Barchester Briefing

Guide to Pension Annuities

Introduction

Having successfully built up a pension fund during your working life, there will come a time when you will need to make some important decisions about how to use this fund. These decisions involve how you intend to draw your pension income to ensure the benefits best suit your needs in retirement. It is normal for people who are retiring to convert a portion of their pension fund into a tax-free lump sum with the balance used to purchase an annuity.

What is an annuity

An annuity is a regular income paid to you. It is normally paid monthly, although you could choose a different frequency such as quarterly, half yearly or annually if this suits your needs better. Pension annuities are normally payable from the time you retire and are paid throughout the rest of your life.
It is possible for your Pension Annuity to continue after your death and be payable throughout the life of your spouse or other dependent. This is known as a joint life annuity.

It is also possible for the income payable to you or to your dependants to increase each year either at a fixed rate or perhaps in line with inflation. This is known as pension escalation.

Your pension annuity is purchased with the money held within your Pension Fund at the time of retirement. Normally you are free to purchase the annuity from a provider of your choice.

What different types are there?

The difference between annuities is chiefly performance. For example, the table below shows a comparison between two providers. Both providers have quoted based on the circumstances of the same client. The difference in the incomes available is simply down to the competitive position of the two providers.

This difference in the incomes will affect you for the rest of your life. The table shows the extra income payable to you if you purchase your annuity from provider B as opposed to its competitor.

Value of your pension fund at retirement is £100,000	Amount of pension available to you each year	Total amount of pension you would receive		
		After 5 years	After 10 years	After 20 years
Annuity Provider A	£6,670 per annum	£33,350	£66,700	£133.400
Annuity Provider B	£7,300 per annum	£36,500	£73,000	£146,000
Additional income payable to you by Provider B	£630 per annum	£3,150	£6,300	£12,600

These figures assume that there would be no increases in the level of pension annuity payable. Al figures quoted are gross before deduction of income tax and are for illustrative purposes only. Quotations are based on a Male client aged 60. Pension payable monthly in advance throughout the remainder of the life of the annuitant. The pension payments are guaranteed for a minimum of 5 years. Source: My Money Adviser – May 2002.

Who Provides the best annuities?

The amount of income that can be provided for you from your Pension Fund depends on the Annuity Rates available from the Annuity Providers. These annuity rates are determined by the providers and are dependent upon a number of different factors. The size of your pension fund and your age, at the time you purchase the annuity, are particularly important.

Like many other products the most competitive Annuity Provider changes over time. It is quite normal for the competitive nature of the various providers to change from week to week. Once you have purchased your annuity, any amendments made to the annuity rates would have no effect upon your income. Therefore if you are interested in purchasing an annuity it is wise to compare the terms available from different providers. This can prove to be a time consuming process but assistance is available from your Independent Financial Adviser.

Do I have to buy an annuity from my existing pension provider?

Even where you have been making regular payments into a pension policy with an Insurance Company, you should still consider how much pension income your fund could buy from another Insurance company in comparison to the annuity available from your existing Pension Provider. This comparison should be made regardless of how successful the existing Insurance Company has been with the investment of your money during the period before your retirement.
Good investment performance within a pension policy before retirement, does not guarantee that any annuity rates offered by the same Insurance Company will be the most competitive in the market place.

Can I purchase my annuity from a different Insurance Company?

The majority of pension plans allow the value of the fund to be used to purchase an annuity from any authorised UK Pension Annuity provider. Any existing pension fund built up within the policy can be passed across to the new annuity provider. This is known as an Open Market Option (sometimes referred to as an OMO).
If your pension policy provides an OMO it will be possible for you to purchase an annuity from the Insurance Company of your choice. This allows you to obtain the most competitive annuity available at the time of your retirement. Your Independent Financial Adviser can undertake the process of finding the most competitive annuity provider for your needs.

Can my pension annuity increase each year?

It is possible for you to choose the rate by which your pension annuity will increase each year. These increases are known as pension escalation. There is not normally any requirement to have an escalating annuity, however you should remember that without an increasing annuity the spending power of your pension will reduce over the term of your retirement. Sometimes people want a retirement income that rises in line with the changes in the Retail Prices Index (RPI).

The increases to your pension annuity are normally applied annually on the anniversary of the date that you first purchased the annuity from the Insurance Company or other provider. You must make the decision to include pension escalation at the time you purchase the annuity, as it cannot be added at a later point. The level of increase you elect to build in to your annuity will affect the starting level of the income you receive.

The table below shows the effect on the starting level of pension by the inclusion of Pension Escalation at a rate of 3% each year. In this particular instance the reduction in the starting pension is more than 24%.

<table>
<tr><td rowspan="2">Assume the value of your pension fund at retirement is £100,000</td><td colspan="2">Starting levels</td></tr>
<tr><td>Non-escalating</td><td>Escalating at 3%</td></tr>
<tr><td>Amount of pension available to you during first year of your annuity</td><td>£7,300 per annum

(No increases)</td><td>£5,320 per annum

(Increases at 3% pa)</td></tr>
<tr><td colspan="3">These figures assume that there would be no increases in the level of pension annuities payable. All figures quoted are gross, before the deduction of income tax and are for illustrative purposes only.

Quotations based on male client aged 60. Pension annuities are payable monthly in advance throughout the remainder of the life of the annuitant. The increasing annuity assumes that the income will increase at 3% compound. The payments are guaranteed for a minimum of 5 years.</td></tr>
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Under some types of pension plan there are rules regarding the maximum rates of escalation that may be provided. Also in some instances there are minimum levels that is required. This is the case if your pension has been built up from rebates of National Insurance contributions because you have elected to opt out of the Government's State Earnings Related Pension scheme. This is known as Contracting Out; normally any pensions payable from Contracted Out Pension plans must escalate.

The rate of escalation depends on tax years in which the National Insurance rebates were passed to your pension plan. Initially all rebates had to provide for pensions that escalated at a rate of 3% per annum. However this changed for rebates received after the 6th of April 1997. From that date rebates must be used to provide a pension that escalates in line with the retail prices index but subject to a ceiling of 5% per annum. This rate of escalation is known as Limited Price Indexation or LPI.

What impact does my age or sex have on the Annuity?

A pension annuity is payable throughout the remainder of your life from the time you first purchase it from the annuity provider. Therefore your life expectancy has a great influence on the starting level of your annuity. As an example a 60-year-old person would receive a lower annuity than a 70 year old with the same sized pension fund because the younger person has a longer life expectancy.
The effects of life expectancy can also be witnessed in the difference in an annuity payable to a woman compared to man of the same age with the same sized fund. Statistically women live longer than men and this fact is evidenced in most annuities.

What are guarantee periods?

Since a Pension Annuity ceases on your death (unless you have chosen a joint life annuity) and none of the purchase money is returned to your estate, most people look for the annuity provider to provide some form of guarantee. This guarantee provides a minimum period during which the pension will be payable. This period starts from the commencement of your annuity payments. Normally the guarantee period is five years, although under some company pension schemes this period could be as long as ten years.

Should you die during the guarantee period then your next of kin will continue to receive the annuity payments until the end of the guarantee period. Alternatively the provider may pay a lump sum in lieu of future payments, the method they use would be determined at outset of the annuity. You should ensure you are aware of the type of guarantee, if any, that you are buying when your annuity is purchased, as it cannot be changed once the payments commence.

Can I provide a pension annuity for my partner?

The pension annuity payable to you will cease on your death, however it is possible for benefits to continue to your spouse or partner after your death. This is a joint life annuity. The income payable to your surviving partner will continue for the rest of that person's life. Your partner need not be you wife or husband, neither must they be of the same sex. If the person is not your spouse then it will be necessary to show that they are dependent on you financially. This proof is required at the time the partner's pension is to commence.

If you were not married it would be wise to contact your adviser before you decide to purchase an annuity for a partner. This will allow a check to be made that your partner satisfies the conditions applicable to financial dependants and that the benefit you have purchased could actually be provided to them after your death.

Some annuity providers call a Partner's Annuity either a Spouses Annuity or a Reversionary Annuity. These different names describe the same thing.

If you do decide to include a Partner's Annuity then as with annuity escalation, the starting level of your own annuity will be reduced. You may choose any level of partner's annuity you desire, however it cannot exceed the level of annuity payable to you during your lifetime.

You may decide to set any partner's pension at half (50%) of the level paid to you during your life or you may prefer that it would equal two thirds (66.6%) of the level paid to you. The decision is yours but please note that there are rules about the maximum benefit any one person can receive.

The table below shows the impact, on the starting level of your pension annuity, if you include a 50% partner's annuity alongside an increasing annuity of 3% each year.

Assume value of pension fund at retirement is £100,000	Non-escalating Pension	Escalating at 3%	Pension escalating at 3% with 50% partner's pension
Income available to you during the first year of your annuity	£7,300 (No increases)	£5,320 (Increases at 3% pa compound)	£4,646 (Increases at 3% pa compound and your annuity is followed on your death by a 50% partner's annuity)

These figures assume either no increase in the level of pension annuity payable or, where there are to be increases, that the annuities increase at a rate of 3% compound. The figures assume that the pension annuity payments are paid monthly in advance and are guaranteed for a minimum of 5 years. All figures quoted are gross, before the deduction of income tax and are for illustrative purposes only. Based on a male client aged 60, who has a spouse who is 3 years younger. All pensions are paid throughout the lifetimes of the annuitants.

Can I provide a pension annuity for my children?

You are allowed to provide a pension annuity, that becomes payable after your death, for one or more of your children, either natural or adopted. They must be under the age of 18 or, if they are older then, in full time education at the time of your death. Once a child passes age 18 then the pension annuity can only continue whilst they continue in full time education. Things are slightly different if you have a child with special needs: under these circumstances the pension annuity payable to them, can be paid throughout the remainder of their life.

Should I always include pension escalation on a Partner's pension?

You should consider whether the reduction in the starting level of your annuity caused by the inclusion of escalation or a Partner's pension would actually be to your advantage in the long term. If your partner has their own pension annuity, or other form of income and this is sufficient for them to live a comfortable life, then there may be no need to include a Partner's Pension within your own annuity. If your life expectancy is shortened, for instance due to ill health, or you are older, it may transpire that the inclusion of escalation is not in your interest.

If you require any assistance on deciding whether or not to include either escalation or a partner's pension you can contact us.

Once I have purchased my annuity, will my pension fund continue to grow?

By purchasing an annuity you lock in to a long-term income stream. Any Pension Fund used to buy such an annuity no longer belongs to you. Therefore not only would it not be returned after your death but should the investment markets rise sharply your income level would not be changed. Of course the same is true if the investment markets fell after you had purchased an annuity, namely a fall in market values has no effect on your income.

Green Options:

None, so far. Annuities offer a guaranteed income and, as such, must be underpinned with solid guarantees, such as can only be gained from certain property investments and government stocks. Another option is to use a 'drawdown' plan, in which an income drawn down from the pension fund, which remains invested. This involves higher risk. How much higher depends upon the funds chosen for investment. It must be converted into an annuity by age 75, under present law.

For further details:

Visit - http://www.barchestergreen.co.uk
Email - info@barchestergreen.co.uk
Call - 0800 328 6818