Retirement Intelligence

THE CASE FOR ANNUITIES

THEIR ROLE WITHIN THE NEW PENSION FREEDOMS

Supported by our sponsor Partnership. The guide is published for information only and does not in any way constitute financial advice. If you are an individual rather than a pension professional you should take regulated financial advice before making a decision about any retirement income option.

partnership
seeing retirement differently

CONTENTS

1 Introduction 03

2 What is an annuity and what makes them unique? 04

3 The case for annuities 07

- Annuities provide the optimum distribution of income over a lifetime
- They provide insurance against outliving income (but people generally underestimate how long they will live)
- They are the only policy that can pay a guaranteed income for life, especially for those with a medical condition
- They meet the retirement income needs of many people

4 In defence of annuities 12

5 The future for annuities 19

6 Conclusion 23

This paper is intended to be read by anyone who is interested in annuities, including individuals who may purchase an annuity themselves, financial advisers and other pension professionals. The paper is written in non-technical language as much as possible and in order to appeal to such a broad audience I have tried to strike a balance between providing an easy to understand case for annuities and producing a serious evaluation of their advantages and disadvantages.

1 INTRODUCTION

When the Chancellor of the Exchequer, George Osborne, announced the most fundamental changes to pensions in almost a century in his 2014 Budget speech, many people thought this sounded the death knell for annuities. Rather than signaling the end of the road for a policy that has been around since Roman times, the new pension reforms mark the beginning of a new era for annuities.

I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left

Voltaire

I believe that once people weigh up the tax consequences of taking their pension pots as a cash sum, or the risks involved with pension drawdown plans, there will be renewed interest in annuity policies because they are uniquely placed to provide a guaranteed income for life with peace of mind and security.

The case for annuitisation has never been stronger. For example, according to research from the International Longevity Centre-UK (ILC-UK) the majority of people approaching retirement age want to use their pension pots to deliver a secure guaranteed income for life. In their report entitled '*Making the system fit for purpose*' published in January 2015, nearly 70% of respondents who had a personal or company money purchase pension pot favoured a secured income option while only 7% said that taking cash to pay for holidays, a new car, house repairs or other big ticket items was the most important option and 5% of respondents said paying off debts was the most important thing to do.

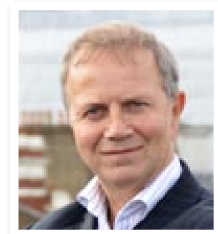
This suggests that if annuities had not already been invented, they would be invented now, to solve the age old problem of how to guarantee an income for life without the risk of running out of money.

This paper considers the case for annuities now there is more freedom and choice. It is necessary not only to look at the advantages of annuities but also the disadvantages of the other options. As we will see when we consider the risks of drawdown, annuities, especially enhanced annuities are a hard act to beat especially when the invisible force of 'mortality drag' is taken into consideration.

Before arguing the case for annuities I should briefly explain what an annuity is for the benefit of those who do not already know.

About the author

Billy Burrows is a well-known expert on annuities. He has over 20 years' experience in the annuity market. During that time he has advised individual clients on their annuity and drawdown options, worked for one the UK's largest annuity providers and contributed to numerous articles about annuities in the national and trade media.



You can read more about Billy's experience of annuities on the back cover.

2 WHAT IS AN ANNUITY AND WHAT MAKES THEM UNIQUE?

A lifetime annuity is a policy that when puchased converts a capital lump sum into a series of future income payments for as long as the policyholder is alive.

Most annuities pay a guaranteed income for life and have the following characteristics:

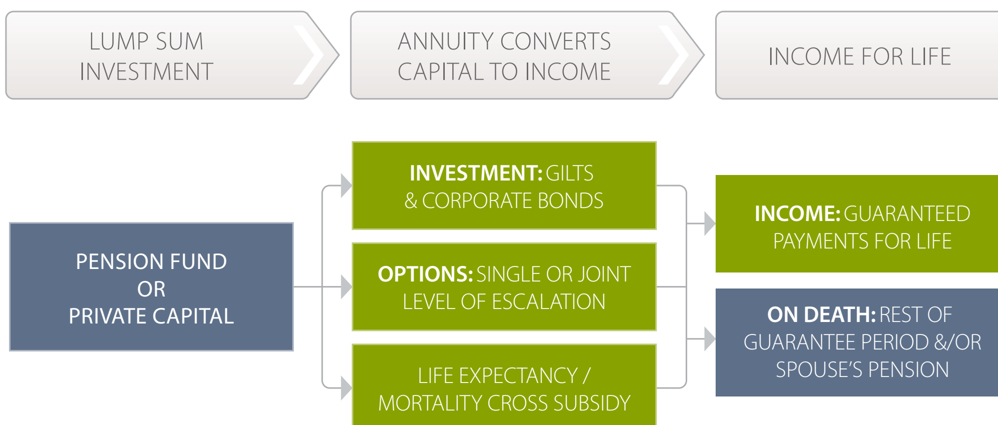
- They pay an income for the rest of the policyholder's life, no matter how long that is
- They are based on the principle of 'mortality cross subsidy'
- Enhanced rates are available for those in poor health
- On death, payments stop unless a joint life annuity, a guaranteed payment period or value protection option has been selected
- Payments can remain level or increase each year

In order to meet the income for life promise, annuities are based on the concept of *mortality cross subsidy (see right).*

Mortality cross subsidy is unique to annuities and clearly favours those in good health who may live longer than expected at the expense of those who die early. To overcome this problem some insurance companies provided *enhanced annuities.* Enhanced annuities pay a higher income for those who have a medical condition that may reduce their normal life expectancy *(see section on enhanced annuities – page 9).*

The person who purchases an annuity is called the *annuitant*, and the amount of income they receive depends on the following factors:

- The amount of money invested
- Age of policyholder and partner if a joint life annuity
- Anticipated life expectancy (taking health and lifestyle conditions into account)
- The underlying interest rate
- Options selected



Mortality cross subsidy

Actuaries calculate annuity rates assuming people will live until their normal life expectancy.

Some policyholders will die before they are expected to and some will live longer than expected.

Insurance companies make a profit from those dying early and a loss from those living longer, but they also use savings from the early deaths to subsidise the income paid to those who live longer than expected.

This is mortality cross subsidy.

Annuity options

A basic annuity will stop making payments when the policyholder dies. In order to protect against the risk of losing out if the annuitant dies before getting a good return on the investment, or losing out to inflation, annuities have a number of options. These include; joint life, guaranteed income periods, value protection and escalation.

Type	Options	Description
Single life		This pays the highest level of income but payments stop when the annuitant dies unless a guaranteed period or value protection has been selected.
Joint life	• 50% • 2/3rds • 100%	On the death of the policyholder, payments can continue to a surviving spouse or partner at the selected level. See box below for the tax treatment.
Guarantee period	• Nil • 5 years • 10 years	This means that annuity payments will be paid for a minimum period of time. If a 5 year guarantee is selected (this is the norm) and the policyholder died after 2 years, the beneficiaries would continue receiving income for the next 3 years. If it was a 10 year guarantee, the payments would continue for another 8 years. See below for the tax treatment.
Value protection	• 100% • 50%	Sometimes called the money back option, when the last policyholder dies it pays out the difference between the amount invested and payments already made. See below for the tax treatment.
Escalation	• Level • 3% • RPI	A level annuity means the payments remain at the same level throughout. Escalating at 3% means the income increases each year by 3% and the RPI option means the annuity increase each year in line with the retail prices index.
Payment frequency	• M / Q / A	Payments can be made at these different frequencies: Monthly (M) / Quarterly (Q) / Annually (A) – and in advance, in arrears.

Tax: All income payments to the policyholder are taxed as income at their marginal rate. If the policyholder dies before age 75 any income or value protection payments paid to beneficiaries will be tax free. If the policyholder dies after age 75 any income paid to beneficiaries will be taxed at recipient's marginal rate or if paid as a lump sum there will be a 45% charge (marginal rate from April 2016).

The table below gives examples of the typical annuity payouts for some of the most popular annuity options.

Annuity basis: 1st annuitant age 65, 2nd annuitant aged 60				Gross annual income for £100,000 purchase	
Type	Partner's pension	Guarantee period	Escalation	Standard	Enhanced *
Single	0%	5 years	Level	£ 5,566	£ 6,754
Joint	50%	5 years	Level	£ 5,031	£ 5,374
Joint	2/3rds	5 years	Level	£ 4,870	£ 5,052
Joint	2/3rds	5 years	3% p.a.	£ 3,129.00	£ 3,393
Joint	2/3rds	5 years	Inflation linked	£ 2,613	£ 3,002

Source: Retirement Intelligence / Annuity Exchange – top provider rates, March 2015
Tax will normally be deducted at source before payments are made.
* Smoker, high blood pressure, obese and mild diabetes.

Other types of annuities

Most annuities are purchased with the money saved up in a pension plan and understandably these are called *pension annuities,* but annuities can also be purchased with private savings and these are called *purchased life annuities (PLAs)*. There are very few PLAs sold (see box below) so this paper will concentrate on discussing pension annuities.

Although the vast majority of annuities purchased are the guaranteed type, there are also annuities where the future payments will increase or decrease in line with investment performance. These are called *with-profit* or *investment linked annuities*.

Purchased life annuities	With-profit or investment linked annuities
PLAs are very similar to a pension annuity except for two things; the money invested comes from private savings rather than a pension fund, and less income tax is paid. HM Revenue and Customs treat part of each PLA payment as a return of the original capital (called the capital content) and there is no tax to pay on this slice of income. The remainder of each payment is called the interest element and tax is charged at the savings rate of 20%, unless the policyholder is a higher rate tax payer in which case higher rate tax is payable. Some companies provide enhanced PLA's which pay a higher income for those with a medical condition that might reduce their life expectancy	These annuities are invested in either a with-profits or managed fund. At the outset the starting level of income is selected between a maximum and minimum amount and in subsequent years the annuity income is recalculated to take account of the actual investment growth or losses. The rationale for these policies is that an annuity is a long-term investment and consequently it makes sense to invest in assets that may grow over time and therefore provide a higher income in the future. The income could also reduce. As these annuities are more risky they are only suitable for those who understand the risks and can afford to shoulder any future reduction in income.

Annuities are very safe – there is no investment risk

In the UK annuity policies are issued by life assurance companies which are regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). This means that annuities are highly regulated and insurance companies must ensure that they invest their annuity funds in safe funds so they can always meet their future annuity payments. Therefore annuities are one of the few financial products that provide an income guarantee.

Conventional annuities are known as "non-profit" policies. This means that payments are guaranteed as long as the company is solvent because there is no investment risk.

If an insurance company were to be declared insolvent and was unable to pay annuity payments, policyholders are protected by The Financial Services Compensation Scheme (FSCS). The amount of compensation will change in July 2015 from 100% of the first £2,000 of the annual annuity payments plus 90% of the remaining payments to 100% compensation for the total value of the annuity. Policyholder protection is triggered if an authorised insurer is unable, or likely to be unable, to meet claims against it, for example if it has been placed in provisional liquidation.

However, if you have an investment linked annuity e.g. with-profits, unit linked or flexible annuity, the payments are not guaranteed in the same way.

3 THE CASE FOR ANNUITIES

The case for annuities can be made very simply; they are the only policy that can pay a high level of guaranteed income for life. In this sense an annuity is a pension, and in the rush to give people more choice it is easy to lose sight of why people save for a pension in the first place.

A more sophisticated case can be made because annuities meet the needs and objectives of people who want to make sure that they will have a regular income for the rest of their life with the peace of mind and security that they will never run out of income.

In order to argue the case for annuities I will consider the following:

1. The advantages of annuitisation
2. They provide insurance against outliving income
3. They are the only policy that can pay a high level of guaranteed income for life, especially for those with a medical condition*
4. They meet the retirement objectives of many retired people

What is a pension?

A pension is an income paid regularly to a person, typically following their retirement from work.

A typical pension will be payable for life, will not normally reduce but may increase each year.

1: THE ADVANTAGES OF ANNUITISATION

Economists, especially those in the US, have been interested in the concept of annuitisation (the process of converting a lump sum into income for life) for a long time and have argued that those who want to find the best way to stretch their income over their lifetime should purchase an annuity.

Ever since the US economist Menahem Yaari wrote about the life-cycle of a consumer with an unknown date of death but with the need to maximise income, annuities have played a central role in economic theory. Yaari showed how a consumer who did not need or want to leave money to the family, but wanted to get the maximum utility from their income, should annuitise their retirement savings.

If there were no annuities, people of pension age would be faced with two dilemmas when it came to taking an income from their pension pots; how much income to take and where to invest their money.

If there were no annuities people would be faced with two dilemmas when taking an income from their pension pots; how much income to take, and where to invest their money

How much income to take?	Where to invest the money?
If too much income was taken from their pension pots they would run the risk of running out of money but if they took too little income they could die without having enjoyed all the income they could have had. In economic terms, without annuities people will either over spend or underspend because it is almost impossible to arrange their finances so they die with a zero bank balance.	Without annuities, there would also be the problem of where to invest the capital. Investing in the stock market would put the capital at risk because it would fall in value if there was a stock market crash. However investing in cash or low yielding assets would provide a poor return on the money.
Annuities solve this problem by guaranteeing a known amount of income as long as the policy holder (or their partner) is still alive.	Annuities solve this problem by providing an internal rate of return higher than cash but without any investment risk to the policyholder.

* While some commentators suggest the income from an annuity is not high, I will explain why I disagree.

2: INSURANCE AGAINST OUTLIVING INCOME (BUT PEOPLE GENERALLY UNDERESTIMATE HOW LONG THEY WILL LIVE)

'In the long run we are all dead' said the famous economist John Maynard Keynes, but how long is the 'long run'?

The short answer is that it is often much longer than people think because many grossly underestimating their life expectancy.

It is generally acknowledged that many people of pension age underestimate how long they will live by between 5 to 10 years. This may have serious consequences for those trying to organise their own retirement income plans because it increases the risk of running out of income in later life.

The table below sets out the average life expectancy for men and women.

	Men		Women	
Age now	Years	To age	Years	To age
60	27.39	87.39	29.62	89.62
65	22.63	87.63	24.70	89.70
70	18.01	88.01	19.90	89.90
75	13.07	88.07	15.37	90.37
80	10.00	90.00	11.29	91.29
85	6.84	91.84	7.83	92.83

Sample Expectations of Life from the CMI (Continuous Mortality Investigation) 2014 Model

As we will see later, one of the reasons some people do not like annuities is that they worry that if they die (and their partner if it is a joint life annuity) soon after taking out an annuity, the capital is gone and there is nothing to pass on to the rest of the family.

However, the advantage of an annuity is that if someone lives well beyond their normal life expectancy, they will not outlive their income.

The annuity paradox

Academic researchers, mainly in the US, use this term when they try and answer one of the most important questions in retirement income planning:

Why, if annuities provide the optimum income payments for someone who wants to maximise their lifetime income without taking risk and ensures they do not outlive their income, do many people favour higher risk drawdown options?

The answer to this riddle is twofold. First, many people are reluctant to make irrevocable decisions, and secondly there is a reluctance to choose an option that does not pay a lump sum to their heirs.

In this paper we will discuss the advantages of committing to a lifetime annuity and show how annuities can also benefit the wider family.

The case of Madame Calment

At the age of 90 Madame Calment entered into an annuity contract with her lawyer, Andre Raffray.

He agreed to pay her a monthly income in return for her apartment when she died. This proved to be a bad deal for the lawyer because he died first, having paid out nearly double the value of the property. Madame Calment was 121 when Monsieur Raffray died; his family continued paying out until she died a year later at the ripe old age of 122.

3: A HIGH LEVEL OF GUARANTEED INCOME FOR LIFE, ESPECIALLY FOR THOSE WITH A MEDICAL CONDITION

How high is a high income? The answer is higher enough to be more than on offer from other investments, but low enough to ensure that it can be guaranteed for life.

At the time of writing, the annuity income for a 65 year old investing £100,000 in a single life policy was just over £5,500 per annum gross *(see table page 5)*. Put another away, it represents a return of 5.5% guaranteed.

Those with a keen eye for figures will spot that the reason why the return is so high is because annuity payments comprise part repayment of the original capital. Therefore it is not a like for like comparison with the income from an ISA or savings account. Never the less, there is no alternative that guarantees as high an income guaranteed for life.

Higher income for those in poor health

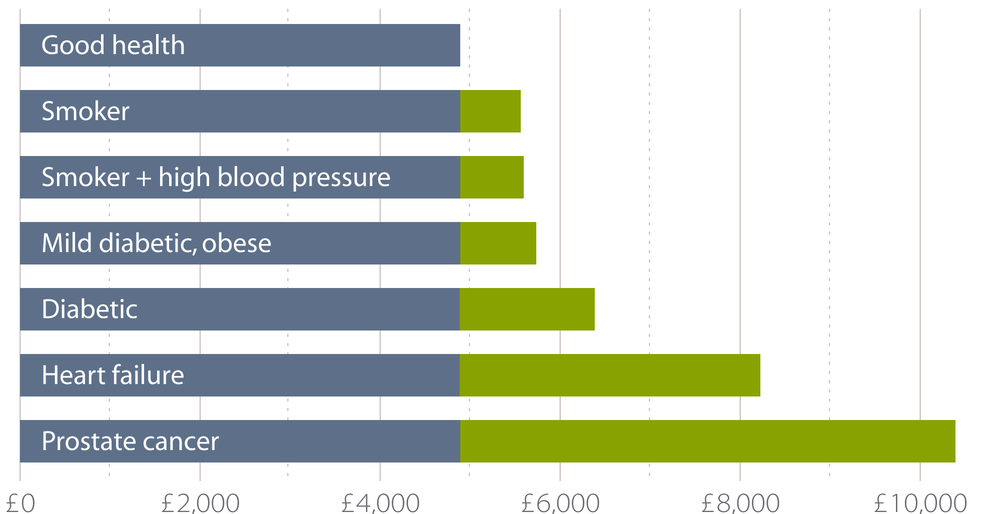
As we have seen, annuities are based on the principle of mortality cross subsidy and while this is good for those in good health who stand a good chance of beating the bet with the actuaries, they may not be such a good bet for those in poor health. To solve this problem, insurance companies offer enhanced annuities which pay out a higher income for those in poor health.

Those who smoke, take prescription medication or have been in hospital recently may be able to qualify for an enhanced annuity.

The table below compares the annuity income for a range of medical conditions.

Enhanced annuities

You do not have to be ill to qualify for an enhanced annuity. Many of those living with common medical conditions such as diabetes can qualify.



Source: Retirement Intelligence – February 2015
Gross annual income, £ 100,000 purchase, single life and level payments.

As the table shows, the increase in annuity income between a standard and enhanced one can be as much as 40% and for those with severe conditions, significantly more.

You can get a higher income elsewhere but it may not be sustainable

The annuity critics are quick to point out the advantages of the alternatives such as pension drawdown or fixed term income plans where it is possible to take a higher income. This misses the point that an annuity pays a guaranteed income for life whereas the other polices (except unit-linked guarantees) do not guarantee an income for life and consequently the income could be less in the future.

Financial advisers point out the importance of 'sustainable income'; i.e not only avoiding running out of income but ensuring that a certain level is maintained. An annuity is the only policy that ensures that a given level of income is sustainable. This means an enhanced annuity is still the best way for those in poor health to maximise and sustain their income for the rest of their life.

Strictly speaking, a sustainable income should increase in line with living expenses and an inflation-linked annuity does exactly that.

4: MEETING THE RETIREMENT INCOME NEEDS OF MANY PEOPLE

An essential part of retirement income planning is arranging an individual's financial affairs to meet their longer term objectives. However many people have difficulty in setting out their objectives and there are normally two reasons for this.

First of all is the tension between short term needs and requirements and longer term aspirations. For many people the short term need might be to have as much income as possible whereas the longer term aspiration might be to have an income that will help them maintain a certain standard of living with peace of mind and security. Secondly, behavioural finance shows that most people value more money now as opposed to more money in the future.

Although everybody is different, everybody needs sufficient income every month in order to meet their everyday expenditure and maintain their standard of living. Therefore one of the most important retirement income planning questions is "Where will this income come from, both now and in the future"?

Many people recognise the importance of having enough income throughout their retirement but often struggle to express exactly what their retirement income objectives are. For most people, income requirements may include:

- The need for a high level of income
- Guaranteed to be paid for the rest of their life
- To continue for their spouse, partner or dependents if they die first
- Not taking undue risk

In addition people will often express the need for flexibility as well as the need for guaranteed income. However flexibility and certainty are opposite sides of the coin.

In most cases the best way to get certainty is with an annuity and the best way to get flexibility is probably through drawdown.

Why we should take annuities more seriously

We should not just take my word for this; after all I could be accused of being biased! Consider the following extract taken from a paper entitled *'Annuitisation; it shouldn't be a secret'* published by the National Association of Variable Annuities (NAVA) in the US over 15 years ago. I remember every word because it made such an impact on me and I have used it in a number of presentations.

In this paper the NAVA put forward some powerful arguments why people should take lifetime annuities more seriously and made the following observations about the concerns and needs of many older investors:

- Concern for lifetime income and risk of outliving their financial asset
- A strong desire to preserve one's standard of living in the long-term
- A desire for professional asset management
- The need of many older individuals for simplicity and structure in their financial affairs
- Coming to grips with their own mortality and expressing concern about the desire or ability of a surviving spouse to manage money in the event of their own death

The paper went on to give many reasons why investors in the US don't take annuities more seriously:

- Benefits of annuitisation are not sufficiently emphasised
- Desire for flexibility, control and death benefits
- The mistaken belief that the same goals can be achieved by a systematic withdrawal from a mutual fund (drawdown fund)

When we look at drawdown we will see that as people get older the need for income security becomes more important. This is a time when most people should be taking less risk rather than more so the case for annuities is even stronger at certain ages.

In the section on the alternatives to annuities we will also explore what is meant by the 'mistaken belief' that drawdown is better than an annuity.

Annuities have many benefits, including the ability to bring simplicity and structure to retirement income planning

KEY POINTS

- If there were no annuities people would be faced with two dilemmas: How much income to take, and where to invest their money
- The 'annuity paradox' – why don't more people purchase annuities when they have choice?
- Annuities pay higher income for those in poor health
- They meet the needs of most people who need a sustainable retirement income

4 IN DEFENCE OF ANNUITIES

Annuities are not without their critics. The three most cited criticisms are:

1 Annuities pay a low rate of income and are poor value for money

2 The income stops when the policyholder dies

3 There are better ways to convert a pension pot into income e.g. drawdown or fixed income plans

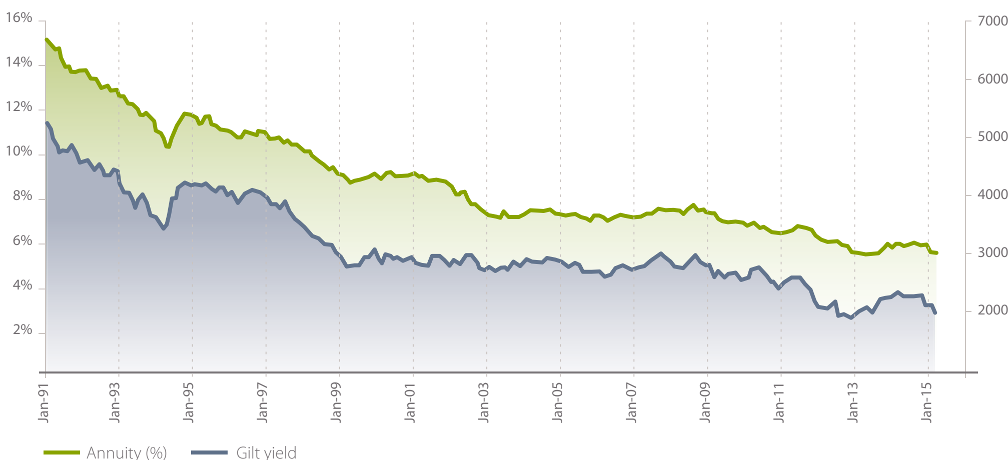
Nobody has been so eloquent with their criticism as Lord Grantley speaking in the House of Lords in October 1997 when he said "In my view, there are two overwhelming reasons why people should not invest in annuities under any circumstances. The first is that investing in annuities is contrary to the interests of a family. Annuities are virtually unique among all forms of investment in that they are worth nothing when the investor dies. The second reason is simply that annuities are a lousy form of investment."

Other people criticise annuities in less eloquent tones. I'll address each of these criticisms in this section, to see if they stand up to scrutiny.

1: ANNUITIES PAY A LOW INCOME RATE AND ARE POOR VALUE

It has been said that we live in a world where many people know the price of a lot of things but they don't know the value. Annuities are a case in point. It is true that the income from annuities is close to the lowest levels in living memory but just because annuity rates are low it does not mean that annuities are bad value.

Annuity rates are low because fixed interest yields are low. The chart below plots the income from annuities and long dated gilt yields since 1990.



Source: Retirement Intelligence – March 2015

This chart show that annuity rates move in parallel with gilt yields and that the relationship between the yield and rates has remained constant. Therefore the problem of low annuity rates is not the fault of the annuity concept; it is the result of low interest rates and yields.

I too have criticised annuities in the past for paying low rates. I was making the point that investment linked annuities can overcome some of the problems associated with low interest rates. However for those who do not want to take any investment risk, guaranteed annuities are a hard act to beat, as I will demonstrate on page 13.

Annuities do provide value for money

There are two ways of addressing the value for money question; by using actuarial techniques and by using simple logic.

I am not an actuary, and even if I was one, few of the readers would understand actuarial speak anyway so after looking at the technical analysis I will use some simple logic to demonstrate that annuities are good value.

There is a significant amount of academic research that has used technical analysis to show that annuities are good value. For instance, the Financial Conduct Authority (FCA) published a paper in December 2014 'The value for money of annuities and other retirement income strategies in the UK' and concluded that annuities purchased on the open market provide reasonably good value for money because consumers get the vast majority of their premium returned to them in income.

$$Money's\ Worth = (A_t + p_t) \cdot \sum_{i=1}^{T} \frac{\pi_{t,t+1}}{(1+R)^i} = 1,$$

Above: One of the formulas used by the FCA used to calculate the money's worth of annuities. Thankfully I can reach the same conclusion with my simple mortgage in reverse calculations.

Jonquil Lowe of the True Potential Centre for the Public Understanding of Finance at The Open University Business School published a paper in July 2014 showing that many lifetime annuities offer fair value for money.

There is a much easier way of showing that annuities are good value for money. Think of an annuity as being like a mortgage in reverse. When you purchase an annuity the insurance company will pay you back your capital and interest over the life of the annuity. With a mortgage you repay capital and interest for a fixed period of time until the loan is paid off. With an annuity there is not a fixed term because the insurance company will pay out as long as the policyholder is alive, no matter how long that is.

Let's compare the repayments for a 23 year mortgage with an annuity for a 65 year old in good health who has a life expectancy of about 23 years.

	25 year repayment mortgage	Annuity for a 65 year old
Loan /annuity	£ 100,000	£ 100,000
Interest rate / gilt yield	2.3%	2.3%
Term / life expectancy	23	23
Loan / Annuity payments	£ 467 per month £ 5,603 per annum	£ 464 per month £ 5,566 per annum gross
Total payments	£ 128,892	£ 128,064

The simple conclusion to these simple calculations is that standard annuities do repay the capital with a fair rate of interest over a given period.

Edmund Cannon and Ian Tonks, both professors of economics, published a comprehensive study of annuities in 2008 entitled *Annuity Markets* in which they showed that annuities provided fair value.

However, over recent years three things have happened to reduce the value for money from annuities. First, life expectancy has increased for all pensioners so insurance companies have had to spread payments over a longer period of time.

Secondly, annuitants have had less benefit from the so-called mortality cross subsidy because those with below average life expectancy have purchased enhanced annuities.

Thirdly, insurance companies have had to set aside capital to bolster their capital reserves to meet new capital adequacy rules called Solvency II.

Although the income from annuities has fallen significantly, the value for money has only reduced by a relatively small amount.

2: THE INCOME STOPS WHEN THE POLICYHOLDER DIES

This statement is only true for a single life annuity where the policyholder dies without having the benefit of a guaranteed income period or value protection. In practice very few people purchase an annuity without some type of safeguard against early death.

When advice is given, most people who are married or who have a financially dependent partner purchase a joint life annuity where the income continues to the spouse or partner if the policyholder dies first.

There are three ways in which someone can guard against the risk of dying soon after taking out an annuity:

- Guaranteed income period
- Joint life option
- Value protection

The income paid to beneficiaries from a guarantee period, value protection or the joint life option will be tax-free if the policyholder dies before age 75. After age 75 income paid to beneficiaries will be taxed at the recipient's marginal rate or if paid as a lump sum there will be a 45% charge (marginal rate from April 2016).

In practice, most people who seek advice and who are married or who have a partner, purchase joint life annuities so income is paid as long as one of them is still alive.

Where do insurance companies invest their annuity funds?

Although the 15 year gilt yield is used as the benchmark to price annuities insurance companies invest their annuity funds in a range of investments including:

- Corporate bonds
- Infrastructure projects
- Property

Your local shopping centre may be owned by an insurance company that has invested some of its annuity funds.

3: THERE ARE BETTER WAYS TO CONVERT INTO INCOME E.G. DRAWDOWN OR FIXED INCOME PLANS

The only alternative to an annuity is a form of drawdown, and there are a number of different types of drawdown including:

- Capped drawdown
- Flexible drawdown (soon to be called flexi-access drawdown)
- Uncrystallised funds pension lump sum (UFPLS)
- Fixed term income plans
- Guaranteed drawdown (unit-linked guarantees)
- Phased retirement

Just to confuse matters some polices describe themselves as being annuities when they are not annuities at all, for example *fixed term annuities* and *variable annuities*.

Fixed term income plans	Drawdown
These pay a guaranteed income for a fixed period of time. At the end of the period a guaranteed maturity value is paid back into the pension plan.	Regular income payments are paid directly out of the pension fund. The remaining fund remains invested. Capped drawdown means that maximum income must be kept below the GAD limit. There are no limits for flexi-access drawdown.
Uncrystallised funds pension lump sum (UFPLS)	**Unit-linked guarantees**
This is a brand new option and will allow a pension provider to pay the policyholder a lump sum directly without the need to officially convert to a drawdown plan. In line with other options, 25% of the payment will be tax free and the balance will be taxed at the marginal rate.	Sometimes called 'guaranteed drawdown' or 'variable', these policies pay a guaranteed income for life which can increase but never go down.

All drawdown policies (except unit-linked guarantees) have one thing in common and that is they don't have an income for life guarantee. This means that it is possible to run out of income sometime in the future if investment returns are lower than expected or the investor lives longer than expected.

There are three main advantages to drawdown, compared with purchasing an annuity and these are:

- Income flexibility
- Control over investments
- Choice of death benefits

However as with all advantages, they are also disadvantages. Before anybody considers giving up the annuity guarantee of an income for life for the flexibility of drawdown they need to be aware of, and understand the importance of investment risk and mortality drag.

Investment risk

At first sight this might seem straightforward because everybody knows that if you invest in the stock market the value of shares can go up or down, but in the longer run there tend to be more ups than downs.

Whilst this might be the case for those savings up for a pension, it is not necessarily the case for those taking income out of an investment. Investing during retirement is different to investing before retirement because of what is known as the 'sequence of returns risk'.

Put simply, if the investment returns are low or negative in the early years of a drawdown plan it will make it very difficult for the drawdown plan to make up the early losses in future years and may lead to a significant reduction in capital and or income.

Year	Return	Income	Balance	Return	Balance
0			£100,000		£100,000
1	–15%	–£5,000	£80,750	22%	£115,900
2	–4%	–£5,000	£72,720	8%	£119,772
3	–10%	–£5,000	£76,516	30%	£149,203
4	8%	–£5,000	£60,948	7%	£154,298
5	12%	–£5,000	£60,424	18%	£176,171
6	10%	–£5,000	£62,075	9%	£186,577
7	–7%	–£5,000	£62,782	28%	£232,418
8	4%	–£5,000	£53,737	14%	£259,257
9	–12%	–£5,000	£50,687	–9%	£231,374
10	13%	–£5,000	£40,204	16%	£262,594
11	7%	–£5,000	£39,781	–6%	£242,138
12	–10%	–£5,000	£37,216	17%	£277,452
13	19%	–£5,000	£28,553	19%	£324,217
14	17%	–£5,000	£27,557	–10%	£287,296
15	–6%	–£5,000	£21,204	7%	£302,056
16	16%	–£5,000	£18,796	13%	£335,674
17	–9%	–£5,000	£12,555	–12%	£290,993
18	14%	–£5,000	£8,612	4%	£297,433
19	28%	–£5,000	£4,624	–7%	£271,962
20	9%	–£5,000	£0	10%	£293,658
21	18%	–£5,000		12%	£323,297
22	7%	–£5,000		8%	£343,761
23	30%	–£5,000		–10%	£304,885
24	8%	–£5,000		–4%	£287,890
25	22%	–£5,000		–15%	£240,456
	Avg. 7.00%			Avg. 7.00%	

Above: Sequence of returns risk. Source: Retirement Intelligence – March 2015

The left hand side of this table shows the fund values year by year for a £100,000 invested with income withdrawals of £5,000 per annum and investment returns as shown.

The right hand side shows the effect if the investment returns are reversed.

Notice that although the average return is the same in both cases at 7%, in the first scenario the fund runs out after 20 years whereas in scenario two the income can be paid for 25 years and there is a healthy balance left.

Mortality drag

When drawdown was first introduced, a well-known actuary pointed out that comparing annuities with drawdown was not comparing like with like, because with annuities, policyholders benefit from mortality cross subsidy whereas with drawdown they do not.

Therefore comparing annuities with drawdown is not straightforward but it is essential to have a way of comparing them especially as many drawdown policies may not be for life and may be used to purchase an annuity at a future date.

Mortality drag – the invisible force

If an annuity purchase is deferred, the annuity payable at a future date will be higher because of the policyholder's increase in age, but an invisible force slows down this rate of increase, called *mortality drag*. This is described as *the negative effect of missing out on mortality cross subsidy if an annuity is deferred*.

The practical relevance of mortality drag is that a pension drawdown fund has to increase in value by an additional amount to compensate for the lack of mortality cross subsidy if it is to maintain its ability to buy an annuity paying the same income in the future.

Let's look at a simple example where a £100,000 fund could purchase a single life annuity for someone in good health at age 63 paying £5,158 per annum. The table below shows how much a pension drawdown fund needs to grow each year in order that an income of £5,158 can be paid each year and at the end of the year an equivalent annuity could be bought assuming no change to the underlying annuity interest rate.

Mortality drag

When someone purchases an annuity they will be investing along with many other people. During the course of the year some of these people will die and the profit will be distributed amongst the other policyholders. Therefore if someone invests in drawdown instead of purchasing an annuity they will not benefit from this mortality cross subsidy.

The mortality drag effect is magnified when enhanced annuity rates apply.

Age	Fund at year start	Standard annuity	Fund growth	Fund at year end	Annuity rate 1 year older	Income if annuity purchased year end
63	£100,000	£5,158	2.64%	£97,449	5.29%	£5,158
64	£97,449	£5,158	2.73%	£94,920	5.43%	£5,158
65	£94,920	£5,158	3.24%	£92,803	5.56%	£5,158

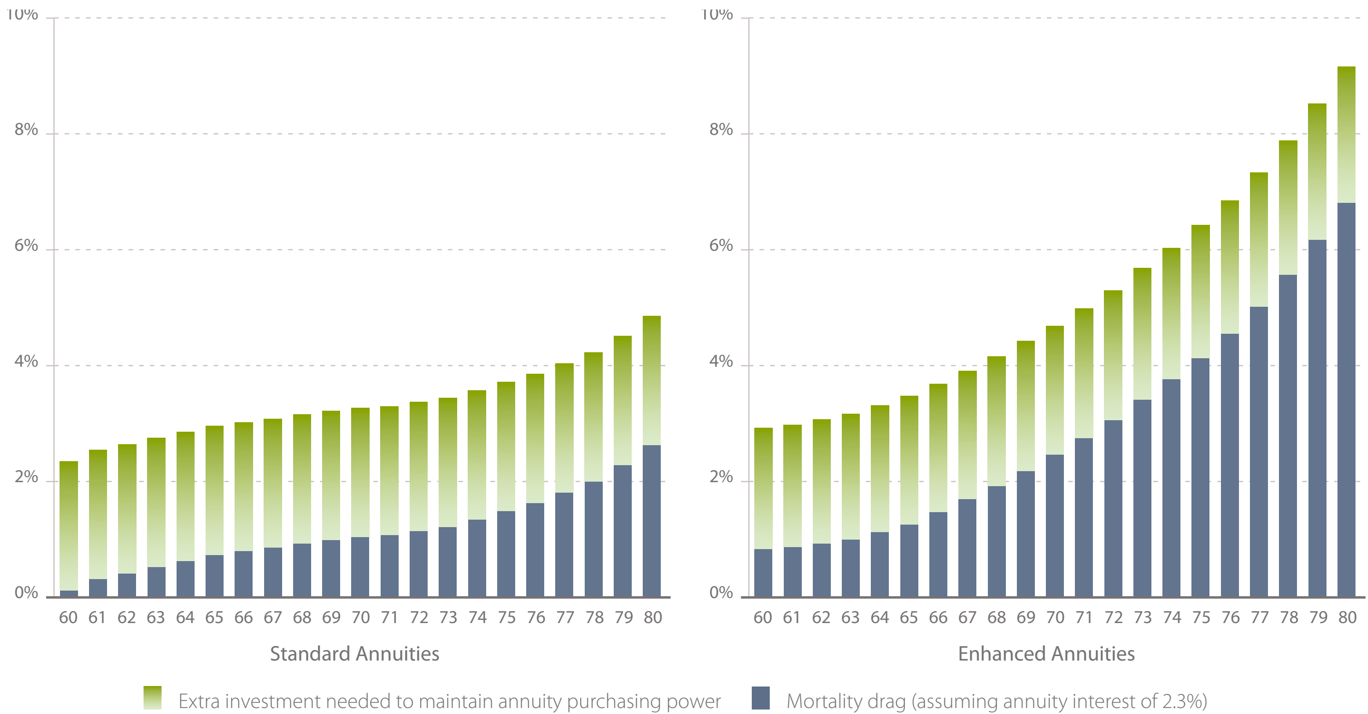
* A notional 'mortality drag' has been calculated by subtracting an assumed 'annuity interest rate' from the fund growth. The 'annuity interest rate' for this purpose has been taken to be the yield on 15 year gilts which was 2.3% at the beginning of March 2015.

The required fund growth and mortality drag increases each year and this reflects the need to compensate for mortality drag. If we repeat these calculations using enhanced annuity rates we will see that not only is the income taken higher, but the required investment returns and mortality drag is higher.

Age	Fund at year start	Enhanced annuity *	Fund growth	Fund at year end	Annuity rate 1 year older	Income if annuity purchased year end
63	£100,000	£6,605	3.46%	£96,805	6.82%	£6,605
64	£96,805	£6,605	3.96%	£93,981	7.03%	£6,605
65	£93,981	£6,605	4.89%	£91,928	7.19%	£6,605

* Enhanced annuity for a smoker with high blood pressure, diabetes and who is obese.

The charts below show how the figures for both standard and enhanced annuities change over a longer time period. This chart on the right is probably unique as this is probably the first time a chart showing the mortality drag for enhanced annuities has been produced.



Source: Retirement Intelligence – March 2015

This might sound like double Dutch, but all you need to know is that when comparing an annuity with a drawdown, is that drawdown has to compensate for the absence of mortality drag by producing consistently higher returns each year compared to the underlying rate of interest used to price the annuity. The amount of drag increases with age as the charts demonstrate.

KEY POINTS

- Annuities do provide 'value for money'
  Important not to confuse low interest rates with value for money
- Annuities are like a mortgage in reverse
- Valuable benefits such as joint life, guarantee periods and value protection
- The grass may look greener but rarely is; annuities are a hard act to beat
- Watch out for sequence of returns risk
- Mortality drag; the invisible force that increases the rate of return needed to maintain annuity purchasing power

5 THE FUTURE FOR ANNUITIES

I believe there is a strong case for annuities and they will continue to play an important role in retirement income planning. Although everybody will be free to take their pension as a cash lump or regular income payments, many people will recognise the advantages of securing a guaranteed income and use some or all of their pension pot to purchase an annuity.

Looking to the future, I predict four important trends:

1. New product developments and annuity buy back
2. More sophisticated use of annuities in retirement income planning
3. Increase in the personal underwriting of annuities
4. Better understanding of the behavioural aspects of decision making

Don't forget: Everybody needs an income and the better off you are the more income you will need, and the stronger the case to have some of this guaranteed.

1: NEW PRODUCT DEVELOPMENTS AND ANNUITY BUY BACK

As part of its pension reform programme, the government has introduced changes to the rules for annuity policies so that insurance companies can develop new options including the option to exchange existing annuities for a cash sum.

Insurance companies can now increase the length of the guarantee period on annuities. The maximum guarantee period in the past was 10 years but will be extended by some insurance companies to 20, even 30 years. This, together with more favourable taxation of the value protection benefit will help those who are concerned about dying and leaving their dependants short of income.

In the past it was not usually possible to change the income from a guaranteed annuity if personal circumstances changed. In the future insurance companies will be able to design annuities where the income payments may increase or decrease in specific circumstances. This will obviously affect the starting income but will provide valuable peace of mind for those who want the option for an income boost in certain situations such as if they need long-term care.

There is now an interest in deferred annuities. For example someone could purchase an annuity at say age 60 which would not come into payment until they reach age 85. At first this might seem like dead money but if age 85 is reached the income will be guaranteed for the rest of their life. This could be a very useful addition to a drawdown plan because it would provide insurance against running out of income in later life.

The final piece of the annuity jigsaw was announced in the March 2015 budget when details were announced of plans to allow people to convert existing annuities in payment into a cash sum. The proposal is to allow people to assign the income from an annuity to a third party (not the original annuity provider) who will pay a cash sum either directly to the policyholder or into another pension plan. Tax will be paid at the recipient's marginal rate when cash is paid out. The intention is that the so called annuity buy back option will be available after April 2016 and this means that those who purchased an annuity in the past will be able to take advantage of the new pension freedoms.

2: MORE SOPHISTICATED USE OF ANNUITIES IN RETIREMENT INCOME PLANNING

In the past, many advisers and their clients thought of an annuity purchase as a black or white decision; smaller funds purchased an annuity and the larger funds invested in drawdown. This rather simplistic approach to retirement income planning should be replaced by a more sophisticated approach to annuities based on customer needs and wants.

Generally speaking there are three important things everybody should consider when they reach retirement age;

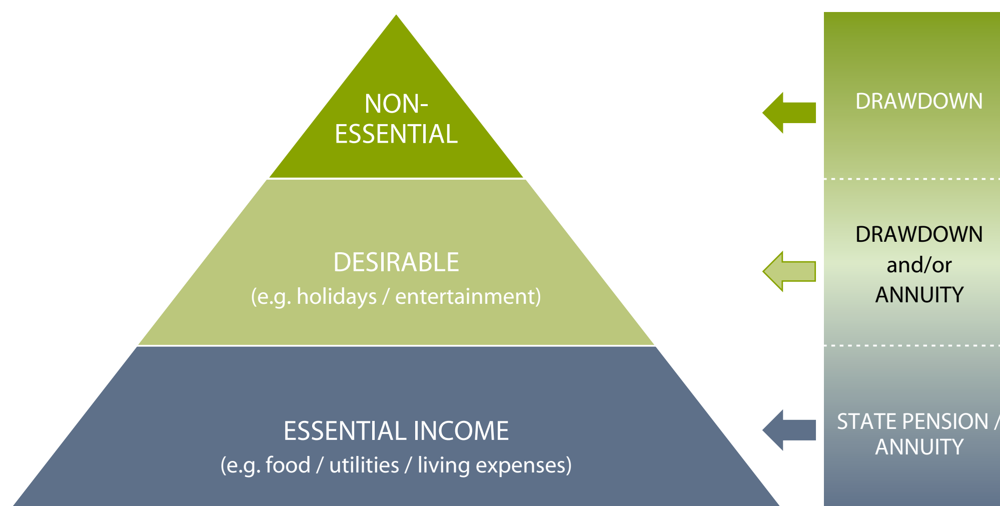
- How much income is required now and in the future?
- How much flexibility will be needed?
- How much risk should sensibly be taken?

It may be harder to answer these questions than it seems.

Income requirements

Most people need income, but while it is tempting to have the pension pot paid as a cash sum this may not be the best answer for those who do not have a genuine need for cash, for example to pay off debt or to fund a luxury such as a new car or a world cruise. Not only is there a risk of paying too much tax, but taking a pension in cash means giving up the option to have a regular income each month.

Many financial advisers suggest people consider the 'income pyramid' (see below). Using this approach all essential income should be totally guaranteed, income for desirable expenditure such as holidays should be as safe and secure as possible while non-essential income can be taken from more risky investments.



There are many advantages to this approach and it helps to highlight the important role that annuities can play in securing a solid base level of income. In many cases it makes sense to sure up the foundations of the pyramid in future years by purchasing more annuities. Not only does this increase the amount of guaranteed income, it helps take advantage of the increased benefit from the mortality cross subsidy as people get older.

Flexibility

Flexibility and certainty are opposite sides of the coin. For most people flexibility is desirable but certainty is more important.

There are very good reasons why people may want flexibility; income needs may change, circumstances can alter and health may deteriorate. But this flexibility comes with the price of less certainty.

One of the best ways to maintain flexibility whilst having an income is to invest in a drawdown plan. However as this strategy may be too risky for many, it might make sense to split a pension pot between annuities and drawdown in order to have some flexibility and some certainty.

Most people are not entirely logical and make decisions based on a combination of simple logic and complex emotion

Risk

Although when asked, many people will say that they don't want to take any risk with their pension income, they often mean that they don't want to take 'undue' risk rather than no risk at all.

The easiest way to explain this is to discuss what risk factors need to be considered at retirement:

- Risk of dying too early or risk of living longer than expected
- Risk that inflation will erode the spending power of a fixed income
- Interest rates – if they increase it should be possible to get a higher annuity in the future
- Risk of significant movements in the financial markets
- Risk that health may deteriorate thereby reducing life expectancy

As neither annuities or drawdown on their own deals with all these risks, a good way to reduce risk in retirement is to invest in a combination of annuities and drawdown.

3: INCREASE IN THE PERSONAL UNDERWRITING OF ANNUITIES

One of the most important changes I have seen in the annuity market over the last 20 years has been the increased use of advanced underwriting techniques for enhanced annuities.

In one sense most annuities are now underwritten because most companies price their annuities based on the postcode of the annuitant. This reflects the trend towards to the personalisation of annuities based not only on health but more general socio-economic factors such as type of employment and education.

However the biggest influence on annuity pricing, except for yields, will be medical underwriting and specialist insurance companies such as Partnership are the at forefront of medical underwriting and continually use vast amount of data to constantly improve the terms it offers for people with specific medical conditions.

4: BETTER UNDERSTANDING OF THE BEHAVIOURAL ASPECTS OF DECISION MAKING

One of the advantages of taking regulated financial advice is that a good financial adviser will help their clients think clearly about their retirement options and help them to avoid making mistakes due to their behavioural biases.

We often think we are making rational decisions when in reality we are being influenced by a number of behavioural factors that result in our making sub-optimal choices.

The most obvious behavioural factors include:

- **Myopia** - This is where people focus on the short term and don't think about how their actions will affect them in the future.
- **Hyperbolic discounting and time preferences** – This is where people think a cash sum now is worth more than income in the future.
- **The framing effect** – This is where the way in which an option is explained can influence the decisions made.
- **Heuristics** – This where people often make decisions based on their own instincts and emotions rather than logical analysis.

This may sound too abstract for many people but it is very important when considering whether or not to purchase to an annuity that the facts are presented correctly. For instance, research shows that if an annuity is presented in a narrow 'investment frame' that focuses on risk and return, many people find them unattractive. However, if presented in a more positive 'consumption frame' that provides information about the amount of money they could spend in retirement, many people find annuities more attractive.

A better understanding of the role of behavioural factors will help the UK pension industry communicate with customers in a much better way and this should result in more people making better decisions resulting in better outcomes.

KEY POINTS

- New rules will encourage product development
- More sophisticated use of annuities
  - To provide guaranteed income as part of the income pyramid
  - As part of a combination of annuities and drawdown
- Increase in personal underwriting of annuities
- Deeper understanding of behavioural factors
  - Myopia: short-sightedness
  - Framing effect: decisions influenced by the way in which options are described
- The future for annuities looks good – very strong case for annuitisation

CONCLUSION

Now everybody has the freedom to take their pension in any way they wish, it might seem that those with small funds will take their pension as cash and those with above average sized funds will invest in drawdown.

But on reflection, many of those who may be thinking about taking their pension fund as a cash lump sum may change their minds when they realise that any lump sums will be taxed at their marginal rate of tax, which could be as much as 40% or even 45%. Those considering drawdown may also change their minds when they understand the uncertainty and risks they will be taking.

The cash option might make sense for those who have a specific need for immediate cash; the most obvious is the need to pay off debt. However this strategy will not make sense for those who have sufficient short term cash and place a high priority on securing an income in the future.

Drawdown will make sense for those who will benefit from having income flexibility, control over their investments as well as the option to leave a lump sum to their beneficiaries after their death. But this flexibility comes at a price because the total amount of income from a drawdown plan could be less than from an annuity if investment returns are lower than expected.

I can think of no better way to conclude this paper than to remember the immortal words of Jane Austen in her book Sense and Sensibility; *"An annuity is a very serious business; it comes over and over every year, and there is no getting rid of it".*

Billy Burrows – Retirement Intelligence

Billy Burrows has been involved with annuities for over 20 years, advising clients on all aspects of annuities and retirement income options. Since January 2013 he has concentrated on strategy, marketing and consultancy.

In 1993 he helped establish Annuity Direct and then in 1997 he set up William Burrows Annuities. A year later he joined Prudential Annuities as their Marketing Director for annuities. In 2001 he returned to running William Burrows Annuities and in 2010 the business was incorporated with Better Retirement Group Ltd to provide clients with a wider range of services.

In June 2014 he became an associate director of Key Retirement Solutions, the leading over-55's specialist adviser. He is also a director of the Retirement Intelligence and Retirement Academy which provides consultancy services to insurance companies on new product development, marketing and strategy.

Billy was awarded the Scottish Widows Industry personality of the year award in 2008 for his commentary on the annuity market, variable annuities and "the third way" products.

He is frequently quoted in the national press and appears on radio, podcasts and videos and writes extensively on annuity and drawdown options.

billy@retirement-intel.co.uk
www.retirement-intel.co.uk

Partnership

Partnership is a FTSE-listed specialist provider of financial solutions for people with health/lifestyle conditions. Twenty years ago, the company launched the UK's first enhanced annuity and since then has gone from strength to strength.

Partnership provides annuities for clients with a wide variety of lifestyle habits and health conditions, from the relatively minor such as a smoking habit and high blood pressure, to the more serious such as heart failure, stroke, diabetes, kidney failure and cancer. During the process of assessing over 755,000 lives, the company has collated more than 160,000,000 data points.

www.partnership.co.uk

Retirement Intelligence ©2015

Design: paulmckenziestudio.co.uk