

**AA** Financial Services

***we'll help you enjoy  
your retirement***

*come to us for impartial advice*



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*page subject*

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## **Foreword**

*We arranged for this guide to be produced to assist the many people who contact us to obtain better information on the different aspects of financial planning in retirement.*

*We hope it gives you some insight into the areas where you can make savings, maximise your income or protect your hard earned capital. There are so many options open to investors that it is difficult in a short guide to do much more than touch on each of them briefly. If you need more information or advice, please telephone us on **0800 587 7903** and our team of advisers will be happy to help you.*

*We wish you a healthy and long retirement.*

**AA Financial Services Ltd**

This booklet is available in Large Print, Audio and Braille on request. Communication can also be made using the BT Typetalk Service Line.

## Introduction

Everyone has the right to enjoy a happy and comfortable retirement. Sorting out your financial affairs is an essential first step. The purpose of this short guide is to prepare you for the transition.

Firstly you have to look at the options you have from any provision you have made for funding your retirement. These may include:

- **Pension schemes**
- **Savings plans**
- **Stocks and shares**
- **Property**
- **Cash**
- **State benefits**

We will look at each of these areas to help you assess the issues and decisions you will need to make in order to maximise your income potential. Some are simple with many more being complex. Decisions you

make now often cannot be reversed and will impact upon you for the rest of your life.

Additionally we also look at tax because although you might not feel any different when you retire, the tax man will view you more kindly if you are over 65 years of age. The Inland Revenue gives older people a more generous personal allowance allowing you to keep more of your income. However you will need to keep an eye on capital gains and inheritance taxation.

Finally the Government arguably does not do enough for pensioners but it is surprising how many people in retirement do not claim the benefits to which they are entitled. We give an overview of the state retirement pension and other allowances you may be eligible to receive.

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## Taking your Pension Benefits

If you have been saving into a personal pension or an occupational pension scheme run by an employer, now is the time to start thinking about what to do with your money.

### **Tax-free lump sum**

Most pension schemes allow you to take a portion of your benefits as a tax-free cash lump sum when you retire. It is up to you to decide if you want to take the money and how you want to use it.

You can spend it in any way you like, on a new car or a holiday of a lifetime.

Or you might want to consider re-investing the money. This can be a good idea if you want an additional source of income on top of your pension during your retirement. Alternatively, you may want the capital to grow to pay for any residential or nursing care in the future. Several companies offer long term care insurance plans. These have been expensive in the past,

but recent Government reforms mean premiums should become more affordable for pensioners.

The disadvantage of taking the tax-free cash option is that there is less money in your pension fund to be converted into an income. You may decide it is better leaving the money where it is. There are other tax efficient ways of generating income and these should be investigated before making a final decision.

The rest of your pension savings will be used to generate an annual income for the rest of your life.

### **Occupational Pension Schemes** **Final salary**

If you are a member of a 'final salary' pension scheme run by an employer the process of setting up an income will be done for you. As the name suggests, final salary schemes provide a pension that is a proportion of your earnings at retirement linked to the number of years you have been in the scheme. Most schemes provide

## **Taking your Pension Benefits** *continued*

a pension of either 1/80th or 1/60th of final earnings. So for example, after 20 years this would give a pension of  $20 \times 1/80 = 25\%$  of final earnings. A scheme giving 1/60th of final earnings would provide a more generous pension. After 40 years' service this would pay a pension equivalent to two-thirds of the final salary.

### **Example**

*Mr Jones has worked for his employer for 30 years, he is retiring and his salary is £20,000 p.a. His occupational pension scheme is a final salary scheme providing benefits on a 60ths basis.*

*To calculate his retirement pension, Mr Jones needs to use the formula below:  
 $30 \times 1/60 \times £20,000$   
 $= £10,000 \text{ p.a.}$*

Final salary schemes are sometimes called 'defined benefit' schemes as the amount of pension they provide

is defined from the outset. However, many company pension schemes and all personal pension plans fall into an entirely different category called 'money purchase'.

### **Money purchase**

With money purchase schemes the pension that is produced is not based on an individual's earnings. Instead, money is paid in by members and their employers and in most cases is invested in the stockmarket. Over time individuals build up a pension fund of their own. The size of their pension in retirement depends crucially on how much was paid in and how successfully the money was invested. The more that goes in and the faster it grows, the bigger the pot of money that can be used to buy a pension.

If you are retiring from a money purchase scheme you have to do something that members of final salary schemes do not. You must use your pension fund – minus the tax-free lump sum if you are taking that – to buy a pension annuity.

## **Taking your Pension Benefits** *continued*

### **What is an annuity?**

An annuity is a life insurance contract sold by insurers and other specialist companies who will take your pension fund and in return pay you an income for the rest of your life.

Obviously, the bigger your pension fund the bigger your annuity income will be. But another crucial factor is life expectancy. Insurers will assess how long your life expectancy is (known as mortality) to determine how much to pay. If they think life expectancy is short they will offer you a higher annuity. If life expectancy is longer they will offer a lower annuity so that, all things being equal, the amount paid out is the same. Enhanced annuity rates are often available to individuals who are smokers or have health problems.

### **Shop around**

When you approach retirement your pension provider will send you details of the annuity they can offer. But they should also tell you of your 'open market option', basically your right to look at what other annuity companies are offering.

It is well worth shopping around, as it could be that your pension company will not be offering the most competitive annuity rate. Frequently there can be as much as 30% difference between the poorest and the best rate!

## **Annuity Options**

There are additional benefits you can add to whichever annuity you buy. All of these will affect the income you get.

### **Joint life**

So far we have only looked at annuities based on an individual life. In fact many people buy an annuity on a joint life basis to provide for themselves and their spouse. However, a joint annuity covering the lives of a male aged 65 and his wife aged 62 pays typically 24% less than a comparable single life annuity on the man. Many couples minimise this by selecting a 50% spouse's pension, which pays approximately 14% less than the single life annuity on the man.

### **Regular payments**

A pension is normally paid monthly in arrears. However you can choose to receive it quarterly, half-yearly or even annually. An annual annuity will pay around 4% more than one paid monthly.

### **Guaranteed annuities**

Buying an annuity is a gamble. If you die soon after retirement the insurance company gets all your pension savings for virtually nothing. To avoid this some people buy annuities that guarantee to pay an income for 5 or 10 years. If they die during this period the annuity will be paid to their estate. But the guarantee can be expensive and will reduce the level of income.

### **Escalating annuities**

Other people buy 'escalating' annuities. These steadily increase the income you get each year. This can help to offset the effects of inflation. The disadvantage is that you start off your retirement with a much lower income than you would with a conventional level annuity. A typical 65-year-old man would be in his 80s before he had received the same total amount as he would with a level annuity. That said, the average 65-year-old male is now expected to live well into his 80s.

## **Annuity Options** *continued*

You can choose to have your annuity linked to the Retail Prices Index (RPI) to shield you from inflation. As the cost of living goes up so will your pension, thus maintaining the spending power of your money.

This inflation proofing is worth considering as even modest inflation of 2.5% will reduce the buying power of £1,000 to just £684 in 15 years. One interesting point that is frequently overlooked however, is that a pensioner's income requirement often falls as they age owing to a more active lifestyle in the early years of retirement than when they are older.

### **Investment-linked annuities**

Traditionally most insurance companies offering conventional annuities invest in low risk Government bonds, called gilts, whose returns are linked to long-term interest rates. When interest rates fall – as they have done in recent years – annuity rates dwindle.

A few companies have developed investment-linked annuities to solve

this problem. By investing in 'with profit' or 'unit-linked' schemes that in turn invest in the stockmarket, these annuities offer the prospect of higher income than conventional annuities and many have a guarantee that the income will not fall below a fixed level. However, even plans that smooth out the ups and downs of the stockmarket will not stop the income from fluctuating. So, if you need certainty around your income you should consider a conventional annuity instead.

### **Purchased life annuity**

This is an annuity that many people buy to boost their income in retirement. It is bought with cash, whether that is savings in the bank or building society or the tax-free lump sum from your pension fund.

If leaving money to your estate is not a priority, purchased life annuities can be a good idea as they are tax efficient. Income from a pension annuity is considered to be earned income and therefore subject to

## **Annuity Options** *continued*

income tax. In contrast, part of the income from a purchased life annuity is regarded as a return of your own capital by the Inland Revenue and so is not taxed. This 'capital content' increases as you get older so if you delay buying the annuity you can maximise your tax-free income.

### **Making a Will**

Having a valid will is important at any stage in life. If you have already drawn up a will, you should check that it represents your current wishes and circumstances. If you have not drawn up a will, you should seriously consider doing so.

If you should die without making a valid will your estate will be distributed according to the Intestacy Rules, which may not be in accordance with your wishes

### **Do I have to buy an annuity when I retire?**

No, you can delay your annuity purchase if you think annuity rates are poor and may improve later. There are

two main ways of doing this: income drawdown and phased retirement. Both are specialist options and require a large pension fund of around £200,000 to be successful. These schemes are generally more suitable for experienced investors prepared to accept a medium to high level of risk. Consequently, many people are better off buying an annuity when they retire.

In any case when you reach 75 you are legally required to use the money left in your fund to buy an annuity. It is possible that the Government may relax the law in future, but at the moment the compulsion to buy annuities remains.

### **Income drawdown**

This is the first method of delaying your annuity purchase. Under income drawdown your pension fund remains invested although you cannot pay more money into it. You must withdraw a minimum amount each year as your income and this level is re-set every three years by a formula stipulated by the Government Actuaries Department.

## **Annuity Options** *continued*

You must decide whether to take the tax-free lump sum before embarking on drawdown. If investments perform sufficiently well, the fund should grow enough to balance the withdrawals and so preserve your wealth. You can decide to stop this and buy an annuity at any time before you reach 75.

If you die during income drawdown (before an annuity has been purchased) your entire pension fund can be taken as cash by your spouse or a dependant, after a 35% tax charge. This money will not be considered part of your estate and will escape inheritance tax. Alternatively, the fund can remain in drawdown and pension instalments continue to your spouse or dependant and an annuity purchased later.

Nevertheless, income drawdown is high risk. Timing an annuity purchase is difficult and in the meantime your pension fund is likely to fluctuate in value.

### **Phased retirement**

This does not so much delay annuity purchase as staggers it. Your pension fund is split into many segments, typically 100. When income is needed, a number of these segments can be encashed to give the required amount producing tax free cash and a release of pension fund in order to purchase an annuity. This tax free cash, together with the income from your annuity provides the income. The unencashed segments remain invested and can be gradually encashed in later years when additional income is required. Again the remaining pension fund must be used to purchase an annuity by your 75th birthday.

On death, providing the original fund did not come from a company pension scheme, your spouse could receive the value of your remaining fund, free of any taxes. If your funds did originally come from a company scheme, your spouse would normally receive a tax free cash sum equal to 25% of the fund with the balance being used to provide an income.

## ***Investing for Income***

Phased retirement can be an attractive alternative to buying an annuity as the remaining funds can continue to be invested for growth. Normally you would expect to be investing in funds, the value of which can fluctuate. This means that this type of investment is suitable only for those prepared to accept an element of risk.

### **National Savings**

These are a range of savings and investment products backed by H.M. Treasury. There are income products where the capital is guaranteed and a fixed and guaranteed level of income is paid. Similarly there are growth products where the growth rate is guaranteed and either fixed or linked to the Retail Prices Index.

The rates on these products vary from time to time and details of the current rates are available from your local Post Office or on the web-site ***[www.nationalsavings.co.uk](http://www.nationalsavings.co.uk)***

### **Investment Bonds**

These products vary enormously depending on what sector or market the fund invests in. For those individuals seeking income, the following bond types are the most popular:

***Guaranteed Income Bonds*** offer a rate of income that is known in advance and guaranteed. The capital investment should also be

## ***Investing for Income*** *continued*

guaranteed so there is no risk. However, some bonds guarantee the income but not the security of your capital so care is needed.

***Distribution Bonds*** invest in a wide range of assets e.g. equities and fixed interest securities. Income is normally distributed quarterly or half yearly. The income payable is variable as it is dependent upon the returns earned by the underlying fund.

***With Profit Bonds*** invest in a broad range of areas including equities. The returns earned by the fund are added to the bond in the form of regular and terminal bonuses. The returns are “smoothed” which means that in better performing years some of the investment return is held back to support a bonus payment for poorer performing years.

***High Income Bonds*** generally offer a fixed amount of income and are established for a specific term, normally between 3 and 6 years. The original capital investment is returnable at the end of the term but the proportion will normally be linked to the performance of stock market indices or sectors and may therefore be subject to a reduction.

### **Unit Trusts**

Many investors use unit trusts to access a broad range of markets and sectors around the world without the direct exposure of a share holding. Funds are split into different commercial or geographical sectors and it is therefore possible to select unit trusts with a higher or lower degree of risk to capital or income.

## **Equity Release**

Many individuals have been fortunate enough to have had membership of a good occupational pension scheme throughout their working lives. Others have been able to build up savings to support them through retirement but many people have most of their wealth tied up in their home.

There are equity release plans offered by some insurance companies and banks that exchange part of the value of your house for a capital sum or income. Equity release is generally only suitable for individuals or couples over age 70.

The capital sum can be invested to provide an income if required. The home-owners stay in their home and upon death, the loan is repaid out of the proceeds from the sale of the house. It is normally recommended that individuals interested in using their property in this way discuss it with their family. It is an important decision that of course impacts on any inheritance that family members may be expecting. Income or capital from the schemes may also affect entitlement to certain means tested State Benefits. It is therefore important to obtain advice from an Independent Financial Adviser experienced in dealing with these arrangements.

## **Tax**

Even though you may have stopped working, the taxman does not let you off the hook in retirement. Although individuals aged 65 and over can receive more money before being taxed, most sources of income during retirement are subject to income tax.

The good news is that most pensioners do not have to fill in a self-assessment tax return. This is because most pensioners have their tax deducted at source by their pension provider. If your financial affairs are more complex, however, you may be asked to fill in a tax return. This should be sent back by 30 September each year if you want the Inland Revenue to calculate your tax bill and by 31 January at the latest.

### **Age Allowance**

Individuals over age 65 have a higher personal allowance known as the "age allowance". However, the allowance is subject to an overall income limit, which is announced in the Budget every year. Income

in excess of the limit for the current year reduces the age allowance by £1 for each £2 that the income exceeds the limit. People with high incomes can totally lose the benefit of the age allowance but their allowance will not be less than the normal personal allowance for the year.

### **What is taxed?**

Your old age pension from the state and private pensions paid by previous employers or personal plans set up by yourself are all subject to tax.

How you pay the tax varies.

Tax will not be deducted from your state retirement pension before you receive it. It will be paid gross. By contrast, if you receive an occupational pension this will be paid by your former employer via PAYE (pay as you earn) and will be taxed. Your PAYE code will be adjusted to take account of the old age pension. This is why you will see more tax deducted from your occupational scheme when you start to receive your state retirement pension.

## **Tax** continued

Other state payments such as widow's pension and incapacity benefit (after the first 28 weeks) will also be taxed. Otherwise, the list of what is and what is not taxed remains much the same as before retirement.

With a few notable exceptions savings and investments are subject to tax. This includes interest from bank, building society or some National Savings investments; dividends from shares and unit trusts; and taxable gains on life assurance policies.

### **Joint income**

If you are married you will be liable for any tax due on half the amount of joint income. If you or your spouse hold the following in joint names you will be treated as if you own them equally.

- **bank or building society a/c**
- **shares**
- **property that you rent out**
- **any other property that provides income.**

### **What is not taxed?**

For people about to retire now the main social security payments outside the tax system are attendance allowance, disability living allowance, and for most individuals, income support.

Income from tax-free savings schemes such as Peps (personal equity plans), Tessa (tax-exempt special savings accounts), ISAs (individual savings accounts) and income and terminal bonuses from Save As You Earn schemes are not taxed.

### **How much can I earn before I am taxed?**

Everyone gets a personal allowance, the amount of income they can receive without having to pay tax. The good news is that individuals aged 65 or over get bigger allowances than younger people.

### **Blind person's allowance**

If you are registered blind in England or Wales or live in Scotland and Northern Ireland and have seriously impaired

## **Tax** continued

eyesight you can receive an additional allowance on top of your personal allowance before you are taxed.

### **How do I work out my tax?**

If you have to fill in a tax return there is no change from before – you need to add up your gross income for the year, adding back any tax that was taken off before you received it. For further information read Inland Revenue leaflet 'Income tax and pensioners'.

### **Do I have to pay income tax?**

Not necessarily. If your total taxable income is covered by your tax allowances you should not pay income tax.

Private and company pensions are normally paid after basic rate tax of 22% has been taken off. If your total income is less than your personal allowances you should ask your pension provider not to deduct the tax. Ask them for a form R89 to make the request.

Similarly, most banks and building societies take the equivalent of basic rate tax off interest from savings before they pay it. But if you are a non-tax payer you can arrange to have your interest paid gross, before tax. This is called 'registering'. To do this you need to complete a simple form – R85 – available from your bank or building society.

If your circumstances change and you become a taxpayer you must inform your pension provider, bank or building society immediately. Even if you only pay tax at the starting rate of 10% you may be able to claim back some tax on bank and building society interest. To claim back tax, fill in repayment claim form R40 (2001) available from your local tax office.

### **Capital gains tax (CGT)**

If you are thinking of boosting your retirement income by selling some assets this is a tax you need to be aware of. CGT may be payable on any profits made from selling an asset for more than it was bought for. The rate

## **Tax** continued

you pay depends on the level of your income tax after the addition of any profits. Stocks and shares, land and buildings and business assets are those most commonly hit by CGT. However, CGT is not normally charged if you sell your home.

The good news is that with some careful financial planning it is possible to avoid this tax. Each of us has an annual CGT allowance that allows us to take gains free of tax up to a certain limit each year. Gains made from Peps, ISAs, Tassas, most life insurance policies and Save As You Earn schemes are also exempt from the tax.

### **Inheritance tax (IHT)**

It is a similar story with inheritance tax. As you sort out your financial affairs for retirement you may want to think about what you will pass on to your family and friends when you die. Now is a good time to update your will.

At first sight IHT, commonly known as 'death duty', looks fearsome. When

an individual dies his or her 'estate' is liable to 40% tax if the value of assets left behind exceed a certain threshold. This level is currently set at £242,000 (2001 – 2002) which is not that much when you consider the rapid property price rises that have increased the value of most people's main asset, their home, in recent years.

In practice, however, only around 3% of estates have to pay IHT. With pre-planning, it is often possible to avoid some, or all, IHT liability. Transferring assets between spouses and making gifts to relatives and charities are classic ways of reducing your estate so that it falls within the tax-free band.

### **Keeping records**

It is sensible to keep anything sent to you by your tax office, pension provider or former employer in case the Inland Revenue asks you to complete a self-assessment tax return.

You can be asked to produce records for up to 6 years.

## **What the state provides**

### **State pension:**

Anyone who has reached the state pension age and who has paid enough National Insurance (NI) contributions can claim a pension from the state. Currently the State Retirement Pension is available for women from the age of 60 while men have to wait until they are 65. However, this will start to change from 2010 and by 2020 women will also retire at 65.

The Department of Work and Pensions (formerly the Department of Social Security) should contact you four months before your retirement date inviting you to claim and detailing how much you can expect. If you do not receive a letter, contact your local social security office. Details will be in the phone book.

To help you plan ahead you can also get a forecast of how much state pension you will receive. Phone **0191 218 7585** or write to: Retirement Pension Forecast and Advice Unit, Pensions and Overseas

Benefits Directorate, Tyneview Park, Newcastle upon Tyne NE98 1BA.

The State Retirement Pension is made up of two main elements, the Basic Pension and the Additional Pension. Both are based on the amount of NI contributions you either made while at work or were credited with during any periods of low earnings.

### **Basic state pension:**

To qualify for the full basic state pension a man needs to have paid, or been credited with, 44 years of NI contributions. For a woman, the figure is currently 39 years. Anyone with fewer qualifying years than this will get a reduced basic pension. And if you retire with fewer than quarter of the qualifying years you will not get any basic pension at all. Moreover, you will not get a refund of the NI contributions you did make.

### **Married women, parents & carers**

Married women who cannot get a basic pension based on their own record may be able to claim one using their husband's. But you can only do this

## **What the state provides** *continued*

if he is already getting a pension and you are 60 or over. The most you can get is 60% of the basic pension. You do not have to be living with your husband to get this pension.

Parents or carers who have either been out of paid work or who have not paid enough NI contributions because they were looking after children or sick relatives can ask to have these 'years out' disregarded. Under the Home Responsibilities Protection scheme individuals can get a reduction in the number of qualifying years needed to get a basic pension. But to get the full basic pension they will still need at least 20 qualifying years of NI payments.

Lastly, you can delay taking your basic state pension beyond your retirement age. If you claim it later you may earn extra pension, depending on your circumstances.

If you do not qualify for a basic state pension you will be entitled to receive a non-contributory pension when you

reach 80. This is currently set at 60% of the basic pension.

### **Additional pension:**

If you have worked as an employee since April 1978 you will have built up an extra state pension through the State Earnings-Related Pension Scheme (SERPS). Like the basic pension, SERPS is based on your record of National Insurance (NI) contributions but differs from it in being linked to your level of earnings as well. So, the more you earned the more you can expect. As a rule of thumb, however, you will not get more than 20% of the average earnings on which you paid NI contributions.

The amount of additional pension you get will be reduced if you were a member of an employer's pension scheme or took out a private personal pension plan that was 'contracted out' of SERPS.

Under the contracting out arrangement the part of your NI contributions that would have gone into SERPS was diverted into your own pension. As you

## **What the state provides** *continued*

put less into SERPS it is only fair that you get less back. If you received Invalidity Allowance before you reached state pension age you may be entitled to an Invalidity Addition on top of your pension. You may also be able to get extra pension if you are responsible for your husband or wife, or any children.

### **Inherited SERPS**

If you or your spouse are due to reach state pension age on or after 6 October 2002 you need to be aware of an important change in the rules. Until that date widows or widowers can inherit 100% of their spouses' SERPS pension. From that date the Government will start to cut back the amount of SERPS that a spouse can claim on the death of a partner. If your husband or wife will reach state pension age between 5 October 2002 and 6 October 2010 you will receive a maximum of between 60% and 90% of their SERPS. If they reach state pension age after 6 October 2010 you will be entitled to only a maximum of 50% of their SERPS.

### **Other state support:**

There are a range of benefits you can claim if you are on a low income and have modest savings. Chief of these is the **Minimum Income Guarantee** (MIG). To qualify you or your partner must be aged 60 or over and have less than a fixed amount of savings. The level of savings may change so you should contact your local social security office to find out the current limit. There is a sliding scale of MIG depending on your level of savings.

You may get more if you are a disabled person and live alone or with someone else who is also disabled; if you are a carer getting Invalid Care Allowance; you have housing costs that are not covered by housing benefit; or, if you or your partner get child benefit for a child.

If you need help looking after yourself or become ill or disabled once you reach 65 you may also qualify for Attendance Allowance. Most pensioners get a Christmas Bonus, winter fuel and cold weather payments.

## Conclusion

Having read this guide you may feel fully equipped to plan your income and growth requirement in retirement or like the majority, you may feel you understand a little more about what is available.

If you are seeking advice on any of these matters, you should seek independent financial advice.

In the marketplace there are advisers who are independent and those who are tied to one company.

Both sets of advisers can provide you with financial advice regarding these matters, but only independent financial advisers can access investment contracts and companies from right across the market.

If you need more information or advice, please telephone us on **0800 587 7903** and our team of advisers will be happy to help you.

The information given in the guide is believed to be accurate at the time of publication (November 2001).

However, some information may be subject to change and the effects of changes may vary according to your individual circumstances e.g. levels and bases of, and relief from, taxation are subject to change.

## Glossary of Terms

### **Annuity:**

The income generated when the pension fund is exchanged for a lifetime income.

### **Final Salary:**

A type of occupational pension scheme that accrues pension each year for its members. The level of pension is a known and predictable amount and linked to length of service and earnings close to retirement age.

### **Money purchase:**

A type of benefit accrual that some occupational pensions and most personal pensions enjoy. Operates like a savings account where contributions are invested and when the account matures at retirement age, the fund is used to generate an income.

### **Terminal Bonus:**

A bonus paid, usually from a with profits investment, when actual returns attributed to the investment have been greater than the regular bonuses added. The difference between the two being defined as the terminal bonus.

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