# ANNUITIES

These notes are intended for individuals who are about to take benefits from their pension arrangements or who are already in drawdown and intend to purchase an annuity. Either way, these notes are limited to a brief explanation of the types of annuity available and how they can be shaped to your particular circumstances. They will not cover the issues of annuity versus drawdown or whether to commute part of your pension fund for tax free cash. It must be stressed that these notes are for information purposes only and are based on our understanding of current rules and regulations which are always subject to change. Before discussing the types of annuity on the market, there are four decisions that need to be taken with regard to the shape of the annuity which are explained below;

1. <u>Frequency of Payment</u>

Your annuity can be paid to you monthly, quarterly, six monthly or annually and in advance or in arrears. For a fixed purchase price, pensions paid in arrears, and less frequently, will be of a slightly higher magnitude than pensions paid in advance and more often.

2. <u>Level or Escalating</u>

Your annuity can be level in payment throughout its term or start at a lower level and escalate by either the Retail Price Index or a fixed percentage, most commonly 3% per annum compound. The higher the level of escalation, the lower the initial starting level of pension. Please note, the value of a level pension will be eroded each year by the rate of inflation.

3. <u>Single Life or Dependant's Pensions</u>

A pension can be paid just on your life or it can include a provision for one or more dependant's pensions to be payable upon your death. Dependants are normally spouse (including common law) or children under the age of 18 and each dependant's pension can be any percentage of your pension at your date of death providing the sum total of all dependant's pensions do not exceed 100% of your pension at date of death. The greater the level of dependant's pension the lower the starting level of your pension.

4. <u>With or without guarantees</u>

Annuities (subject to any dependant's pensions) cease on death but it is possible to build in a guarantee that the pension will be paid for five or ten years minimum and life thereafter. For example, if you choose the 10 year guarantee and died after, say, two years of payments, your pension would be paid for a further eight years to your estate at which point all payments would cease or dependants' pensions would commence.

All of the above are relevant to most types of annuity purchased. What follows now is an insight into the types of annuity available.

Conventional Annuity

A conventional annuity is guaranteed to provide the return fixed at outset. The insurance company involved will invest the purchase price in guaranteed investments such as government securities to under-pin the return they offer to the annuitant. Following purchase, the annuitant is unconcerned about the performance of investment markets and will receive his agreed pension at the appropriate interval. This type of annuity is certain, therefore, and in common with any other annuity, will cease on death subject to any guaranteed periods or dependants pensions to be paid.

With Profit Annuities

These types of annuities are likely to appeal to people who would prefer their purchase price to participate in world investment markets holding out the prospect of increased pension payments in the future. The purchase price is therefore invested in an insurance company's with profit fund which itself invests in a broad range of equities, property and fixed interest stocks for the purpose of long term capital growth. The with profit fund is then distributed in the form of annual bonus declarations to clients' policies. It is the level of declared annual bonus which will determine the level of annual pension. At outset a client's initial level of pension is based on their assumed level of future annual bonus which can range anywhere from 0% to 6% per annum. The higher the assumed level of annual bonus, the higher the initial pension and vice versa. For example, if a client assumes an annual bonus rate of 3% per annum they will be quoted the initial level of pension to be payable. If subsequent annual bonus declarations are higher then their pension will increase but, equally, if they are lower the pension will decrease. (Unless you have chosen a 0% bonus rate in which case your pension can never fall in value.)

These types of annuities continue to make inroads into the market share of conventional annuities which have suffered significantly from falls in annuity rates over the last several years.

Unit Linked Annuities

With these types of annuity the purchase monies are invested in any number of a range of unit linked funds which can fall in value as well as rise. This means the pension in payment is likely to be more volatile, sometimes rising and sometimes falling, often quite markedly at times of stockmarket weakness and strength. This is a high risk retirement strategy.

Rolling five year annuities

A recent innovation; it is now possible to purchase an annuity but split it with part of the total purchase price being placed in a temporary five year annuity whilst the remainder of the fund is invested in one or more of a range of managed funds. These managed funds will invest predominantly in equities so the investment return is not guaranteed and at the

end of five years when your first annuity ceases you can either purchase another five year temporary annuity or a conventional annuity guaranteed for life. How much income is secured at that point depends on the performance of the managed funds over the preceding five years. These are higher risk than either conventional, or with profit annuities and are not for those people for whom their pension represents a high proportion of their retirement income. However, one advantage of these types of arrangement is that you can change the shape of the annuity at each five year anniversary to cope with changes in circumstances. It may no longer be appropriate to provide for a dependant's pension, for example.

Typically, the initial level of pension will be equivalent to a conventional single life non-escalating annuity but if maximum income is not required for the first five years it is possible to elect to receive as little as 50% of the annuity available leaving a larger fund for investment.

Fixed Period Annuities

Another recent innovation, these are annuities that, in exchange for the initial purchase price, guarantee to pay an annuity for a fixed period of five years. Whilst of limited appeal, these may be of interest to members of Small Self Administered Pension Schemes or Self Invested Personal Pensions who wish to purchase an annuity using only a proportion of their pension funds leaving the rest of it fully invested in assets such as commercial property etc. At the end of the five year period another fixed period annuity could be purchased or any other type of annuity as was felt appropriate at the time.

Flexible Drawdown Annuities

All of your purchase monies are invested in one or more managed funds, the returns of which are at the mercy of world stockmarkets. Within certain limits, you can vary the rate of withdrawal to provide your pension although the more that is drawn out the greater the investment return required to maintain the value of the underlying funds and ensure continuity of pension payments in the years to come. This type of annuity is likely to appeal to those people who want something less than the maximum level of pension in the earlier years, perhaps to supplement continued earned income, and who feel optimistic about long term returns from equity markets.

Value Protected Annuities

Most annuity products offer an annuity rate to a new client based on the pooling of risk. The rate offered at outset is based on the assumption that a certain number of individuals will die earlier than expected and the profit from their unspent monies is re-distributed amongst other annuitants. The price for that "mortality gain" is that there is no lump sum returned to the estate on a member's death. A value protected annuity works on the concept that an individual's purchase price is invested in their own pot and, at date of death, the residual pot is paid out the deceased member's estate less a 35% tax charge. Because there is no pooling of risk, value protected annuity rates can be substantially

lower than more conventional annuity products, but may well have appeal in limited circumstances.

## As at November 2006

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