Guidance Notes - Pensions

Annuity options on retirement

Traditional annuities are not as popular as they once were, but shouldn't be written off. More and more retirees are moving into income drawdown with the intention of taking an alternatively secured pension (ASP) from the age of 75. But the alternative – the traditional and once compulsory annuity – is still around and has developed significantly over the last decade.

Conventional Annuities

Conventional annuities provide an income for life, but the level depends upon the fund size, the age and sex of the annuitant, prevailing annuity rates – which are determined by long-term gilt yields – mortality assumptions, and the type of annuity selected.

Conventional annuities can be guaranteed for up to ten years. If the annuitant dies, payments continue until the end of the guaranteed period. Annuities can be established on a single or joint-life basis so that the annuitant's income, or a proportion thereof, can be paid to a spouse or civil partner on the annuitant's death. Payments can be level or escalate at a rate of 3% or 5% per annum.

The cost of building in a guarantee is relatively low, but purchasing a spouse's pension or some form of escalation can have a significant impact on the annuitant's starting income. For instance, a 65-year-old male building in a two-thirds pension for his 62-year-old wife will see a 10% reduction under current rates.

Indexed-linked Annuities

Rather than escalating at a fixed percentage, conventional annuities can rise in line with movements in the Retail Price Index (RPI). As annuities are generally backed by indexed-linked gilts, the starting pension will be significantly lower than the level option. For example, RPI-linking currently reduces the initial pension for a 65-year old male by 35%.

Capital Protected Annuities

Pensions simplification introduced capitalprotected annuities as an alternative to guarantee periods. On death before 75, capital-protected annuities provide a lump sum equivalent to the original purchase price less the gross income received, which is then subject to a 35% tax charge. The cost of capital protection depends on the age of the annuitant and this option is currently provided by relatively few insurers.

Enhanced Annuities

Enhanced annuities have been available since 1995 and offer higher pensions for individuals with particular medical conditions or lifestyles. Initially they were aimed at smokers, but they now also cater for diabetes sufferers, blue-collar workers, the obese and, most recently, those living in postcodes where mortality rates are higher than the national average. Although underwriting in this sector is automated around a points system and rarely requires specific medical evidence, the differences in annuity rates are worth exploring. For instance, a 65-year-old male smoker could expect a 6% higher pension than the conventional alternative.

Impaired life annuities

Taking out an impaired life annuity involves a detailed investigation of the annuitant's medical history and possibly a medical examination. Where an individual qualifies, the increase in annuity rate can be significant and will be reflective of both the annuitant's reduced life expectancy, as well as that of his/her spouse or civil partner if a joint-life annuity is selected.

Where retirees would qualify for an impairment, they might place greater importance on maximising the death benefits available, which could lead them away from an annuity purchase and towards income drawdown or phased retirement. Also, where life expectancy is below 12 months, serious ill-health commutation becomes an option.

With-profits and unit-linked annuities

With falling conventional annuity rates, many retirees have turned to investmentbased annuities which rely on future investment returns to provide and maintain a higher level of income.

With-profits annuities emerged in the late 1990s and provide an income linked to the insurer's with-profits fund.The starting income will depend on the bonus rate assumption made, and then on whether the assumed rate is met. If bonuses exceed the assumed rate, the annuitant's pension will increase, and if not, the income will fall, although never below a predetermined base level which will be paid for life, irrespective of performance. Unit-linked annuities are linked to individual funds and are potentially more volatile than their with-profits counterparts.

With-profits and unit-linked annuities are growing in popularity, but the potential for a rising income must be carefully balanced against the possibility of a reduction.These are not without risk and are not appropriate for everyone.The latest offerings in this growing area are annuities which provide a minimum income guarantee as well as investment links, the performance of which have the potential to boost annuity levels in the future. As ever, seeking advice is imperative.

Guaranteed annuities

Finally, before making any decisions about annuity purchases or the other options available to you when you draw benefits, ensure you check to see whether your pension plan has a guaranteed annuity built into it. These can be up to 60% higher than those available for similar annuities on the open market and are generally found in older with-profits pension contracts.

If you would like to arrange a free no obligation meeting to discuss your Annuity options on retirement, please contact John Lang - Director, Tower Hill Associates Limited on 020 8891 6375.