The retirement challenge - living too long?

Nigel Emery of Prudential Annuities offers a solution to the current problem facing retiring company executives.

According to research conducted on behalf of The Rowntree Foundation, life expectancy for men has increased by about 10 years since the end of the Second World War. Whilst this improvement spans the whole population, recent work by Prudential shows that wealthier people have benefited most from improvements in diet and public health, reflected in their living longer than the population in general.

This expectation of a much longer, healthier retirement creates a challenge for providers of Retirement Income products.

To date in the main there have been three pension routes by which company directors can save for their retirement: personal pensions, executive pension plans and small self administered schemes. The options available depend on the type of pension scheme that they have when they retire, although forward planning means there are opportunities to switch between different types of scheme in the lead up to retirement.

Executives' pension options

Feature	EPP	SSAS	Personal Pension
Tax free cash	All tax free cash must be taken at the outset of retirement	All tax free cash must be taken at outset	Tax free cash can be taken incrementally through a phased retirement plan
Annuity	Must be purchased by age 75	Must be purchased by age 75	Annuity purchase can be immediate or gradual over a period of time using a phased retirement plan or segmented Income Drawdown arrangement (but the annuity must be purchased in full by age 75)
Income Drawdown	Annual income of up to the amount available from an RPI linked annuity with full contingent widow(er)'s benefit	Annual Income of between 90% and 100% of the annuity that could have been bought at retirement. Any divergence from this must be explained by the scheme actuary	Annual income of between 35% and 100% of the maximum. This is determined by yields on long dated gilts and factors set by the GAD. These are based upon a single life non-escalating annuity
Income Drawdown reviews	Drawdown arrangements must be reviewed annually until an annuity is secured	The suitability of purchasing an annuity must be reviewed annually. The income drawn must be certified in each triennial review conducted by the scheme actuary.	Limits are reset every three years based upon the fund value and GAD limits at the time
Use of scheme surplus	Any surplus must be dealt with at retirement. This can be achieved in 3 ways: • Augmentation of benefits • Offset against employer's existing liabilities to pay further contributions to the scheme • Repayment to the employer	No requirement to deal with the surplus	n/a

Having reached retirement, the executive is faced with the thorny issue of how to arrange his or her retirement income. There are two options:

1. Secure a guaranteed lifetime income for themselves and their spouse and/or dependants immediately by buying an annuity; or

2. Draw an income directly from the fund as an interim step before buying an annuity.

Recent press comment suggests that buying an annuity at the current time may represent a poor deal. This autumn gilt yields fell to below the 5% for the first time since the 1950's.

So does income drawdown provide the obvious solution? Drawdown has benefits as well as risks associated with it. One often overlooked is that an annuity must be purchased at the end of the day. Since most professionals are likely to live to a ripe old age it is important to consider not only the method used in the early years of retirement but also how to secure an income for the latter years. This means considering the long-term outlook for annuities.

Annuity rates comprise two elements. The first of these is the likely pattern of deaths among annuitants – known as mortality. The size of the mortality element depends on when annuitants are expected to die; the longer people live, the smaller the subsidy. With such dramatic improvements in longevity the mortality cross subsidy element has fallen, which is already being reflected in the annuity rates on offer. Prudential and other leading annuity providers have reduced their rates in 1998 to reflect lighter mortality.

If people continue to live longer annuity rates will be forced down.

The second element is the yield on long dated gilts. Gilt prices depend upon a number of factors, including the supply of gilts, which in turn depends upon Government macro economic policy. Both the UK Government and EMU members' monetary authorities are committed to reducing the level of government borrowing The shortage of gilts has certainty contributed to the fall in annuity rates throughout 1998. Furthermore, the long-term outlook for inflation is that it will continue at modest levels and this is likely to depress gilt yields further.

The problems experienced with income drawdown are leading some experts to conclude that they have only a limited role to play at retirement. They are best suited to those who view their pension fund as an investment, designed for capital growth, rather than as an income-generating asset. Although originally intended as a safe haven whilst waiting for annuity rates to rise, in practice in the last three years they have only been advantageous to those who have died rather than those who have survived. But how many people plan to die? Indeed, as mentioned, Prudential's records show that on average the wealthy are less likely to die before age 75 than the less well off.

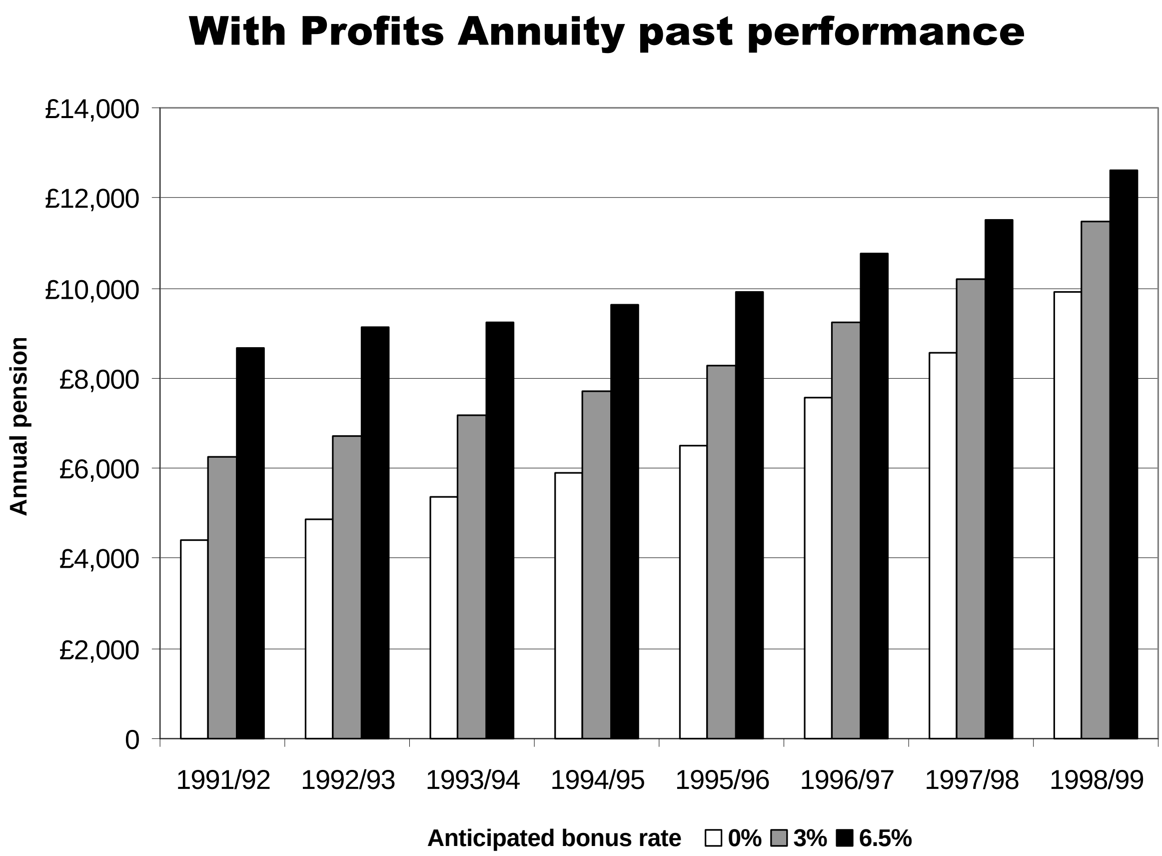
Is the outlook for retiring professionals all bad?

Income drawdown can be risky and in the long-term annuity rates are more likely to fall than rise - so is there a way forward that combines the best of both worlds? A product combining the guaranteed lifetime income of an annuity with the equity backed investment of drawdown?

Until now investment-linked annuities, introduced in the late 1980s, have received little publicity. These benefit from being backed by equity investments, which historically have produced higher returns than gilt investments over the long term.

An investment-linked annuity is very similar to a conventional annuity in terms of the payments options and widow(er)'s and dependants' pensions available. The main difference is that the annuitant has some control over the starting income and the degree of risk they want to take. With a with profits annuity this is achieved through a mechanism known as the anticipated bonus rate.

The way it works is that the director selects at outset an anticipated level of future bonus, normally in the range of between 0% and 6%. Where a higher anticipated bonus rate is selected, the starting pension will be high but the prospects for growth will be proportionally reduced. In contrast, selecting a low anticipated bonus rate means the starting income will be low, but the growth prospects substantial.



Source: Prudential. Based on a fund value of £100,000, man aged 65 and woman aged 60 buying an annuity with a contingent **b** *spouse's annuity and a 5 year guarantee on 1 April 1992.*

The graph above shows the historic effect of anticipated bonus on starting pension and subsequent rates of increase. For instance, a Prudential with profits annuity bought in 1991, with an anticipated bonus of 0% would have grown by 124.7%. In contrast, 6.5% anticipated bonus, would have limited the pension growth to 49.4%, although the starting pension would have been 25.8% higher at outset.

To conclude, the products currently available at retirement often struggle to meet the needs of those retiring. Conventional annuities suffer from low gilt yields and improving mortality. Income drawdown is really only suited to those with large funds looking for capital growth. The With Profits Annuity meets the retirement challenge by combining equity backed growth with a safe income payable for life. Or put another way, it's an insurance against living too long.

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