Annuities Guide
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What is an annuity?

An annuity is the only retirement option that pays out a regular income to a policyholder for the rest of their life, irrespective of how long they live. The pension annuity provides a steady stream of money in retirement, providing certainty for the future. It is generally purchased between the ages of 55 and 75, using either part or the entire pension fund saved up during a person’s working life. As with the level of tax relief, these ages may be subject to change.

Level of Pension Income
The level of pension income received by a policyholder depends on the annuity rates at the time the annuity is purchased from an insurance company. A person’s sex, age and health also have an impact on the level of income received. Once an annuity has been purchased, the regular amounts that an annuity pays out cannot be changed.
What is an annuity?

Normally the purchase of an annuity is irreversible, as the pension fund is lost forever after it is swapped for regular income. So you have to make sure you get it right - Contact an Annuity Professional now.

However, a new form of annuity named, “third way” annuities, have emerged which enable a policyholder to receive an income up to the age of 75 before providing them with a second opportunity to buy an annuity. Third way annuities are specialised products and their purchase will require the help of an independent financial adviser.

Purchasing an annuity is one of the most important decisions you will make regarding your retirement, as such a suitable amount of time should be set aside to research, compare and consult before making a decision.
Why bother with an annuity?

So you’ve worked hard your whole life and you’ve been contributing diligently to your pension fund, but what happens when you retire? Fortunately there is a simple answer. You buy an Annuity.

Simply put, an annuity is a one-time product you purchase with your pension pot or savings, to guarantee you an income until you die. Purchased correctly, an annuity will provide you with the financial security to enjoy your retired life.

Compulsory Purchase Annuity – Pension Funds
Generally speaking you will have paid money every month for most of your working life into your very own pension pot. But at the end of your working life what happens to that pot of money? Most people will have the option to withdraw 25% as a tax free cash lump, but what about the remaining 75%?
Why bother with an annuity?

Current legislation states that you must purchase an annuity between your 50th and 75th birthdays. So you effectively trade your pension pot for a product that guarantees to pay you a fixed sum annually until you die. Your pension provider will send you an annuity offer but you are free to shop around and buy an annuity anywhere you want. In fact you will almost always find a better deal if you shop around.

There are several different types of annuity product on offer, giving you a vast choice. Those who live unhealthy lifestyles or who are unwell can purchase special annuities at a better rate, as they are seen to have a lower life expectancy.

Purchased Life Annuity

You can also purchase an annuity with savings, referred to as a purchased life annuity, and this is often taxed more favourably than a pension related one.

Why would people not have one?

There are almost no cons to having an annuity and nearly everyone with a pension fund will eventually buy one. People without pension funds would not have one, leaving them living off a state pension. They do, however, have the option to buy one with savings.
Main advantage

The main advantage of purchasing an annuity is that you guarantee income for the rest of your life, regardless of how long you live. Couples can purchase ‘joint life’ annuities that continue paying even if one half of the couple dies. There is also the option to purchase an annuity that guarantees to pay for a set period, regardless of if you die. These are typically for 5 or 10 years, and whilst offering you a lower rate, you can rest easy that your estate will still receive your payments after you die. If you outlive the guarantee period they will continue to pay until you die.

Some annuities also increase the amount they pay out, either by a fixed amount, say 5%, or in line with the Retail Price Index, effectively negating the effects of inflation on the customer. These again pay a lower initial rate than a fixed annuity, but with people living longer and inflation rising rapidly, these provide further peace of mind for the purchaser.
Pros and cons

**Pro’s**

• A guaranteed income for the rest of your life
• Security and peace of mind that your future is secure
• The only product that guarantees to pay until you die, without risk

**Con’s**

• Annuities can very rarely be changed once set up, so you must get it right first time.

It is highly recommended to seek the help of an IFA, (Independent Financial Advisor). This does not necessarily have to be as expensive as it sounds and in the long run could increase your income substantially.
Buying an annuity

It is important when buying an annuity that you get it right the first time, as once you have purchased an annuity, there is no going back.

Most of you will have what is called an open market option (OMO) clause in your pension. This means you do not have to automatically accept the annuity rate offered to you by your pension provider. If you so wish, you are entitled to take your pension fund to another provider in order to get a higher annuity rate.

The only time that you may not have access to the OMO clause is if you have a retirement annuity contract (RAC). Research carried out by the Financial Services Authority shows that taking the OMO option, just by comparing the other options, can increase your annuity rate by as much as 20 percent. With this in mind, it is massively important you shop around; this could make a difference of hundreds of pounds a month to your retirement income.

Seek Advice

It is advisable to seek professional advice before making any final plans regarding annuities. An Independent Financial Advisor can inform you of your best options and look at the entire market to see what is out there.
Buying an annuity

Whilst Independent Financial Advisors will charge a fee or commission, this usually comes from your pension fund, so often you don’t have to pay any money up front. The additional income they find for you will nearly always outweigh the commission they charge in the first place, making it well worth your while paying the fee.

Annuity Rates
Annuity rates can be affected by a certain number of things. Firstly the provider you choose, who will not necessarily be the provider you took out your pension with in the first place. Secondly, as life expectancy increases, annuity rates tend to decrease. Your health can also affect the rate; often people who suffer from poorer health can receive a higher annuity rate, as they will have a shorter life expectancy. The older you are when you buy an annuity, the better the rate you’ll receive, as you’ll be seen to have a shorter life expectancy. Your sex also affects your annuity rate, women are offered lower annuity rates than men of the same age and with the same pension pot because, on average, they live longer. If you then choose to add on any extras such as index linking, guarantees and survivors pensions, the rate may decrease again.
Buying an annuity

85 % take conventional annuity
Around 85% of people choose to take a conventional level annuity, which is a plan set up to pay the same amount of income each month for the rest of your life. The only downfall is that there is no going back once you have taken out an annuity. The security of this kind of plan is what is attractive, as it offers you a secure fixed income after you retire. Yet, these are often not the most flexible options available.

Risk
If you are a person that likes to take some risk, or can afford to do so, you could choose to opt for an investment linked annuity. These annuities are beneficial if the returns on the underlying investments are strong. However, if the investments falter, your income may decrease over time. All of these plans should only be considered after gaining independent financial advice.

There are numerous types of annuity that can generate income, you could use half your pension to buy an investment linked annuity and the rest to buy a conventional annuity.
Buying an annuity

Flexible
Annuities can be extremely flexible, as you can tailor them to suit your needs. For example, if you are married or have a civil partner, you can take out a joint life annuity. You also may have the option of a guarantee, which can provide you with income regardless of if you live or die over a certain period of time.

Inflation
Inflation linked annuities provide you protection against inflation, as they will increase your payments in line with inflation. These will start with an initial income 30 to 40 percent lower than a conventional annuity. Conventional annuities do provide you with a certain safeguard against inflation, with payments that rise a set percentage each year. This protects you unless inflation starts to increase substantially while the set percentage remains the same.

The most important thing to remember when buying an annuity is to shop around. In order to get the best deals on the market you just need to put a little time, and potentially money, into researching the options that are best for you against what is initially offered to you by your pension provider!
Tax & National Insurance

All retirement annuities are taxed through PAYE, (Pay as you earn), just like company or personal pensions. Your annuity provider will send you tax codes which will dictate how much tax will be deducted before you receive your income. This code is based upon information about your age and overall income.

Purchased Life Annuity

If you have a purchased life annuity, 20 per cent tax will be automatically deducted from the income element you receive from it. Yet if your overall level of income means you are not a 20% rate taxpayer you can ask to receive purchased life annuity income tax free and you can make this claim by filling out a R86 application.

There are different factors that your tax free allowance depends on, firstly, your age, your income and nearly everyone gets a tax free allowance of £6,475 in the tax year ending on the 5th April 2010, and this is the amount you can receive without having to pay any tax.
Poor health

Impaired Annuities
If the state of your health is severely questionable, or if perhaps you are a long-term smoker, it is of crucial importance to realise that both these factors will greatly affect your annuity claim to a rather significant degree. Although this may sound like it will mean bad news, it is actually rather valuable.

Why? The Annuity rate available to you is inversely proportional to your health, which in basic terms means that essentially the unhealthier you are, the better your annuity rate will be! Why, for the first time in financial shopping history, is it actually worth your while to be an unhealthy citizen? Simply because your annuity administrator would not expect you to live for as long as somebody who is a picture of health, and therefore not have to pay you an income for as long.

This is the basis for the title “Impaired”, or a far more fittingly descriptive term: “Enhanced”. A doctor’s report is usually required, as a means of testing that your application form details are correct.
Impaired annuity statistics

• A staggering percentage of retiring Britons, as much as 40%, qualify for a selection of these benefit enhancements in some shape or form, but due to simply being uninformed of the small-print, they miss out as a result.
• 1 in 10 decide to choose an impaired benefit.
• 4 in 10 actually qualify for one, but simply fail to mention it.
• According to The Association of British Insurers, this translates to 125,000 pensioners missing out on a collective sum of around £250 million in uncollected retirement income between them.
• A smoker’s annuity payment is boosted by somewhere between 8% and 23%. But don’t start smoking just yet, as there are reports 1,000 separate medical conditions that would qualify a pensioner for an impaired annuity.
• The Royal Bank of Scotland says retirement income can be increased by as much as 39%, when medical conditions are taken into consideration.

The message of utmost importance here, is that no matter how small or insignificant you may think your health condition is, always mention them to your pensions administrator to make sure you don’t miss out.
Types of annuity

Different factors and circumstances can influence how much retirement income you receive. You also need to choose which type of annuity you would like to purchase.

Level Annuities
This ‘standard’ type of annuity will essentially pay the same amount to you each year for the rest of your life but you should receive a slightly higher amount when you begin your retirement. This annuity is dependent on inflation, however, so the real value of that annual amount could decrease over the time of your retirement. As retirement may last over 30 years, you need to consider whether the amount your annuity provider can offer you, will continue to keep you financially secure even if inflation has a negative effect.

Temporary Annuities
In this case, you would exchange a smaller cash sum with your insurance company for a short-term annuity. For example, you might stick with this annuity for 5 years. At this point, your payments will end and you can reconsider your annuity choices depending on your circumstances.
Types of annuity

**Investment-linked Annuities**
A fairly risky type of annuity that depends on how well your fixed-interest assets, such as bonds, perform in the stock market. If you made this choice, you will be subject to possible sudden drops and rises in the stock market.

**Increasing Annuities**
If you made this choice, at the beginning of the annuity, you would select an annual rate of increase. This choice is often made to protect the purchaser from rising inflation. There are two types of increasing annuity that you can choose. There is an escalating annuity, which as described, rises at around 3-5% every year. There is also a Retail Prices Index (RPI)-linked annuity, in which your income will rise and fall in relation to inflation.

**Deferred Annuities**
With this method, you may pay a single payment, or multiple payments to your annuity provider at the beginning of your retirement, but you will not receive an income for perhaps months or years after. You could possibly benefit from rising annuity rates, but due to several affecting factors, it is very difficult to predict whether you will or not.
Conventional annuity

Whilst a conventional annuity will generally offer the highest rate, it is neither inflation proof, nor will it pay anyone else when you die. Annuities can include built in options, which whilst lowering the income you receive, can provide peace of mind in the event of your death. These include pensions linked with your spouse, whereby he/she will continue to receive an income should you die.

There are also inflation related annuities that will rise and fall with the rate of inflation. Another option is a guaranteed period annuity, which will pay for your entire life, but it will also continue to pay your estate for a set period in the event of your death. For example, if you set up a guaranteed annuity for 10 years, and you were to die 4 years later, the annuity would continue to pay your estate for another 6 years.

Different Views

Insurance companies can have different views on life expectancy, whether they take geographic life expectancies into account depends on the types of business they want to attract. Therefore the types of annuity rates they can offer vary widely from one company to another. It is always a good idea to shop around for the best annuity deal.
Inflation proof annuity

An inflation proof annuity is a name given to an index based annuity that increases and decreases your monthly payments based on the retail price index (RPI).

This starts with a basic payout amount and has a preset interest rate that gradually increases the payout. So when the RPI increases, so does the interest rate and vice versa, meaning, if the RPI rate decreases so would the interest rate.

Advantages
Even though conventional annuities with fixed annual increases do offer protection from the effects of inflation, they do not protect you against inflation if it starts to rise very quickly. The income you receive before tax will therefore always keep its real value throughout your retirement.

Disadvantages
There are also some disadvantages to this type of annuity; for example, you would start off on a lower income than you would with a fixed rate annuity. If inflation falls below zero your annuity payments may be reduced with some providers, unless you were to take out a guarantee against negative inflation at the start; though these guarantees will affect your rate further still.
Joint-life annuity

Before you buy a lifetime annuity you will need to decide whether you want one designed just for yourself or one that will include your partner. Fortunately these come in a variety of different forms, hopefully suiting everybody’s individual needs.

Annuity Income
You can usually decide upon how much of you annuity income is paid to your partner when you die. This can be as high as 100%; however, most couples opt for a payout between one $\frac{3}{4}$th and two $\frac{3}{4}$ths of the original annuitant’s income. The more you choose to be paid to your partner upon your death, the lower the original annuity will be. Some companies may not set up a spouse or partners annuity if they are more than ten years younger than you, so this is something to keep in mind when comparing annuities.

This partner does not have to be your wife or husband. A joint life annuity will continue to pay an income to your spouse, partner or financial dependant after you die. If your financial dependants are your children, this type of annuity will usually pay until they reach a certain age, usually where they would be expected to be financially independent.
Investment-linked annuity

Within investment-linked annuities, lies the potential to exponentially increase your post-retirement income. This sets them apart from the conventional level annuities and escalating annuities because they are linked to your fixed-interest assets such as bonds and gilts.

There are two types of investment-linked annuity that you can choose.

**With-profits annuities**
Your insurance company will have a With-Profits Fund and your income will depend on the performance of this fund. Your income will be made up of a minimum starting income, and bonuses dependent on certain factors.

**Unit-linked annuities**
With unit-linked annuities, your income will be determined by the performance and value of your investments. Here you may have the ability to choose the level of risk your investments will face, with the aid of a fund manager. This is the more risky investment-linked annuity. If your investments fall, there is typically no minimum income provided for you to fall back on.
Deferring your annuity

When you reach retirement age, you can take the option of deferring your annuity. A deferred annuity is a type of annuity contract which allows you to delay the payment of your pension funds until you choose to receive them. This could mean a delay of income instalments or a lump sum.

Why defer my annuity?
Deferring annuity is now becoming more attractive due to falling annuity rates. Life expectancy is increasing, and though this is fantastic news for your health, it could impact negatively on your pension income. Annuity providers are being forced to reduce their rates to lower their costs; the longer you live, the longer they will have to pay out.

Is it worth deferring my annuity?
If you are financially prepared to defer your annuity, then for most people, it certainly seems like a good choice to make. However, it is only worth waiting if you are sure that you will live long enough to make up the income that you deferred. A person putting off retirement at age 60, until the age of 65, may find themselves having to live to the age of 100 to actually make a worthwhile return.
About PensionCalculator.org

PensionCalculator.org is a free independent Pension & Annuity Information resource. Our goal is to help individuals and families of every age and walk in life, to better understand and prepare for their later years and retirement.

PensionCalculator.org was established with the vision of providing the most thorough and complete independent overview of the options and services available within the Pension and Retirement sector.

When it comes to matters of Finance, very often your own personal circumstances will differ from others around you, so we at PensionCalculator.org will always urge our users to seek advice from qualified regulated professionals.