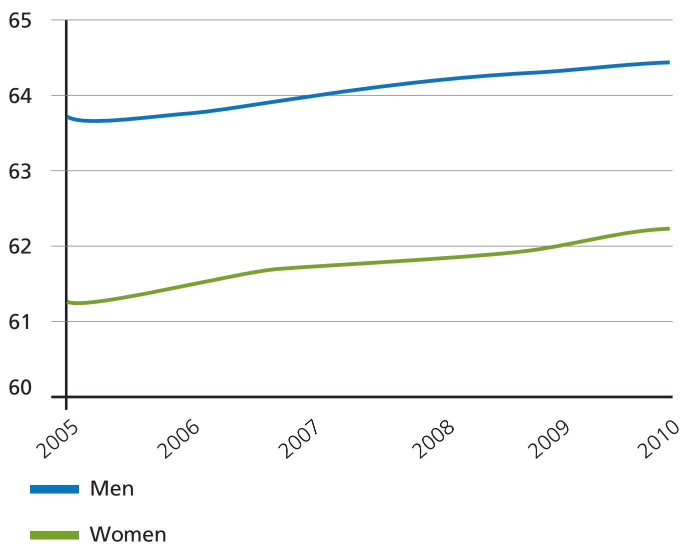
People's lives have changed, but pensions haven't kept up

Retirement and pensions have not kept up with improvements in life expectancy and national health. People now approaching traditional pension ages are realising that their long-held expectations are not being fulfilled. Solving the crisis of inadequate later life income will require a combination of better pensions or savings approaches and new thinking on retirement. The reality is that expectations of retirement with a good private income are hopelessly unrealistic.

Reform is urgently required if we want to make the most of the talents and potential of older citizens, as well as avoiding a potential DC pension disaster.

Longer working lives are increasingly becoming a reality. Figures from the Office for National Statistics show that by 2010 the average age of retirement for women was 62.3 (higher than their state pension age) and was 64.6 for men. The trends since 2004 are shown in the chart below. Retirement ages have continued to increase further for both men and women since 2010.

Average age of withdrawal from the labour market using the duration of working life indicator: by gender, 2005 to 2010



Source: Annual Population Survey (APS) - Office for National Statistics

The joys of working life

A record one million people are now still working beyond age 65. The old notions of 'early retirement' are being consigned to history but far too few workers are planning ahead for longer working lives. This has to be part of the solution to our pensions crisis and, in fact, can be a very positive model for the future. Of course, some people have had to keep working longer because their pensions are not meeting their income needs. Many are facing significant shortfalls in the pension income they were expecting.

Investment options for pensions have often disappointed expectations - a need for ongoing planning: Many people have experienced the ups and downs of the stock market, which have played havoc, even with previously perceived 'safer' investments such as with-profits funds and endowments. Having been through stock market crashes and the financial meltdown, they have then found that the policies pursued to deal with the economic crisis have hit pensions hard. This reinforces the fact that pension planning needs to be an ongoing process. As markets change and people's lives and needs develop differently over time, pension plans should adapt too.

Working longer is also an option: You should also be able to include working longer as part of your financial planning. If you cannot afford to save significant sums right now, that should not mean you save nothing. But it will mean that your savings are less likely to be sufficient to ensure you can stop working and still replace your previous earnings as adequately as you would have hoped. You could, therefore, plan to stay working, perhaps part-time, so that your savings can supplement declining earnings, rather than having to replace your work income altogether.

Bonus years - a new phase of life waiting to be grasped: It is increasingly common for older people to keep working and, indeed, this is healthier for most of us. A period of part-time work, after a full-time career can help ease gently into retirement, and the whole concept of retirement is changing. It will become a 'process' rather than an 'event'. The end of the Default Retirement Age has been a major achievement in enabling people to continue working if they want or need to. This has many benefits. For example, if there is an option to keep earning, then pensions or savings only need to supplement falling income rather than replacing earnings altogether. This would be a whole new phase of life, after a full-time career. Depending on how you feel and what type of work you can or want to do, you could keep working for many years, but at a reduced pace. As a result of the tremendous successes of medicine, most people will now live longer and can carry on working well, even after suffering illnesses that many used to be disabled by, or die of. Work itself is now much less physically demanding too. This has opened up the chance of ‘bonus years’, which can be a whole new phase of life in your sixties and even seventies, when you are still working, contributing to the economy and your own economic welfare, rather than just retiring completely. During these ‘bonus years’, people can earn more money and even add to their savings. There is no one ‘right’ age that would apply for everyone. Individual differences will mean some starting their ‘bonus years’ earlier or later than others. Therefore, each individual can plan as they go along, depending on their own circumstances. This means pension planning has to become more flexible as retirement becomes more flexible too.

Everyone will need to take more responsibility for assessing their own position and that will be best achieved with the help of a financial adviser. Each person will have a different combination of savings, pensions and work income. They will need some guidelines to assess their own position of course, but financial planning will always involve trade-offs. There are few explicit guarantees and, ultimately, financial plans can be blown off course and need to be readjusted through time.

“This has opened up the chance of ‘bonus years’, which can be a whole new phase of life in your sixties and even seventies, when you are still working, contributing to the economy and your own economic welfare, rather than just retiring completely”

Current DC pensions are not fit for a flexible future working life. They are often geared to a fixed retirement age that is known well in advance. For millions of us, this will not be how our lives develop. The next Chapter looks at the changing attitudes to retirement.

Chapter 3: What does research tell us about attitudes to ageing and retirement?

In order to explore ways in which the concepts of older age and retirement are changing, MetLife conducted several surveys to assess attitudes in the run-up to traditional retirement age. This provides further insight into how people's lives are changing.

‘Old age’ stereotypes out of date

Attitudes to old age, among people approaching later life, are significantly different from the stereotypes. Harris Interactive interviewed 1,420 people aged between 50 and 60 and asked them how they felt about turning 60 and at what age they would regard themselves as old.

The key findings were:

- 54% were not bothered about turning 60
- 54% did not think they would be old until their 70s
- 28% did not think they would be old before age 80

How do you feel about turning 60?	
Not bothered at all	32%
Not bothered	22%
Neutral	26%
Bothered	12%
Bothered a great deal	7%

Past surveys have suggested most people no longer consider themselves to be old (in the conventional sense of the word) in their sixties, even though they might previously have expected to be. These MetLife Survey results confirm that most of today’s fifty-somethings say they will not be ‘old’ until they reach their seventies, or even their eighties.

When are you old?	
<60	6%
60-69	21%
70-79	46%
80+	28%

This provides further clear evidence that attitudes to ageing have changed dramatically. Pension and retirement thinking, however, seems stuck in the past.

Retirement reality is changing too

The Survey results show that most 50-60 year olds want to be optimistic about their future standard of living, but realise they may not be on track. They are worried about how they will manage and many believe they may not be best served by retiring at the conventional age.

The key findings were:

- Just 25% plan to fully retire straight away
- 49% want to continue working past the default retirement age of 65
- 40% expect to stage their retirement and work part-time for a while

In addition to the Survey, MetLife also commissioned individual interviews with a nationwide sample of respondents, which showed that many recognise they will retire differently from previous generations. They say that retirement will be more of a ‘gradual change’, a re-balancing of work and leisure time.

Here are some examples of the responses:

‘Retirement isn’t one thing it’s the rest of your life, it’s more than one event isn’t it?’.

‘It’s planning for the future rather than just retirement’.

‘For me it would be having the choice not to have to work full time, five days a week, that you could perhaps do other types of work and you would work less hours, but it doesn’t mean that you would actually stop work altogether’.

Valuing work in later life

These exclusive Metlife Survey results show that work has value to people beyond the income it provides. 80% of those who are now retired actually went straight from full-time work to full-time retirement. They report that not only do they miss the money from work, but even more of them miss their work colleagues. Many of the men and women working beyond age 65 not only want to earn more money, but they also want to keep up with their social relationships at work, feel useful, stay active and be respected. The following findings for three key groups highlight how older people are recognising the benefits that staying at work can offer:

Those who have already retired were asked:

Was there anything to do with work that you missed when you retired?	
Being with my colleagues/workmates	61%
The money	47%
The work that I did	28%
The feeling of being useful	25%
The respect of my colleagues for what I did	24%
Having something to do	12%
No, nothing	17%

People in their 50s but not yet retired:

The Survey of 50-60 year olds asked what they thought they would miss once they retired. This also shows that they expected to miss work colleagues, feelings of being useful and even the work itself, as well as the money:

Is there anything to do with work that you think you will miss when you retire?	
Being with my colleagues/workmates	48%
The money	63%
The work that I did	29%
The feeling of being useful	37%
The respect of my colleagues for what I did	25%
Having something to do	29%
No, nothing	8%

People who had continued working part-time after pension age:

Those who are still working beyond age 65 say they are doing so for personal fulfilment and to stay active, as well as wanting more income.

Why did you primarily return to work part-time after retiring?	
For the income	36%
For personal pleasure/fulfilment	32%
To stay active and engaged	25%
Want income to maintain current lifestyle	18%
Want income to enhance current lifestyle	8%
Need income for basic expenses	8%
No, nothing	8%

There are clearly benefits to staying in work which can enhance people's lives in numerous ways. The overwhelming majority would like to work part-time and ease into retirement rather than staying full-time and then suddenly stopping.

This research confirms the view that people's lives are already changing and will continue to evolve in coming years, with a significant redefinition of later life work and income expectations. It will no longer be the norm to automatically stop work completely at a particular age that is set many years in advance.

Pension products and planning are not keeping pace with the changes in retirement realities

As this Report is focused on how pensions can fit better with people's lives, it is also important to assess how well people are prepared for the investment challenges posed by DC pensions and whether these pensions are currently fit for purpose to prepare for later life financial needs. With longer lives and less secure pensions, people need to take responsibility for their retirement planning – but are they equipped to do so? MetLife commissioned further research with consumers and advisers to investigate these issues for this report.

The focus was on how well savers understand pension risks and how well advisers believe their clients understand risk.

The results show that consumers are aware that there are risks but are not confident about how well they understand them. The findings suggest many people are frightened of the investment risks they face and would really prefer to return to the old days of guaranteed employer pensions. As this is highly unlikely, they say they would welcome the possibility of having some elements of their future pension guaranteed, to give them more peace of mind.

Some of the key findings were as follows:

- 60% of all adults say they do not understand or don't know whether they understand the risks associated with investing in a defined contribution pension scheme
- That rises to 75% among the 18 to 24-year-old age group – a key target for auto-enrolment
- Only 23% say they have taken advice
- 67% would be more likely to save into a pension scheme if it guaranteed their capital
- 72% would be more likely to save into a pension scheme if it guaranteed a level of retirement income.

Similar questions were put to advisers. The responses show high levels of concern about clients' retirement planning - 60% of clients are relying on stock market out performance while just a third of clients are likely to achieve their target retirement income.

Adviser research key findings

Similar questions were put to advisers. The responses show high levels of concern about clients' retirement planning - 60% of clients are relying on stock market outperformance and just a third of clients are likely to achieve their desired retirement income.

The key findings were:

- 78% of advisers believe reviewing pension fund performance should be a constant process
- Advisers believe 60% of their clients are relying on stock market outperformance to deliver retirement income
- Advisers believe only 33% of their clients will achieve their target retirement income
- 69% of advisers believe clients would be more likely to save into a pension scheme if it guaranteed a level of income
- 73% of advisers believe clients would be more likely to save into a pension scheme if it guaranteed their capital.

The next Chapter explores the ways in which the pensions industry currently tries to help people prepare for their retirement income. In light of the Survey results, it considers whether the standard investment approaches for accumulating pension savings and dealing with investment risk, particularly in later life, are suitable.

Chapter 4: What are the steps to take in building for the future?

What is currently offered to help you plan and build an adequate pension fund?

Many people are concerned about their financial future. They want a decent standard of living when they retire, but find the prospect of planning for their pension too daunting. There is standard advice for trying to build up your pension fund which can be considered in a number of stages and it is generally comprised of the following steps:

Step 1: Take advice - failing to plan is planning to fail

It is vital for anyone making long-term investment decisions or planning for retirement to make a financial plan. Most of us have neither the time and skills nor the inclination to do this properly, but a professional financial adviser can help make a plan which is implemented and regularly monitored along the way. If you fail to plan, you are probably planning to fail. Building up long-term savings is not easy and the optimal strategy will vary from individual to individual.

Step 2: Save what you can – and not necessarily just in pensions

Saving more can be a sensible thing to do even if there are other financial pressures. Some people are put off by the inflexibility of pensions - indeed UK pensions are more inflexible than in most other countries. If you are relatively young, pension contributions are locked away for decades and you cannot get the money back even if you really need it. That could mean you may want some savings outside of your pension funds. As long as you understand the various benefits and restrictions of each type of saving, you can put together a strategy to help move towards your later life income goals. Pensions do benefit from tax relief at the highest rate. The effect of tax relief is shown in the adjacent table. It often makes sense to take advantage of an employer contribution, as well as the tax benefits and the higher your marginal rate the more you gain.

Contribution	Tax relief rate	Amount saved in one year	Amount saved in ten years	Amount income sacrificed over 10 years
£100 per month	0%	£1,200	£12,000	£12,000
£100 per month	20%	£1,500	£15,000	£12,000
£100 per month	40%	£2,000	£20,000	£12,000
£100 per month	45%	£2,182	£21,818	£12,000

An alternative to pensions is to save in an Individual Savings Account (ISA). Instead of receiving tax relief up front, the money saved in an ISA comes from your after-tax income but is not taxed when you take it out. So, saving £100 per month into an ISA would grow almost tax-free and the proceeds would also be tax-free. Savings in a pension will also grow almost tax-free, but the income you receive is taxable. This tax could, however, be at a lower rate than the relief given when contributions were made, as by the time you retire you may have moved from paying 40% or 45% income tax to 20%. This tax arbitrage can provide a real saving.

Step 3: Building up a pension fund over time

Planning for retirement is not a one-off exercise. Throughout the years, plans may need to change, depending on your circumstances and the investment markets.

- Try to think about how you would like to invest your money - discuss the concept of investment risk with your adviser and how to try to achieve higher returns over time by putting money into the financial markets.
- Keep track of your pension savings - if you leave an employer you may want to transfer your pension to your new firm. Many DC pension schemes will penalise you if you leave your pension fund behind when changing jobs, by charging you much higher fees than when you were working for your old firm.
- Monitor your investments over time and check if your pension provider is offering good investment options.
- Ensure you know what charges you are paying.
- Ensure you check how your pension investments are doing relative to the lifetime limits on pension assets (from 2014, the maximum amount allowed in a pension fund, without tax penalties, will be £1.25million).

Step 4: What to think about as you get older?

- Request a forecast of your State Pension which you can get through the Pensions Service. Not everyone will be entitled to the full State Pension so it is important to know roughly how much you will be entitled to.
- Start paying off debts if possible – that should include your mortgage as well as unsecured debts such as credit cards or loans.
- Ensure you have a will in place if you don't already.
- You will need to estimate how much pension you can expect from past and present pension providers and employers. If you have changed employers regularly you may have a range of company pension funds varying between defined contribution and defined benefit pension schemes. Contact all pension providers to ask for estimates and up-to-date statements. Ensure you have tracked down any old pensions.
- It may be beneficial to consolidate pension funds or it may be better to leave them as they are. Speak to a financial adviser to obtain the most suitable solution for you.
- Try to work out a target for how much you think you might need in retirement. Take into account lifestyle changes but be realistic. For example, if you are no longer working you will not need to pay for commuting and you may have paid off your mortgage by the time you retire. You may also want to allow for increased utility bills from being at home more often and perhaps extra holidays.
- Add all your expected pension income together to see how much you might expect. If you want more than this, you need to decide whether you can save more for retirement. (Extra saving can help bridge any gaps but if you expect to have a low income in retirement then saving may reduce some state benefits, so you will need to bear this in mind). If you cannot save more, you need to think about where other income might come from, such as downsizing your home or working longer.
- It will be important to choose your investments carefully as you approach retirement. As long as you have checked that your total pension savings are within the lifetime limit of £1.25million, you may want to think about the best investment strategy. If you have an income shortfall, would you be happy to take more risk in the hope that you will make extra returns to hopefully provide yourself more income? Or are you too worried that you could actually lose money instead?
- Or would you like to try to find a way to avoid losses, benefit from some upside and still have a bit more certainty but at the cost of paying for guarantees?

The answers to these questions may vary from one individual to another, but many people who are in standard investment funds in DC pension schemes are not offered any choice.

Step 5: As you approach, say within six months of, State Pension age

- See your financial adviser again and ensure you discuss whether you want to take your state pension straight away or delay. You can receive an extra 10.4% a year for each year you delay (this will be cut to 5.2% from 2016).
- If you are deferring taking your State Pension let the Pensions Service know.
- Inform your local tax office if you have decided to retire at state pension age.
- If you plan to continue working ensure your employer knows as you will no longer need to pay National Insurance contributions.
- Contact your pension providers to find out what choices you have about taking your pension, whether there are any annuity rate guarantees, what they are worth, and whether there are any penalties.
- Discuss how to optimise the income from pension funds. If you are continuing to work, you may want to keep contributing to your pension fund, rather than taking income out.
- Review the investment options for your pension fund and decide what you might want to do with your accumulated pension savings.
- If you are considering buying an annuity, make sure your adviser knows if you smoke or have any medical conditions as this can improve the annuity rate you are paid.
- Consider whether you want to protect the value of your pension savings, or lock into a particular level of pension income either now or in the future. This would mean considering taking out guaranteed products such as Unit-Linked Guarantees. You may be able to guarantee income or capital or both, or you might consider a deferred income guarantee. Bear in mind the potential costs of taking out guarantees against the value they deliver to you and how much you are willing to pay for more peace of mind.

How does the pensions industry offer to help you manage pension risks in the run-up to retirement?

DC pensions often try to help you cope with the risk of market volatility in the run-up to retirement. There are strategies to help people manage their investments and cope with investment risks. In the past, many pension funds merely invested in the stock market and assumed that shares would increase in the long-run and offer the best long-term returns. Equities were expected to do better than inflation and participate in the growth of the economy and offer the best long-term returns. Therefore, pension investors were encouraged to put most of their money in the stock market.

Following the experience of sharp stock market falls since 1999, confidence in relying on equities to deliver good pensions has been undermined. Indeed, in recent years, investors were encouraged to switch their pension investments into bonds in the years leading up to their chosen retirement date, in order to reduce the risks to their capital from market volatility. The standard advice nowadays is to gradually switch out of shares and into bonds or cash the closer you are to retirement. This advice may not be suitable any more.

Switching to bonds is also recommended because standard pension thinking is generally geared to fixed retirement dates and annuity purchase

As you reach retirement with a DC pension, it has typically been assumed that you will go on to buy an annuity with your pension fund. An annuity is an investment product offered only by insurance companies, which takes your pension fund and, in exchange, promises to pay you a specified income for the rest of your life. (See box on Page 29 which explains annuities.) Because annuities are priced relative to bond yields, by switching into bonds and ensuring you reach retirement with a fund invested in bonds, you would then have assets that more closely match an annuity investment. So DC pensions are geared to reach a pre-selected pension age with a fund totally in bonds and cash, ready to buy an annuity. Millions of workers are relying on this type of strategy for their retirement security.

Popular 'default' funds for DC pensions are often designed to do this asset-switching for you

Pension companies have devised special funds to switch your assets out of equities for you, rather than having to make the decisions yourself. These so-called 'default funds' are used by the majority of pension savers, who do not want to make their own investment choices. Two of the most popular fund-styles for this are called 'lifestyling' and 'target date' funds. They each have advantages and disadvantages. They might help some people with their retirement planning but they are not actually a solution to the problem of DC pension risk. They are really designed for old-style retirement thinking and may not fit people's lives today or in the future. This is how these two DC default fund approaches operate.

"These so-called 'default funds' are used by the majority of pension savers, who do not want to make their own investment choices."

Life styling funds - do not match modern lifestyles

A 'life styling' investment fund will usually invest your pension contributions in the stock market in the early years when you are younger and then use pre-programmed computer-based switches from equities, which are considered to be higher risk, to assets that are generally considered to be lower risk (such as bonds or cash) over a defined period of time, usually the last five or ten years before your pre-set retirement date. The idea is that by the time you come to retire, 100% of your assets will be in low risk funds and in theory safe and ready to be used to buy an annuity.

Advantages

- Your fund is automatically switched for you, without you having to make investment decisions.

Disadvantages

- Sticking rigidly to switching all your money into supposedly low-risk assets means you are still exposed to possible losses in the fixed income or government bond markets and can miss out on stock market gains which could otherwise be achieved.
- You might still want to be invested in the stock market when you are retired, rather than being stuck only in bonds when you still have 20 to 30 years to live.
- You might keep working after the date you set when you started your pension. This could mean you did not need to switch out of equities and might then have to buy back the shares you sold.

Target date funds - targeting the wrong date

Target date funds are invested with a specific date in mind which is meant to be the year in which you will retire and start needing to take income from your pension fund. These funds are generally named after the year in which they are due to mature such as 2017 or 2022. The idea is for investment managers to invest your fund so that the value is maximised at the target maturity date which is expected to be the date on which you retire. Funds will be switched into what are considered to be 'safe' asset classes, with a fund manager assessing the markets and making decisions depending on market conditions. This aims to give you a better chance of knowing how much pension fund you will have when buying an annuity.

Advantages

- This can be more flexible than life-styling as the switches do not have to be at certain fixed points prior to retirement, which could mean a better final result.

Disadvantages

- These funds can still be risky depending on the manager. If they have a bullish view on equities they might stay invested closer to the target date and still be vulnerable to last minute shocks. Or if they switch to bonds and the bond market falls sharply, you will still suffer losses. These target date funds do not guarantee the highest value will be achieved on the target date.
- The fund can lose out on good stock market performance before the target date which means there's a price for safety.
- You may not actually retire at the 'target date' your fund has aimed at and may, therefore, actually be better off in riskier potentially higher return assets for longer, and also make extra contributions.

Therefore, these target date funds may be targeting the wrong date. As the nature of retirement is changing for so many people, it is becoming a 'process' rather than an 'event' and this requires different thinking for pensions.

These standard DC pension strategies are out of date

The standard pension fund investment strategies are geared towards pension investors buying an annuity at a pre-set date. (See box explaining annuities on page 29).

In the past, most people had no choice but to buy an annuity when they wanted to take income out of their pension fund. There were few other choices available, so the end-game for DC pension savings tended to be an annuity purchase. It therefore made some sense to run DC investment options in this way, with lifestyling and target date funds gearing up for annuity purchase at a pre-set date. But these standard approaches in DC schemes are no longer appropriate.

Such a one-size-fits-all approach does not fit any more. Firstly, many people will not retire at one pre-set date. Second, many people will not actually buy an annuity, and third, the supposedly low risk assets may still lose money just before your retirement.

Pre-set 'retirement' dates may change

The 'retirement date' used by a lifestyling or target date fund may be wrong if people are working longer. As we saw in the earlier sections, the traditional age of retirement is changing. If people keep working, then the 'target date' or 'retirement date' set by their pension scheme may not be relevant to them. They may either just stay on at work past the age at which they previously expected to retire, or they may move to working part-time for a few years. They may even decide to keep contributing to their pension for longer. This all means that the investment approaches that are geared to end at a certain date will not be appropriate. DC pension savers may, in fact, benefit from staying invested in potentially higher return assets, if they are still earning and can afford to wait longer. If their pension fund has switched them into bonds, in the expectation that they will be retiring, but they do not retire, then their pension investments may not be right for them.

Not everyone buys an annuity

Not only may life styling or target date approaches fail because people's working lives do not fit old stereotypes, they may also be inappropriate because many people may not actually want to buy an annuity nowadays. Especially as annuity rates have fallen so much in recent times, (See Chapter 5 for discussion of risks of annuity purchase) if you are not actually going to buy an annuity then switching into bonds in order to prepare for annuitisation will not have been the right thing to do. DC pension fund investors may have been switched out of the stock market by their default lifestyling or target date fund, only to find they have to reinvest in shares when they reach the 'target date' because they want to still have the chance to benefit from extra returns, perhaps in income drawdown funds or even in an ongoing pension scheme. Recent rises in bond yields may have caused significant losses for investors close to traditional retirement age in lifestyling and target date funds and when they reach their pre-selected date, the value of their fund could have fallen. Indeed, if they had stayed invested in shares, rather than bonds, their fund value could have increased. A strategy designed to be safe may have led to unnecessary losses.

'Low risk' assets have become more risky

Recent monetary policy has pushed down bond yields in an effort to stimulate the economy. The Bank of England has created £375 billion of new money, with which it has bought Government bonds. This caused bond yields to fall sharply. Recently, however fears of above-target inflation and a large fiscal deficit, have caused bond yields to rise sharply. As bond yields increase, the value of the bonds falls, which means an investor who bought bonds when interest rates were lower, will lose money if they sell when rates have gone up again. The interest rate on 15-year gilts, for example, was around 2% in August 2012, but had risen to over 3% about one year later. That means the value of these bonds has fallen sharply.

The table overleaf shows that a pension fund which bought £10,000 of 15-year gilts in August 2012, would have lost over 8% of its value by September 2013. Hardly a 'safe' investment.

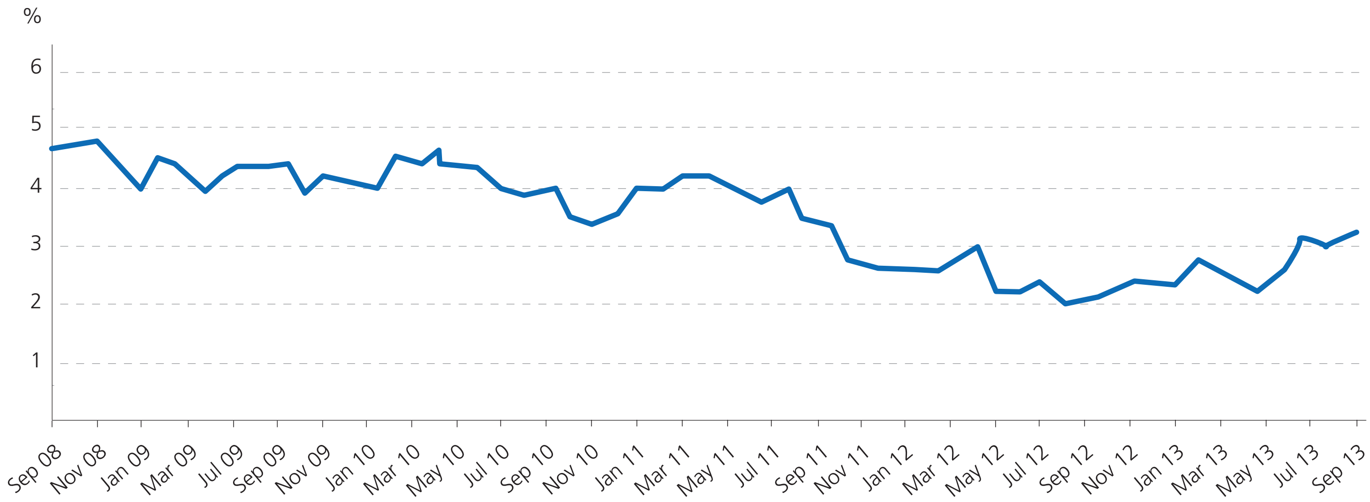
> "Not only may lifestyling or target date approaches fail because people's working lives do not fit old stereotypes, they may also be inappropriate because many people may not actually want to buy an annuity nowadays."

Value of £10,000 investment in 15 year gilts

August 2012 – September 2013.

August 2012	2.14%	£10,000
December 2012	2.33%	£9,876
March 2013	2.47%	£9,787
June 2013	2.61%	£9,717
September 2013	3.19%	£9,205

The following graph shows the trend in 15-year gilt prices since 2008 and it is clear that yields fell sharply and have now risen sharply in a relatively short time. This additional volatility means that gilts may no longer be 'low risk' investments.



Source: Bloomberg

The inflexibility of the current DC pension saving environment does not fit well with modern day retirement realities.

The traditional investment approaches in DC and a 'one-size-fits-all' default fund arrangement may not actually fit large numbers of people's lives. It is important to consider a much broader opportunity set of options for people's pensions in future.

So what might be a better approach?

Staying invested in the stock market or other higher risk assets for longer

Higher risk asset allocations could remain appropriate if you are planning to keep working longer, especially if you are not relying completely on one pension fund to provide your retirement income.

Advantages

- You will still have the chance to benefit from rising markets which can help boost your retirement income.

Disadvantages

- If you are relying on this particular pension fund for most of your retirement income the downside risks are very high. Higher risk can mean rich rewards but also large losses.

Adjusting your investment approach regularly each year

Some people will be happy to work with their financial adviser to assess their investment approach regularly and manage their pension assets flexibly. If you keep working, you may want to continue to have the chance to benefit from strong markets, but once you start cutting back your working hours, you may want to take smaller risks. In the current investment environment, however, the Bank of England's policy of Quantitative Easing has distorted the price of supposedly low risk government bonds and made them more risky than before. This has increased the relative attractiveness of equities, which may also have become relatively less risky, so it is not clear how reducing investment risk might best be achieved these days.

Advantages

- Can allow more time to benefit from rising markets and increase the value of your pension fund.

Disadvantages

- Lower risk bonds may still be risky and lose money.
- You may miss out on good market performance.

Unit-Linked Guarantees on your pension fund and future income

If you are concerned about protecting the value of your pension fund, whether against losses in equities or in bonds, it is possible to buy guaranteed pension products, which can form part of your investment planning for retirement. Products such as Unit-Linked Guarantees can offer you a guarantee on your future income or on the capital value of your assets while still having the chance to benefit from rising markets. (See Chapter 6 for more details). These guarantees are backed by insurance companies. You invest in funds which will put your money into a mixture of equities and fixed income assets.

Deferred income guarantee:

If you are not sure when you actually want to retire and when you will start taking income from your pension fund, you might consider buying a deferred income guarantee.

Advantages

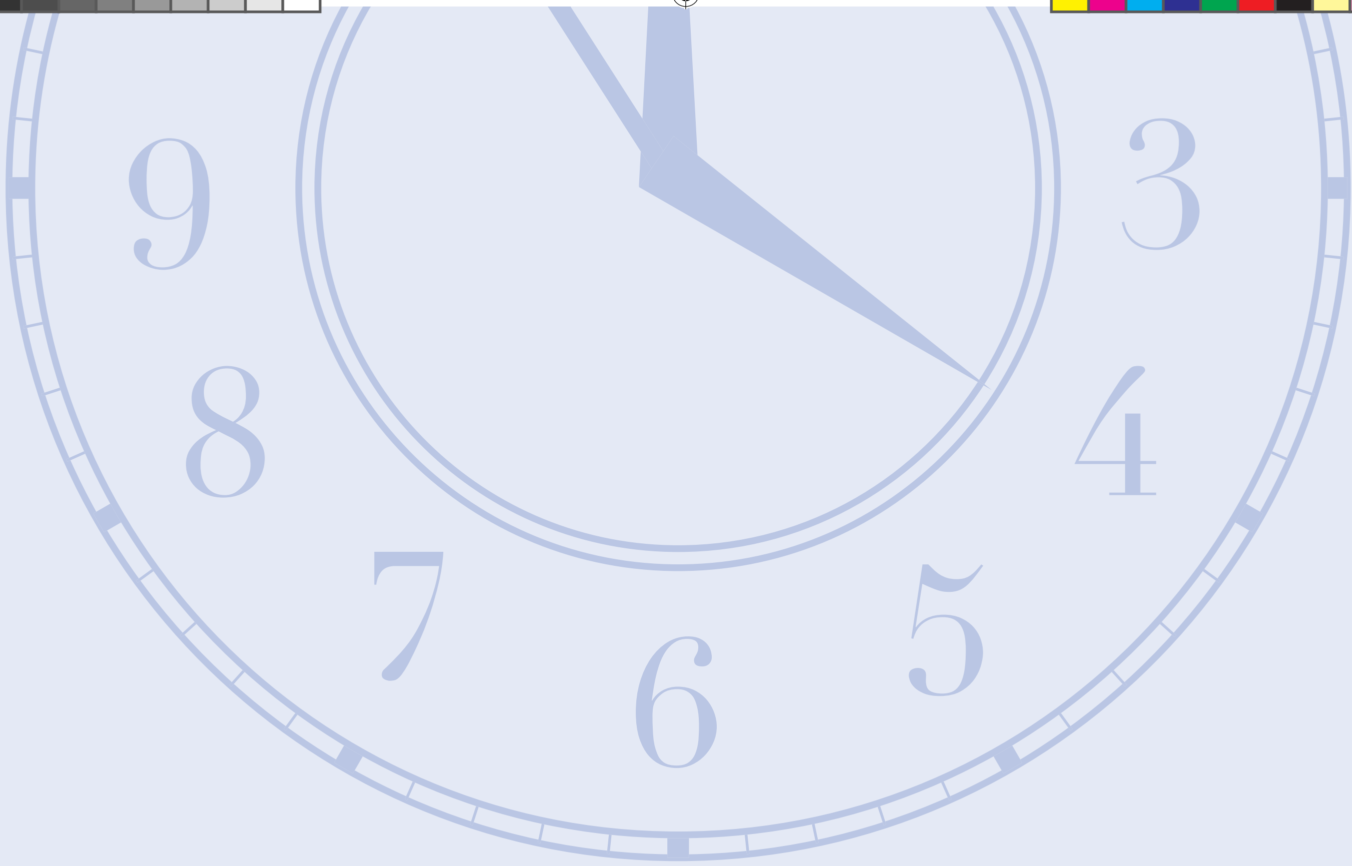
- You have certainty on future income.
- You can continue to invest in higher risk assets to benefit from future market growth, but with some protection against market falls depending on the funds chosen.
- Gains can be 'locked-in' every year so that once made they cannot be taken away.
- You have access to your funds so if your circumstances change you can change your investment approach.
- You can change your retirement date without needing to change investment strategy.

Disadvantages

- There are specific charges for these guaranteed products which will reduce the performance of your investment.
- The level of income you are guaranteed will be lower than the income you would receive from a standard annuity.
- Your guarantee depends on the strength of the company providing it.

This will guarantee the minimum income you will receive in future at a level you can decide today. This income is guaranteed to increase every year until you decide to retire to help protect its real value.

> "Products such as Unit-Linked Guarantees can offer you a guarantee on your future income or on the capital value of your pension fund."



Chapter 5:
What help can the pensions industry give?

How and when to take income from your pension fund – retirement income for DC pension savers.

There are strict rules governing how you are allowed to take money out of your pension fund in later life. Once you reach age 55, DC pension funds allow you to take around a quarter of your fund as a tax-free lump sum, but you then have more limited choices of how to take out income. Until 2011 you had to use the remainder of your pension fund to buy an annuity. Annuities are insurance company products which take in your pension fund money and, in exchange, promise to pay you a guaranteed specific level of income for the rest of your life.

The traditional idea of contributing to a pension fund, saving for many years and then buying an annuity at age 60 or 65 is no longer applicable for many people. In future, millions more workers will reach their sixties and need to consider other options, rather than just automatically being offered and buying a standard annuity at a specific age.

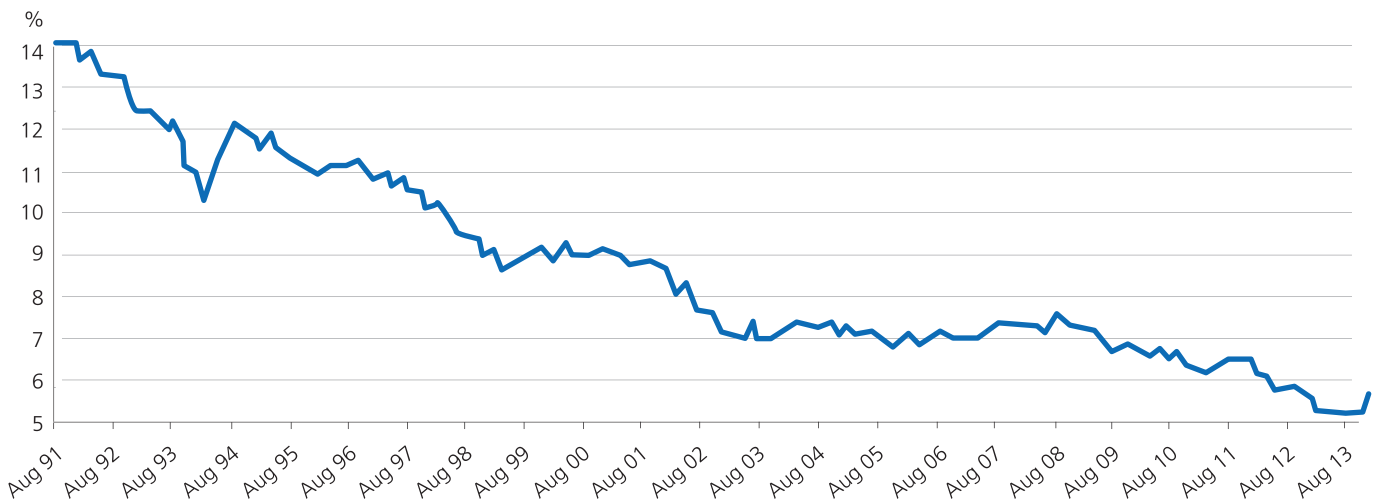
The risks of buying annuities

Annuities have historically been considered low risk, safe or even 'no risk' products. Unfortunately, this notion is flawed. In fact, buying an annuity could be the most risky investment you ever make.

Annuities do offer a guaranteed retirement income, which ensures that your income will continue until you die. Although this sounds appealing, annuities have now become very expensive and most annuities pay the same amount each year with no increase for inflation. So you may keep receiving the same income for many years but it will be worth less and less as inflation erodes its value. As the Bank of England has pushed gilt yields down, annuity rates have fallen too, which means you receive less income from your pension fund. Before interest rates plunged, the value offered by annuities was better. For example, with an annuity rate of around 10%, means the insurer will pay you 10% of the value of your original pension fund each year. So buying an annuity at age 65 meant that, as long as you lived for ten years, you would at the very least receive the value of your original pension fund back.

Annuities can offer the option of a ten year guarantee, so an annuity rate of 10% with a ten-year guarantee is like a 'money back guarantee'. (10% of your pension fund value a year, times ten years equals 100% of the original pension fund investment). However, annuity rates have plummeted in recent years, as shown in the table/chart above.

Currently, annuity rates at age 65 are nearer to 5% than 10% and, therefore, even with a ten year guarantee, if you die before age 75 you will lose more than half your money. (5% of your fund a year, times ten years equals 50% of your original pension fund investment). Buying a standard annuity with a five year guarantee, risks losing nearly three quarters of your money (5% a year times five years equals 25% of your original investment) and without any guarantee could mean losing all your money. Yet people often say that buying an annuity at retirement is the low risk or even 'no risk' option. This is no longer true because this supposedly safe investment risks losing most of your capital. If you have bought a single life annuity, you will leave nothing for your widow or widower after you pass away. The rest of your money will be kept by the insurance company, partly as profit and partly to pay claims of those who live longer. The insurance company also keeps any investment returns they can make on your fund.



Source: http://www.williamburrows.com/charts/annuity10k.aspx

Annuities explained…

An annuity is the most common form of 'pension' received from a private DC pension fund. If you buy an annuity, all the money in your pension fund, after taking any tax free cash, can be given to an insurance company. In exchange for this sum of money, the insurer promises to pay a specified level of income until you die.

Annuities are a unique financial product. There is no other investment you can buy which is completely irreversible, where your capital is at risk, which can charge you significant fees and which Regulators treat as a low risk purchase, with no risk warnings having to be given to purchasers. Once the annuity has been bought, your pension fund is in the hands of the insurance company, so you will not benefit from any more growth in the assets. Instead you will receive a specific amount of pension income for the rest of your life – you can never change your annuity once you've bought it. Annuities provide lower levels of income when long term interest rates are low, so, if you buy your annuity when the value of your pension fund has been hit by falling markets or when interest rates are particularly low (as now), you will never benefit in future from improved markets or rising rates. Equally, once you buy a fixed annuity, if inflation rises sharply you cannot protect your income (unless you have bought an inflation-linked or escalating annuity). You can buy an annuity that increases with inflation, however your starting level of income is considerably lower.

The income that your pension fund will buy can vary significantly over time as annuity rates change. Annuity costs are linked to movements in interest rates (usually government bond yields) and various other factors, including the number of years you are expected to live.

The amount the insurer promises to pay you each year in exchange for the money in your pension fund, will depend on:

- The number of years you (and any partner, if applicable) are expected to live
- The assumed investment return on the sum of money you give them from your pension fund – lower expected returns mean lower pension so lower interest rates will lead to lower annuity rates
- A margin for risk
- A margin for profit
- Any commission and charges the insurer takes from your fund either for itself or to pay to the company or online service you buy your annuity from.

There are different types of fixed annuity available. Sometimes an annuity will be 'joint-life' and will continue to pay out to a named partner or spouse until their death too. If you have an existing illness or reason to think you might die earlier than 'normal', you should not buy a standard annuity. You could buy a special annuity called an 'impaired life' or 'enhanced' annuity, which will give you much higher income than a standard annuity or you could consider leaving your money invested and passing on the majority of your pension fund to your heirs. Unfortunately, many people do not understand the options available to them and end up locked into the wrong type of annuity.

"There is no other investment you can buy which is completely irreversible, where your capital is at risk, which can charge you significant fees and which Regulators treat as a low risk purchase, with no risk warnings having to be given to purchasers."

So what are the different types of annuity you can buy?

Level Annuity	This type of annuity pays you the same sum each year for life
Escalating Annuity	This type of annuity will pay an increasing income (often 3% pa) each year for life
Index/Inflation-linked Annuity	This type of annuity will increase your income each year in line with inflation
Single life Annuity	This annuity only covers one person, so when you die, the annuity income stops, even if that is very soon after you purchase it
Joint-life Annuity	This kind of annuity will carry on paying to a surviving partner after the first person dies (usually at half or two thirds of the amount)
Impaired life or Enhanced Annuity	This kind of annuity will pay more to people are who are expected to have a shorter life expectancy than normal due to a health issue e.g. if you have high cholesterol, blood pressure or other medical conditions
Five year guarantee	If you die within five years of buying the annuity, the income will continue to be paid for at least five years after the purchase date
Ten year guarantee	This means the income will continue to be paid for at least ten years from the date the annuity was bought, even if you die sooner
With profit Annuities	These annuities may pay higher income in future, depending on the performance of an underlying with profits fund investment fund
Temporary Annuities	These pay a fixed income for a set time period - often five years - rather than for life. The remainder of the pension fund can then buy a new annuity at the end of the term which could benefit from any improvement in annuity rates.
Phased Annuity	It is possible to annuitise just part of your pension fund at regular intervals, taking some tax free cash from, say, one tenth of the fund and buying an annuity with the remainder of that one-tenth each year
Value protected Annuity	This kind of annuity will guarantee that the full value of the original pension fund will be paid back over time, even if you die before that has happened. These ‘money back guaranteed’ annuities, unfortunately, face a penal tax charge of 55% on the balance remaining after death

Annuities are no longer appropriate for managing retirement risks

Buying a standard annuity in your 60s is a relatively young age to be locking into a lifetime income which can never change in future. If you are in reasonable health, buying an annuity can amount to gambling that you will stay fit and healthy and live to a ripe old age. Although the annuity income may be 'guaranteed', your capital is not. After many years of saving in a pension fund, your money is at risk when buying an annuity. If you are happy to bet that you will not become ill, that inflation will not be much of a problem, that interest rates will not go back up again, that your circumstances will not change, and that you will not die sooner than expected, then a standard annuity may be the right product for you. But, you need to understand that this is what you are doing, because once you have given your money to the insurance company and bought the annuity, if your circumstances do change, your money is gone and you will not have a second chance. You have to literally live with it.

A standard annuity offers very low or even negative returns

Most people buying annuities at current rates will receive little or no return on their money - many will not get their money returned to them at all. A 65 year-old who does not live to age 82 will not even have all their pension fund paid back to them before they die - and will have received no interest on their fund and no inflation protection. The insurance company will have had their money for many years and earned returns on it, while the pensioner who buys a standard annuity at age 65 will have to live well beyond age 82 to get any return at all. And this is if they buy from providers offering the top rates. The recent publication of official tables by the Association of British Insurers showed the range of rates offered by all companies in the annuity markets. Buying from one of the worst providers would mean not even having had all your fund paid back to you by age 86.

Buyers should be given proper risk warnings

Far from being a low risk purchase, buying an annuity could be the highest risk product you ever buy. Annuity purchase is a long-term investment decision, which risks losing much or all your money, yet people are given no risk warnings about the dangers of buying. Annuities do protect you from running out of money, but you have given the insurance company all your pension fund and they are just paying it back to you. The amount of money they pay you is poor value.

If you die soon after buying a standard, single-life annuity, your pension fund will go to the insurance company, not to your loved ones. If you buy any other financial product that can lose more than three quarters of your money, it would usually be considered 'high risk' - and those selling it to you would be required to give you proper risk warnings. This is not the case with annuities.

Annuities are often described as an insurance product, not an investment

The purchase of annuities is often promoted on the basis that they are actually an insurance product, rather than an investment product. They insure your pension fund against stopping payouts before you die. This may be true, but it is not really the way most people think about their pension saving. If you are investing in a pension fund, you are aiming to build up as much money a possible to benefit from in later life. However, if pension saving is merely destined to buy one poor value insurance product, people may feel differently about contributing so much in the first place. And just having one insurance product will not protect you against many of the other risks that you will actually face during retirement - risks which most people would want to know that their pension saving could protect them from. In today's world, later life income requires more than just achieving an income that stays the same level until you die.

Annuities fail to protect against many later life risks

At current rates, annuities offer little protection against many of the retirement risks you will face. Even though you may have saved in a pension fund for many years that you thought was designed to protect you in retirement, a standard annuity will not help you with any of the following risks. The only risk that a standard annuity meets is the last one on this list.

Annuities leave you open to risks:

Dying relatively young	If you die soon after buying your annuity you will lose most of your pension savings. Pension money outside an annuity can pass to your family.
Inflation	As inflation rises, your level annuity becomes worth less and less each year.
Strong investment markets	If investment markets are strong, your pension fund cannot increase.
Rising interest rates	If interest rates rise, you cannot benefit from better annuity rates in future.
A change in personal circumstances - such as spouse getting ill or dying	Locking into an annuity at age 65 means any change in your circumstances will not be reflected in a better pension income in future.
Becoming ill - or more seriously ill	If you buy an annuity in good health and then become ill, or if you have an enhanced rate but become more ill, you cannot get more income to help.
Funding long-term care needs	Giving all your pension fund to an insurer will leave no money to fund long-term care if you or your partner needs it later. Increasing numbers of people will need money to fund care in later life and current pension products cannot meet this need.
Living much longer than expected	This is the major risk that an annuity DOES protect you against, but you need to live to over 88 before they are good value. Meanwhile, the annuity leaves you exposed to all the other risks listed above

Once you lock into a standard annuity, you have taken away your chance to benefit from any better opportunities in future. It is possible to buy annuities with investment linking or which increase payments each year, but the majority of annuities are standard, level annuities. Nearly every annuity that is sold has no inflation protection at all, because buying an Inflation-linked Annuity offers a much lower starting income.

Buying an annuity is effectively making the following decisions:

- You no longer want to have the chance for your fund to grow
- You do not believe your health will deteriorate further
- You do not believe you will die sooner than the insurer expects
- You cannot afford to delay the purchase of an income stream and keep your options open in case either your own or market circumstances change.

Clearly, there will be people who are comfortable with those decisions, and do not want to leave other options open, but many who buy annuities do not understand that they even have such options. They are being bamboozled, frightened or encouraged into buying one financial product with all their pension savings without realising what other opportunities they have and without understanding the ramifications of what they are doing. MetLife research showed that just one in 10 Financial Advisers would buy a lifetime annuity themselves and 16% would delay making a decision in current conditions. If the professionals have already recognised that annuities are such poor value surely it is time to protect people properly and warn them of the risks. As auto-enrolment extends to millions more workers, change is urgently needed.

What other options are there apart from annuities?

There are a several other routes that can be more suitable when considering what to do with your pension fund. For example:

- Deciding to delay (i.e. do nothing for now)
- Take tax free cash and transfer the remaining fund into income drawdown
- With-profits Annuities
- Phased Annuitisation
- Temporary Annuities
- Unit-Linked Guarantees.

The 'do nothing' option - deciding to delay has tax benefits

There are advantages to not doing anything with your pension fund. As long as you have not taken any money out of your fund and not moved to an income drawdown arrangement, if you die before age 75 your entire fund will pass onto your family tax free. If you have taken cash out or moved into income drawdown, the balance of your fund left when you die is taxed at 55%. Therefore, those who continue working and want to continue investing in the markets to try to make extra returns, may wish to simply leave their pension fund invested.

Income drawdown

In recent years, income drawdown has been an increasingly popular choice. Annuities are extremely inflexible, but income drawdown offers more flexibility, which is often valued highly in the early stages of retirement, if you are still working part time in later life.

If you use income drawdown you will usually have taken your tax free cash lump sum out of your pension fund (the rules allow around 25% to be taken free of tax in one go) and then, rather than buying a lifetime annuity, you can keep your fund invested in the hope of earning extra returns. If you are unhappy with current low annuity rates, or are still working and therefore do not need to take an income straight away, or want the chance to earn higher returns, you can move your pension fund into an income drawdown fund, which can be invested as you wish. By keeping some money in the markets, your fund can increase and may also have some protection against inflation. There is of course, the risk that the value of your fund will fall if the investment markets do badly, resulting in lower retirement income.

Income drawdown is much more flexible than buying a standard annuity, but there are some important restrictions on what you can do with your pension fund. There are two types of drawdown funds available - flexible and capped - and the restrictions are particularly focused on what is called 'capped drawdown' funds.

Flexible drawdown

If you can prove that you already have £20,000 of lifelong guaranteed pension income (which can include the state pension and any private pensions) there is much more flexibility with income drawdown as you can move your money into a flexible drawdown fund. This allows you to take as little or as much money as you like each year and you pay income tax on the amount you withdraw. Most people will probably want to take all their money out of their fund before they die, since the balance of the fund will go into their estate and face a 55% tax charge.

Capped drawdown - less flexible

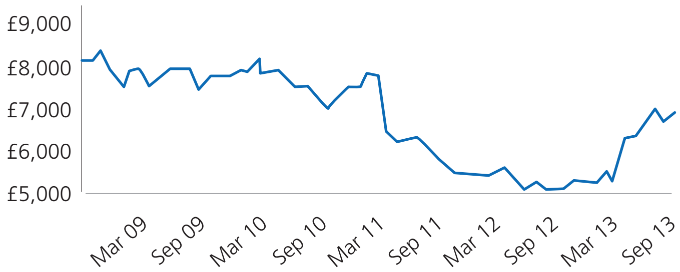
If you cannot prove that you have £20,000 of pension income each year for life, you will need to go into a 'capped' drawdown fund. These products are still more flexible than buying an annuity, however they are very tightly controlled by Government rules and have stringent restrictions on the amount of money you can withdraw each year. Although you do not have to withdraw any income if you don't need to, there are strict upper limits on the maximum withdrawals you can make each year from capped drawdown funds. The inflexibility of the rules can prevent you from taking advantage of favourable changes in your fund or in the interest rate environment. Even if your investments do well, or if interest rates change, you are often barred from increasing your pension income immediately. There are also charges to be paid when in an income drawdown fund.

Calculating the maximum income allowed from an income drawdown fund

The maximum income that can be taken from a capped drawdown plan is set by legislation. The Government Actuaries' Department (GAD) has devised rules to determine the maximum amount of income that can be taken from the capped drawdown plan. Broadly, the rules say that you can take up to 120% of what a fixed annuity could provide. The basis for this fixed annuity is set out by GAD in a set of tables and will depend on 15-year gilt yields, your age and the size of your fund. As gilt yields change the maximum amount of income that can be taken will change. Once set, the maximum is generally fixed for three years or yearly if over 75.

The table below indicates the maximum amount of income that could have been drawn from a plan using the GAD tables and gilt yields over the past 5 years for someone aged 65 with a £100,000 pension fund.

Max GAD - change in income levels 65 year old



Source: http://www.hmrc.gov.uk/pensionschemes/gad-tables.htm#1

Limits only reviewed every three years (annually after age 75)

Once the income limits are set, they are reviewed again exactly three years from the reference date, and the new limits will also depend on the same factors – age, fund size and 15-year gilt yield.

The performance of income drawdown funds depends on the investments the fund has bought.

With-profits Annuities

With-profits Annuities started in the 1990s to help people continue to participate in the markets and benefit from higher expected return investments than bonds. They offer some protection against falling markets by promising to smooth investment returns over time. With-profits funds can be quite complex and inflexible. You normally have to choose an initial level of income which is determined by what is called the Anticipated Bonus Rate (ABR) which varies from around 0% to 5%. The higher ABR offers higher starting income, but this income will then fall if the With-profits investment fund value falls. These annuities can also offer a guaranteed minimum investment level (ABR 0%) but this income is usually very much lower than available on other products. In addition to this, if you die soon after taking the annuity, your entire pension fund is lost, none can be passed on to your survivors. With-profits Annuities can offer some protection against the worst falls in the markets. Some of these funds have performed well over various time periods, but you are still exposed to investment manager risk if the With-profits fund performs poorly.

Scenario 1: assuming annuity rates remain static Fund Value - £100,000

Age (whole years at start of period)	Uncrystalised Fund remaining after £10,000 annuity purchase	Fund Crystalised in year	Cumulative Fund Crystallised	Pension Commencement Lump Sum	Annuity Income from Crystalised Fund **	Cumulative Crystallised Income	Income for year including tax free cash
60	£90,000	£10,000	£10,000	£2,500	£367.56	£367.56	£2,867.56
61	£80,000	£10,000	£20,000	£2,500	£375.72	£743.28	£3,243.28
62	£70,000	£10,000	£30,000	£2,500	£384.24	£1,127.52	£3,627.52
63	£60,000	£10,000	£40,000	£2,500	£397.92	£1,525.44	£4,025.44
64	£50,000	£10,000	£50,000	£2,500	£407.76	£1,933.20	£4,433.20
65	£40,000	£10,000	£60,000	£2,500	£418.20	£2,351.40	£4,851.40
66	£30,000	£10,000	£70,000	£2,500	£430.68	£2,782.08	£5,282.08
67	£20,000	£10,000	£80,000	£2,500	£443.04	£3,225.12	£5,725.12
68	£10,000	£10,000	£90,000	£2,500	£453.84	£3,678.96	£6,178.96
69	£0	£10,000	£100,000	£2,500	£468.12	£4,147.08	£6,647.08
70	£0	£0	£100,000	£0	£468.12	£4,147.08	£4,147.08

** Based on best in market rates as at 26/09/2013 from AVELO Exchange - Legal & General IVPP
**Annuity assumption: Single Life, no escalation, no spouse, no guarantee period payable monthly in advance

Phased annuitisation

Rather than buying a lifelong annuity with all your pension fund, it is possible to purchase an annuity with only a part of your fund and then plan to purchase more at set intervals in future. You can take the tax free cash lump sum and mix it with some annuity bought with part of the remaining fund and this phased annuity is designed to take a bit more cash and buy a bit more annuity each year. Such Phased Retirement Plans will also benefit from passing on the unannuitised amount tax-free if you die before age 75.

The tables below show two scenarios. In the first case, 10% of the pension fund is annuitised each year taking £2,500 as tax free cash and buying an annuity with the remaining fund. Assuming no increase in annuity rates, the income by the final year will be £4147.08. If annuity rates rise by 2% the income will be £4561.05 a year by age 70.

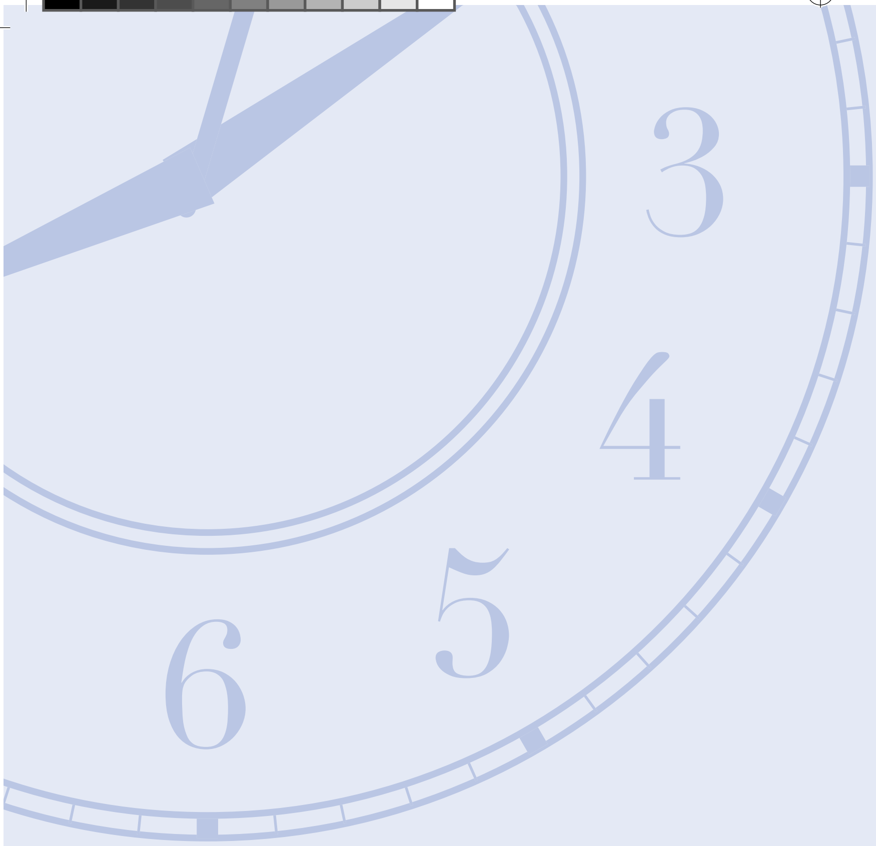
Temporary annuities

Buying a temporary annuity involves giving money to an insurer who commits to pay you a specific income level for an initial period, say five years, but you can then re-fix your annuity rate at the end of the period. If interest rates have risen since your original investment, or if your health deteriorates, you could receive a higher income in future. However, you will not benefit from increases in the investment value of your fund.

Scenario 2: assuming annuity rates improve by 2% each year
Fund Value - £100,000

Age (whole years at start of period)	Uncrystalised Fund remaining after £10,000 annuity purchase	Fund Crystalised in year	Cumulative Fund Crystallised	Pension Commencement Lump Sum	Annuity Income from Crystalised Fund **	Cumulative Crystallised Income	Income for year including tax free cash
60	£90,000	£10,000	£10,000	£2,500	£367.56	£367.56	£2,867.56
61	£80,000	£10,000	£20,000	£2,500	£383.23	£750.79	£3,250.79
62	£70,000	£10,000	£30,000	£2,500	£399.76	£1,150.56	£3,650.56
63	£60,000	£10,000	£40,000	£2,500	£422.28	£1,572.83	£4,072.83
64	£50,000	£10,000	£50,000	£2,500	£441.37	£2,014.21	£4,514.21
65	£40,000	£10,000	£60,000	£2,500	£461.73	£2,475.93	£4,975.93
66	£30,000	£10,000	£70,000	£2,500	£485.02	£2,960.95	£5,460.95
67	£20,000	£10,000	£80,000	£2,500	£508.91	£3,469.86	£5,969.86
68	£10,000	£10,000	£90,000	£2,500	£531.75	£4,001.61	£6,501.61
69	£0	£10,000	£100,000	£2,500	£559.45	£4,561.05	£7,061.05
70	£0	£0	£100,000	£0	£468.12	£4,561.05	£4,561.05

** Based on best in market rates as at 26/09/2013 from AVELO Exchange - Legal & General IVPP
**Annuity assumption: Single Life, no escalation, no spouse, no guarantee period payable monthly in advance



Chapter 6:
Risk and more flexible options

If all investments are risky how can we plan for the future?

The previous Chapters have outlined how pensions have changed significantly in recent years, moving away from the traditional employer guarantees and placing greater emphasis on individuals having to cope with investment, interest rate, inflation and longevity risks. At the same time, people's lives are changing too. Retirement ages are rising and the notion of retirement itself is being redefined.

The standard investment thinking for new-style pensions which will cover millions more workers across the country as auto-enrolment proceeds, is out of touch with the retirement realities of the future. They also entail significant investment risks because even so-called low risk investments may turn out to be much riskier than previously recognised.

Insurance against investment losses - Unit-Linked Guarantees

There is an option to buy protection for your pension funds against falling investment values. You can also protect against falling income. This protection is provided by pension or life insurance bonds which offer explicit guarantees. These products are designed to ensure that you will at least achieve a minimum amount. You would hope to do much better than this minimum, but at least retirement planning can be based on some minimum underpin, which you can rely on even if investment markets prove disappointing. Of course the underpin is provided by the insurance company itself, so this guarantee is dependent on the strength of the insurer.

These guaranteed products can provide insurance against the risks of markets falling below a specified level at some time in the future, using Unit-Linked Guarantees.

Sales of Unit-Linked Guarantees have proved popular in recent years. Especially after the last few years of stock market volatility, there is more demand for guarantees to protect against downside risk.

Year	Unit-Linked Guarantees (premiums)
2007	£0.5 billion
2008	£1.2 billion
2009	£1.0 billion
2010	£0.9 billion
2011	£1.1 billion
2012	£1.4 billion

Source for data:
www.towerswatson.com/en/Press/2013/03/Variable-annuity-sales-soar-to-record-levels-in-2012

You can protect the capital or the income of your pension fund

These guarantees can apply to your income, as well as your capital.

If you don't want to lock into today's annuity rates, and are fearful of market risks with income drawdown, but you still want to have the option of benefiting from higher investment markets and higher interest rates, or if you think interest rates may rise but you are worried about the risks of losses in a standard income drawdown fund, you could consider taking your tax free cash straight away and then buying an income or capital guarantee for the future.

Insurance for some peace of mind?

Insuring your pension can set a minimum floor on your income, or on the value of your pension fund, which could still grow over time if investment markets do well. You can insure against the income from your pension fund in future falling below a minimum level. If investments perform well, your guaranteed income or guaranteed capital value may increase however if investments perform badly your guaranteed income levels or guaranteed capital value remain unchanged.

Obviously, taking out such insurance guarantees has costs. If the stock and bond markets perform well, your pension fund will not get the full benefit, but equally, if asset prices fall, your pension fund will be protected by the insurance. Compare this with house insurance. Most people do not expect to be burgled or have a devastating fire or flood, but they would still usually prefer not to leave their home uninsured. If they do not have to claim, that money is lost, but they don't mind paying just in case. It does, however, depend on how expensive the insurance premium is. People would normally at least get a quote to find out. The same can be done to insure your future pension fund too and this will also have a cost. You will need to weigh up the potential benefits provided by the insurance, against the costs.

Insurance costs have risen:

After the recent sharp falls in markets and annuity rates, the costs of insurance have increased. That does not necessarily mean you should not choose to insure your pension fund. Again, compare this with insuring your other big asset – your house. If you have just been burgled, or just had a flood, the insurance company is likely to increase your premium. You may still take out insurance cover in case it happens again, or you may consider the costs of the insurance too high once you look into it properly. The major point is to at least know that this option is available so you can decide what to do.

How do DC pension funds operate with Unit-Linked Guarantees?

Immediate income guarantee:

If you insure the income from your fund, you can secure a minimum income level that you know you will receive, but still have the opportunity to increase that income if markets do well. If the value of your fund increases, your income level can increase in future, but if your fund value falls, you will never receive less than the minimum guaranteed income. This guaranteed income will, however, be less than you could obtain by giving all your fund to an insurance company and buying a standard annuity straight away. However, a Unit-Linked Guaranteed product allows you to benefit in future from good investment markets and gives you access to the fund to allow you to change your income or product as your circumstances change. If for example annuity rates improve you will be able to take your fund value to buy a higher level of income.

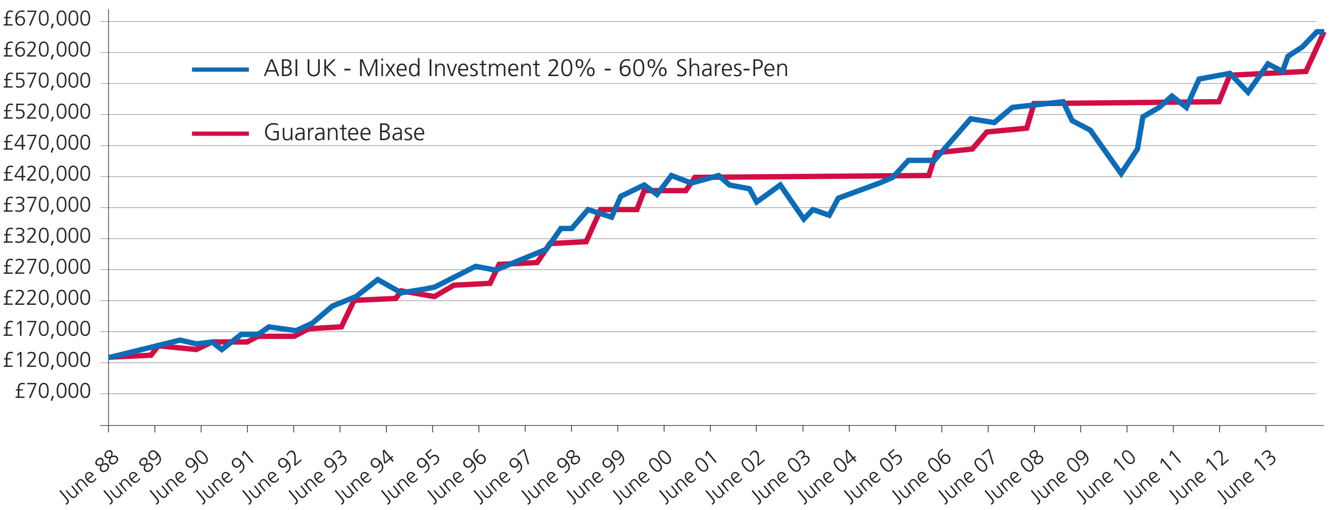
Deferred Income Guarantee:

Even if you don't want to take an income straight away, for example if you are still working, but you want to secure a minimum level of future income now for some peace of mind, you could buy a deferred income guarantee. This will offer you a guaranteed future income that will increase for each year you defer. If you are not sure when you want to stop working, you may want to take a deferred income guarantee to help you plan over time and see how your working life and needs develop. With these products, your pension fund can remain invested in the markets and, if your fund value increases, your guaranteed income level can be reviewed every year and locked into a higher amount if markets have done well, while if your fund value falls due to poor investment performance, you will still have your minimum income protected. This allows you to invest in equities, giving the opportunity to benefit from rising markets over time – but also knowing that you will not end up with less if markets fall.

These guaranteed products can also ensure that if you die relatively young, any money in your fund that has not already been paid out to you will pass onto your family (subject to tax) rather than just being kept by a product provider.

The following graph shows the benefits of having insured your pension fund over past 25 years. If your fund had been invested in a normal insurance investment fund in 1988 (represented here by the ABI cautious managed fund benchmark), it would have performed in line with the dark blue line and would have performed well in the first few years, but then fallen significantly in value since 1999. However, if you had insured the value of your original pension fund, it could also have increased in the early years and the new higher values could have been locked in and then the higher value would have stayed protected even when the markets fell during the credit crisis.

Graph showing benefits of having insured your pension fund over past 25 years

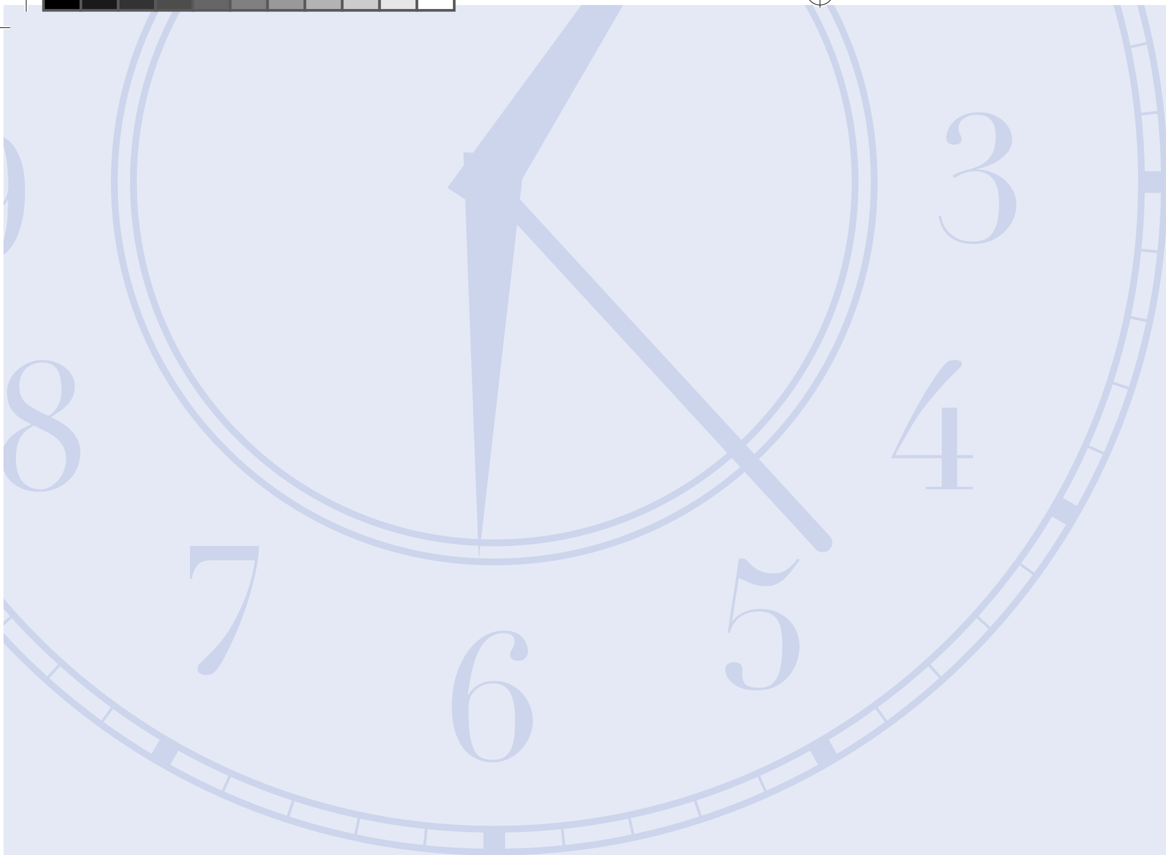


What are the benefits of insurance?

- Easier to plan as you have secured a minimum income but can keep working longer.
- Provides some certainty - of income, capital or both.
- Still benefit from market improvements, but without risking large losses.
- Your pension fund is not wasted if you die early, it can pass on to your family.
- More flexible than conventional annuity, less risky than income drawdown.

What are the downsides of insurance?

- You won't benefit from the full upside if markets do very well due to the insurance costs.
- The value of your pension fund will be less than it could be without insurance.
- Guaranteed products have relatively high charges. These charges include an annual management charge, a guarantee charge, a protection charge and fund charges, as well as charges that you will pay to an adviser who helps you select your guaranteed product.
- The insurance provider could go bust – which means you should try to ensure the provider is financially strong enough to survive extreme market conditions.



Chapter 7: Comparing the options

So how do these options compare when considering the risks people face in later life?

It might be helpful for you to think about the various retirement income options on a relative basis and try to compare them on the basis of various criteria. The following table is not designed to be a recommendation, but is just a framework to help you consider the various options.

You can decide on your own headings and perhaps work out a relative ranking for each of the factors that are important to you. The table shows how the retirement income options might be assessed on the basis of:

- Does this option provide a secure income for life?
- Does this option allow you to pass on capital to your family if you die young?
- Does this option allow you to benefit from strong investment markets?
- Does this option allow you to get better income in later life if you become ill?
- Does this option mean you will not have to pay any ongoing charges or only charges when you buy?

The final column of the table shows the potential initial income that a 65 year old could receive from each of the retirement income options listed in the table.

A Lifetime Annuity would pay £5,900 a year income for life, with no inflation protection, while a With-profits Annuity might pay anywhere between £4,500 and £7,800 a year, depending on the Annual Bonus Rate chosen.

This compares with the maximum income you could take from income drawdown which would be £7,080 a year.

An inflation linked annuity would offer £3,800 a year initially and would increase by inflation annually, but the fund would not benefit from any investment growth. That can be compared with a Unit-Linked Guarantee that would pay a guaranteed income of £4,250 a year, with the fund still invested and having the chance to benefit from investment returns over time, that might increase the income in future. This income is fixed and is not guaranteed to rise in line with inflation, however if investment markets perform better than inflation then the value of this income should increase in later years.

Everyone will have their own set of criteria that they will want to use to assess the relative attractiveness of each of these products but it is important to understand what options there are, before making an irreversible decision that may have to last you for the rest of your life.

Comparison of different options

	Will I receive a secure income for life?	Can I pass on my capital if I die young?	Can I benefit from strong markets?	If I become ill can my income go up?	No ongoing charges	Initial income (approx) £100k fund age 65 MetLife est.
Do nothing	✗	✓	✓	✓	✗	0
Lifetime Annuity	✓	✗	✗	✗	✓	£5,900 pa
With-profits Annuity	?	✗	✓	✗	✓	£4,500 - £7,800 pa
Income drawdown	✗	✓	✓	✓	✗	0 - £7,080 pa
Inflation-linked Annuity	✓	✗	✗	✗	✓	£3,800
Unit-Linked Guarantee	✓	✓	✓	✓	✗	£4,250

Source: MetLife calculations

Chapter 8: Conclusion

The future for pensions is more complex and risky than ever before. The state pension is being reduced and will not provide any earnings related element in the future, while guaranteed employer pensions have nearly all closed in the private sector. They are being replaced by Defined Contribution pensions which expose people to many different risks and require far more careful attention than traditional employer pensions which offered a guaranteed income.

Auto-enrolment will see millions more workers saving in DC pensions, but they need advice to help them plan their finances through their lifetime, as well as a less rigid and more flexible approach to pension planning. Advisers have an important role to play, but investment options need to be designed that can cope with flexible retirement dates.

Some of the standard investment options offered to DC pension savers are not suitable for tomorrow's workers who will not be retiring at a pre-set date, but will continue working part-time. As retirement becomes a process, rather than an event, the need for different options for both investment and income streams is growing. Lifestyling and target date funds are less useful when there is no fixed date to plan towards.

It is becoming harder to predict in advance the precise age at which we will retire, so planning flexibly is ever more important and it will also be necessary to find approaches which offer better later life income streams than can be provided by standard annuities.

Having the chance to guarantee either income or capital can provide peace of mind for those who are uncomfortable with the prospect of taking on stock market risks without any downside protection.

Some people will be willing to pay for guarantees, others would rather take the risks of loss. That is their choice.

There is no one right solution for everyone, but we urgently need to move away from the idea that just locking into a lifetime annuity is a low risk choice. It may mean never running out of money, but it may also mean losing all your capital and leaving loved ones with nothing from your hard-earned savings.

DC pensions are not fit for 21st Century lives. New thinking on both pensions and retirement is urgently required and those who want the best chance of better incomes will need to plan carefully for their future.

This is a significant challenge for the pensions industry as our lives become less predictable and uncertainty about investment returns and future earnings patterns grows.

Increased flexibility to work longer, preferably part-time, can offer real benefits to our later life income security and adequacy, but this also requires new thinking for pensions. It is not easy. Employers are no longer likely to guarantee good pension outcomes, so we are all exposed to more risk. Standard annuities or income drawdown products are not necessarily the best way to find peace of mind and they can expose you to different types of risk.

It will be important to consider insurance protection for your pension fund, just as you would consider insuring your house against events you hope will never happen. Longer retirements, inflation protection and the need to fund later life care will put increasing pressure on later life income. Therefore it is very important to optimise retirement income options. As increased market volatility makes financial planning much more uncertain, explicit guarantees for either pension funds or pension income are becoming more attractive, but more must be done to bring pensions and retirement in to the modern world. As Millions more workers are being automatically enrolled into DC pension schemes and will probably struggle to cope with pension risks, we need to develop new approaches for a new retirement reality.

Want to find out more?

To find out more about how MetLife can make a difference to your clients' financial future, contact us today on 0845 370 6040, or email salesresource@metlife.com

You can also find out more at www.metlife.co.uk

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