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Annuities

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What is an annuity?

An annuity is **an insurance provider's promise to pay you an income for a set purchase price**. This particular guide only looks at annuities in the context of pensions, where the 'set purchase price' is an amount of pension fund and the 'income' is the pension that you would receive for the rest of your life.

You do not need to have a pension fund to purchase an annuity but in that case it would be a 'purchased life annuity' and outside the scope of this guide.

> Let us say that you are 65 years old and you have just found out that you are going to receive an inheritance from an Aunt who has recently died. You have a choice to make because her solicitor has told you that her estate can either send you a cheque for £100,000 or pay you £6,882 a year for the rest of your life. Which is better? Well it depends on a lot of things.
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> For example the lump sum might come in very handy if you have a mortgage, want to move home or carry out some major home improvements. On the other hand if you would simply want to invest the money to increase your income then the annuity could be far better. After all you would find it difficult to match the 6.8% a year that the income represents without using higher risk investments.
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> If you live until age 85 then you would receive a total of £137,640 from the income, but you may consider it more important that the income would never end during your lifetime. Of course if your life expectancy is much less than average as the result of a serious medical condition then the benefit could lay with the lump sum. If the level of future inflation is expected to be high then the lump sum is likely to be more attractive to you.

After your death, payments could continue to a dependant, such as a spouse, (usually at a lower level). The annuity **can be for a fixed amount, or can increase each year**, for example in accordance with changes in the cost of living. It provides certainty and security, compared with the other options that are available.

The annuity provider will calculate from your current age and gender (and also your state of health) how long they think you might live and what return they can obtain on the lump sum you are proposing to invest with them.

In terms of your life expectancy they use **annuity tables which estimate the number of deaths per 1,000 of the population in each age group** so they are not really considering your personal life expectancy. They will then quote a figure which they think they can maintain. This is possible because they provide annuities for a large number of people, some of whom will die sooner and some later than expected and this will mean that they can still keep on paying for those who live longer.

This cross subsidy, that is the benefit you gain from those who do not live so long as you, **is known as 'mortality drag'**.

In essence annuities are **simple, secure and guaranteed**. An annuity gives great security and peace of mind as you no longer have to worry about investment returns. However, if you purchase a level (ie non-increasing) annuity you will also have concerns if inflation is high or rising.

The main point about an annuity is that **it is a 'one-off' decision**. Once it is made it cannot be changed. So it pays to get it right first time. The best ways to ensure that you consider all the options and make a decision which is the best in your current circumstances is to seek advice from an independent financial adviser (IFA).

> "I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left."
>
> Voltaire
> 18th Century French writer and philosopher

What other options are available?

You do not have to purchase an annuity with your pension fund. There are other options when you reach the point at which you want to take your pension benefit. However, **the smaller your pension fund the more restrictive your likely options will be**. These other options are outside the scope of this guide and it is sufficient simply to list these here:

- Under current legislation you can take **a tax free lump sum** (technically known as a 'pension commencement lump sum') of up to 25% of the pension fund.
- If your pension fund is big enough (preferably £250,000 plus) you **can purchase an 'unsecured pension'** (also known as 'pension drawdown') with the remainder of the pension fund rather than an annuity (ie a 'secure pension').
- There are **a small number of 'third way' products** which fall somewhere between the security that comes with the purchase of an annuity and the insecurity that comes from using pension drawdown.

Purchasing an annuity

So to recap:

- An annuity gives you a regular and secure income for your lifetime.
- Your pension fund is encashed to provide a tax free cash sum, with the balance used to buy an annuity from an insurance company.
- You choose a level or increasing annuity payable monthly, quarterly or yearly.
- You can also buy spouse's or dependant's benefits, but this will reduce your own annuity.
- Once you have bought your annuity, you usually cannot change your mind or change the benefits, even if your circumstances change.

Available annuity options

Whilst an annuity is fairly straightforward in that it converts a lump sum (in this case a pension fund) into an income for life, **there are a number of aspects to the design of the annuity** which will each affect the income you receive to a greater or lesser extent

You will be **able to control some of these aspects**, such as whether you wish to have a level or increasing annuity, but some will be out of your control, such as your age and gender.

The main 'design aspects' of your annuity are as follows:

- Age and gender
- Income frequency
- Payments in advance or arrears
- With or without proportion
- Guaranteed periods
- Escalation
- Spouse's pension
- Enhanced annuities
- Unit linked annuity
- With profits annuity

Age and gender

As your annuity will be paid to you for the rest of your life then **your present age and your resulting life expectancy will have the greatest influence** on the level of pension available to you. Across the population women tend to live four or five years longer than men of the same age. **Women will accordingly receive a lower pension than a man** of the same age.

If you decide to have a joint life annuity so that **your spouse or partner will continue to receive a pension for the rest of their life** if you pre-decease them, then their age and gender will affect the level of pension available to you.

A simple example of this is shown in the following table. In each case the annuity amount assumes £100,000 purchase price (ie the pension fund remaining after any tax free cash has been taken), that both people are age 65, in good health and do not smoke. For the joint life annuity it is assumed that the annuity will continue unaltered to his spouse should the annuitant pre decease her.

Gender of Annuitant	Single or Joint Life	Level Annuity £ pa
Male	Single	6,882
Female	Single	6,388
Male	Joint	5,790

Figures provided by *The Exchange* 13.05.2010
showing the most competitive annuity rate in each case

Income frequency

A pension is normally paid monthly, but can be paid less frequently, such as quarterly, half-yearly or even annually. Income paid monthly in arrears would be a few percent less than annually in arrears for the simple reason that the annuity provider is holding onto your money for longer and could be expected to obtain a greater investment return.

The following table shows the effect of having the income paid at different intervals in arrears.

Gender of Annuitant	Income Interval	Level Annuity £ pa
Male	Monthly	6,923
Male	Quarterly	6,966
Male	Half Yearly	7,029
Male	Annually	7,162

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

If you are going to receive a very small annuity then you might prefer to have it paid, say, twice a year so that you can put one payment towards Christmas and the other towards your summer holiday.

Payments in advance or arrears

Each annuity payment can either be **made in advance or arrears**. If you purchase a monthly annuity then it makes little difference in the overall scheme of things whether you are paid in advance or in arrears.

If you are paid half yearly or annually then you will have to wait a long time for the first payment to arrive. The following example shows that there is a 7% difference between an annual pension paid in advance and to one paid annually in arrears.

Gender of Annuitant	Annual Income	Level Annuity £ pa
Male	In arrears	7,162
Male	In advance	6,662

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

With or without proportion

If you decide to have your annuity paid in arrears then you have a supplementary choice to make. What do you want to happen to **the proportion of the annuity payment that you are owed on your death**? Again this will not be an issue if your annuity is paid monthly but if it is paid quarterly, half yearly or annually in arrears then do you want that money paid to your estate?

If you decide to have your annuity 'with proportion' then this final payment will be made to your estate. If you elect to have your annuity set up 'without proportion' then nothing further will be paid on your death (unless there is a guarantee or the annuity is on a joint life basis) and you should get a slightly higher annuity payment.

Gender of Annuitant	Annual Income in Arrears	Level Annuity £ pa
Male	Without proportion	7,162
Male	With proportion	7,051

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

Guaranteed periods

You will always receive your annuity payments for the rest of your life. However, **what if you were unfortunate to die shortly after starting the annuity?** By including a guarantee period your annuity will be paid to your estate for the remainder of that period - generally 5 or 10 years - even if you die within that period.

Gender of Annuitant	Monthly Income	Level Annuity £ pa
Male	No guarantee	6,882
Male	5 year guarantee	6,839
Male	10 year guarantee	6,710

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

You will see that adding a 5 year guarantee period **usually makes little difference to the annuity payments** so we would normally advise you to include at least this level of guarantee. However, if you are age 85 and want to add a 10 year guarantee your annuity payments will be noticeably lower!

Escalation

By far **the largest number of annuities purchased are level** (ie non escalating). An escalating or indexed annuity is one that increases each year. Whilst this is the ideal for anyone purchasing an annuity, choosing this option will result in **a considerably lower starting income** than having a level annuity.

It is therefore important to balance carefully what you need now against what you are likely to need in the future, and also take into account the age to which you expect to live, based on your health and that of your family.

You can **choose to have your annuity increase by a fixed percentage** (say 3% or 5%) **or be linked to the RPI** (Retail Prices Index) in which case your income will increase in line with inflation. It is important to know whether your annuity will decrease in value if there is deflation (ie negative inflation) as some annuities offer a 'no reduction' guarantee.

Gender of Annuitant	Monthly Income	Annuity £ pa
Male	Level	6,882
Male	3% escalation	4,996
Male	5% escalation	3,887
Male	RPI linked	4,214

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

As you might expect your annuity to be paid for perhaps 20 or 30 years it is important that you consider the effects of inflation. In our experience clients who opt for a level annuity for very sound mathematical reasons (ie it might take 20 years to be better off under an RPI linked annuity) **can feel emotionally worse off as their annuity stays the same** and everything they wish to purchase increases.

It can often be better to 'bite the bullet' of a lower income to begin with and know that it will increase in line with, say, the RPI each year in future.

Spouse's pension

Most couples choose to have a pension that benefits their surviving spouse or partner.

This option means that if you pre decease your spouse or partner, **an income is paid to your surviving spouse or partner for the rest of his or her life**. This pension can be 100% of your pension or more usually it is 66% or 50% of your pension.

Gender of Annuitant	Joint Life Annuity	Level Annuity £ pa
Male	50% to spouse	6,290
Male	66% to spouse	6,114
Male	100% to spouse	5,790

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

Enhanced annuities

If you smoke 10 or more cigarettes a day and have done for the last 10 years, or you are seriously overweight, **you may qualify for enhanced annuity rates**. These rates can add 10% or more to your retirement income. The reason, of course, is that your life expectancy is reduced.

Similarly, if you are in ill health or have had **any previous illness or major surgery** which is likely to reduce your life span, again you may qualify for enhanced annuity rates. In the years running up to retirement some clients may provide a higher income for themselves in retirement if they continue to smoke, drink too much and over-eat!

Gender of Annuitant	Monthly Income	Annuity £ pa
Male	Non smoker rates	6,882
Male	Smoker rates	7,861

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

It is estimated that 40% of people can qualify for some type of enhancement to their annuity rates. It is therefore **a tragedy that so few people bother to investigate this possibility** and simply accept the annuity being offered by their existing pension provider.

A recent development is the introduction of **annuity rates based on your occupation and postcode**. The following table shows the different annuity rates for those living in Guildford, Surrey and Warrington, Cheshire.

Gender of Annuitant	Address of Annuitant	Annuity £ pa
Male	Guildford	6,882
Male	Warrington	7,032

Figures provided by *The Exchange* 13.05.2010
Using the same basic information as for the first table

Whilst enhanced annuities offer the prospect of a higher pension for a good number of people who are retiring, **a much smaller number may qualify for an 'impaired life' annuity**.

In very broad terms an impaired life annuity might be offered to someone whose medical condition meant that **there was a very high risk of death within the next five years**, whereas an enhanced annuity might be offered to someone whose health or lifestyle meant that their life expectancy was reduced.

Applying for **an impaired life annuity can be time consuming** because pensions providers normally require detailed medical evidence, sometimes requiring a medical examination and underwrite each application individually. On the other hand **applying for an enhanced annuity is fairly straightforward** with simplified application procedures.

If you ask us to investigate the most competitive annuity for you **we will automatically ask you to complete a short medical questionnaire** so that we can check to see whether you might qualify for an enhanced annuity.

Unit linked annuity

A unit linked annuity moves away from the simple, secure and guaranteed nature of annuities that we have considered so far.

With a unit linked annuity, as its name suggests, you accept a lower initial income in exchange for **sharing in the potential investment growth** produced by the annuity fund.

An added feature is that **some future growth can be discounted to give you a higher initial income level**. If investments do well, this could provide you with an increasing income in the long term. However, if investments do not do as well as expected, **your income may fall**.

Even if your income is based on an assumed growth rate of 0%, **your income could still fall if the value of the underlying investment fund falls**.

With profits annuity

A with profits annuity is a form of unit linked annuity but where the underlying fund is the annuity provider's with profits fund.

With profits annuities do provide an element of 'smoothing' to the investment returns. The idea is that in years in which investment returns are poor **your income will not necessarily go down as much as the underlying investments** have gone down.

It also means that in very good years **not all of the investment return is paid out** as some is retained to cover the poor years.

In practice, however, with profits annuity providers use a combination of annual and terminal bonuses to determine the annuity level each year and **the year which follows one where a large terminal bonus was included** can result in a large fall in the annuity income.

A with profits annuity can be a good alternative to an RPI linked annuity because they both start at a similarly low level but, historically, **with profits bonuses from the major pensions offices have outperformed inflation over the long term**.

Low risk clients who want an increasing income from their annuity can still use a with profits annuity but should not select an anticipated bonus rate (ie it should be 0%). In this way although their annuity can still fall because of the reasons given earlier, **it cannot fall below the level that it was at the outset**.

Less risk averse clients can normally select an anticipated bonus rate. The minimum and maximum rates of anticipated bonus rate you can choose vary by provider, but typically, the range is from 0% to 5%. **If you were to choose an anticipated bonus rate of 3% for example and the actual bonus rate was 2% then your income would fall by 1%**. However, if there was a 5% terminal bonus added in the previous year which no longer applies then the fall in your income would be nearer 6%.

Open Market Option

Far too many people simply take the annuity offered to them. However, people have the right to arrange their annuity from any other pensions office if they can get a better deal.

We estimate **that two thirds of people who have taken the trouble to build up a private pension fund throw away part of the guaranteed income** that it can produce for the rest of their lives when they retire.

In fact, even of those who do make use of the 'open market option', many do not realise that they could qualify for an 'enhanced' annuity because of their health or lifestyle.

When you reach the retirement age specified under your personal pension contract, **your pensions provider will write to you offering various 'annuity' options**.

At that stage **you should show that information to an independent financial adviser** (IFA) so that they can investigate whether a higher, or more appropriate, annuity can be arranged for you, and in the case of a large pension fund, whether an annuity should be used at all.

Advantages of a Conventional Annuity

- You receive a guaranteed level of income for life
- A guaranteed level of income can continue to be paid to your spouse or dependent in the event of your death
- Your payments can be made for a guaranteed period of time (usually for 5 or 10 years). This means that, should you die within this period, payments will continue to be made
- You will be able to take a pension commencement lump sum (ie tax-free cash) immediately (although you will receive a lower annuity payment), to spend or invest as you wish

Disadvantages of a Conventional Annuity

- The level of income is fixed at the outset (unless you opt for inflation-linking) and cannot respond to changing personal financial circumstances
- The level of income will therefore depend on the level of annuity rates available at the time you purchase your annuity. If they are at a low level and you purchase, there is nothing that you can do about it in the future if rates rise once more
- There is no possibility of benefiting from future investment growth on your pension fund, although an implicit rate of investment growth has been assumed when setting the annuity rate to provide your income
- In the event of death, depending on the type of annuity you have purchased, benefits to your dependants could be lower than those enjoyed under some of the other options available to you such as unsecured pension (ie income withdrawal). There may in fact be no payment at all

Advantages of a Unit Linked/With Profits Annuity

- By using a With Profits Annuity your income will never fall below a certain amount.
- In the long run your income could even grow faster than inflation, although this would entirely depend upon the relevant funds' performance, inflation levels and the anticipated bonus rate selected.

Disadvantages of a Unit Linked/With Profit Annuity

- Your income could decrease to a level lower than you had in the beginning.
- Unlike an escalating annuity, there is no guarantee of a rising level of income.
- Past performance is not a guide to future performance.

Risk Factors

- Your circumstances might change after your annuity starts.
- You may not have made adequate provision for your dependant.
- The contract (and therefore payments) will cease upon your death unless you have selected the guarantee option and death occurs within this period.
- Inflation may exceed any rate of escalation provided by your retirement income and consequently its purchasing power would diminish.
- The total return from the annuity will depend on how long you and (if applicable) your dependant live.
- Under a unit linked or with profits annuity your income could decrease to a level lower than you had in the beginning.
- Past performance is not a guide to future performance.

Further information

You can refer to our Guide: *Open Market Option* and to our Guide: *Pension Options at Retirement*.

You can refer to www.moneymadeclear.org.uk/ the consumer website of the Financial Services Authority where you will find a booklet and other information on your retirement options.

You can obtain an online annuity illustration by visiting our website www.arch-fp.co.uk/webline_quotes.php

For personal advice

If you would like to receive advice on the purchase of an annuity, or your retirement options generally, please ask your usual Arch adviser or contact us via one of the following:

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