A guide to annuities

It takes many years of planning and saving to build up a pension fund and when the annuity option is chosen it is very important to obtain financial advice as the income rate being offered by your existing pension provider may not be competitive.

What is an annuity?

An annuity is a guaranteed fixed income and is purchased by the capital sum from your pension plan when you wish to retire and take benefits. The term of the annuity can be for life or for a specific number of years and ceases in the event of death.

The most common reason for buying an annuity is retirement, when the lump sum which you have built up over the years through a company or private scheme is used to buy an annuity and thereby provide you with a lifetime income.

However, they can be bought by any investor requiring income, with a cash lump sum from any source.

What are the retirement rules?

In the past it was compulsory to purchase an annuity at retirement. You can take tax free cash known as 'pension commencement lump sum' of up to 25% of your pension fund at retirement and make or defer your annuity purchase, alternatively, you can draw an income direct from your fund.

A further option is to combine annuity purchase with an annual withdrawal of tax free lump sums so that you take benefits in stages over several years. Not all these options are suitable for everyone and there are costs and risks associated with each. However this guide provides some basic points and a visit to MPL will help you look at each in more detail.

How is the rate of income determined?

Annuity rates are based on a statistical analysis of life expectation according to age as well as current interest rates (based on gilt yields) and current view of long term interest rates. As well as age, current health and lifestyle are taken into account.

Buying an annuity - the process

The first and most important question you have to ask is whether you want to buy an annuity at all (see the alternatives overleaf). It is not possible to change your choice once the decision has been made. Annuity rates will change according to the interest rate climate and if you are buying at a time in the market cycle when interest rates are particularly low, you may not want to commit your whole retirement fund immediately.

Furthermore, by purchasing an annuity it is not possible to participate in future investment growth on your fund. In addition, unless you have written in certain guarantees, you will not be able to pass your annuity income on to your heirs, therefore, in the event of an early death, a substantial portion of the fund used to purchase the annuity will be lost.

What does "open market option" mean?

At retirement age the pension provider will offer a range of annuity options. The open market option allows your fund to be taken to another annuity provider which could be offering more competitive terms. It is now a legal requirement for your pension provider to make you aware of the 'open market option'.

What type of annuity?

a) Single life or joint life?

This will depend on whether you have a partner you need to provide for after your death. If you choose a single life annuity, the rate of income you receive will be based on your age and state of health. If you have a joint life annuity, it will be based on both of your ages and states of health. If your partner is materially younger or healthier than you the rate of income available could be lower than if you opted for a single life annuity.

b) Would you like protection against inflation?

The inflation environment has been benign for a number of years. However, before December 2013, the Consumer Price Index figures was above the Government's target rate of 2%, demonstrating that the potential for increased inflation does exist. Even with inflation at a relatively low rate, a fall of just 2% every year in your disposable income could have an important impact. If you opt for an increasing income the return in the medium term will be lower than for a fixed income annuity. However, there would be benefits in the long term.

c) Would you like a guarantee period?

An annuity income ceases in the event of death but there is the option to include an income guaranteed period e.g. 5 or 10 years. This guarantees that the income will be paid for a set period. Therefore, in the event of your death during the set period your heirs would receive the income for the balance of the period.

d) Could you accept some investment risk?

Investment linked annuities invest your money into stocks and shares and, on the basis that the capital value of the investment increases, that investment growth could offer the potential for higher income payments in the future. This option avoids the necessity to include inflation protection (see 'b' above). There are risks to this approach as the value of your investment can fall or may not grow at all which could have a resulting effect by reducing your income.

e) Do you want to buy an annuity from more than one provider?

Although the income from annuities is guaranteed, retirees still have to take a risk on the provider. As the Equitable Life incident demonstrated, no company is 100% safe. Changes in legislation following the problems at Equitable Life mean that annuity providers are now better capitalised, so investors have greater protection than before. However, as with any investment portfolio, you may feel more comfortable spreading your risk across a number of different providers, which may make other choices easier. For example, you could inflation-proof part of your income or put a smaller amount into a joint life annuity to provide for a dependent.

f) Do you qualify for an 'enhanced' annuity?

If you are suffering from a life-shortening condition, such as heart disease or cancer, you would be eligible for an 'enhanced' or 'impaired life' annuity. Some life offices also provide these annuities for 'lifestyle choices' e.g. enhanced rates for cigarette smokers. In general, the term 'impaired life' annuity is used where there is a reasonable expectation that the person will die within five years. An 'enhanced' annuity is for someone whose life expectancy is reduced but not perhaps to such an extent.

What are the alternatives?

a) Deferred annuity purchase

Deferring the purchase of an annuity might mean the rate of income you receive will increase. If you are able to be flexible, you may also be able to choose a more favourable time in the interest rate cycle and benefit from any possible growth in your pension fund for longer. However, please be aware that your retirement fund can be eroded by poor investment performance, lower interest rates or even future lower annuity rates.

If you defer the purchase of an annuity but require income in the meantime, you can arrange an unsecured pension (drawdown) scheme for the interim which allows you to draw an income direct from your pension fund. The fund remains invested until you want to use the capital to buy an annuity. Investors can vary the amount of income without limit. Those who want to continue working could initially draw a smaller pension but increase the amount slowly until retiring fully. Some clients take the tax free lump sum immediately but leave taking any income until later.

b) Phased annuity purchase

Phased retirement allows you to buy an annuity or drawdown income in stages rather than all at once. You decide the level of income you need each year and take that amount from the plan. The annuity rate will vary due to your age and interest rates which could ultimately benefit or could work against you depending upon the economic factors like your age and interest rates will change every year, which could ultimately benefit or could work against you depending on the economic environment at that time.

Once you have decided to take benefits there is the option to take part of your tax free cash lump sum plus income, either from an annuity or from the invested fund. Under current legislation the maximum amount of tax free cash is limited to 25% of the fund value but it can be extremely tax efficient by taking part tax free cash and part income and this option provides flexibility for the future as your income needs change.

c) Other options – fixed term annuities

Since 2006 it has been possible to purchase a new style of annuity – one that provides a guaranteed level of income for the term of the annuity (typically either until age 75 or for a fixed term of 3 to 25 years). This approach enables people retiring to enjoy the same certainty with regard to their income as they would enjoy in a conventional annuity, but for the term selected rather than throughout life. At the end of the term the fund will have a guaranteed maturity value from which can be purchased either a further fixed term annuity, a conventional annuity or any of the other forms of retirement income plan covered in this document and available under current pension legislation. In this way it is possible to change the shape and options contained in the annuity purchase.

If you would like to discuss any of the information provided in more detail, please contact your MPL adviser.

MPL Wealth Management Ltd
45 Doughty Street London WC1N 2LR
Tel: 020 7831 4711
Fax: 020 7831 3137
enquiries@mplltd.co.uk
www.mplwealthmanagement.co.uk