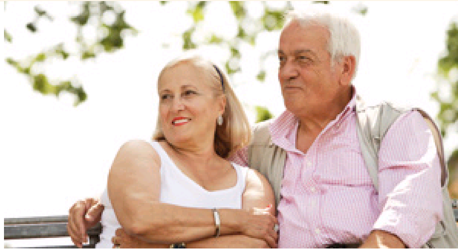

Can I avoid buying an annuity?

By Matthew Craig | 10:58:32 | 09 June 2008

Annuities are probably one of the least popular and most misunderstood aspects of retirement among ordinary investors.

According to David Marlow, director at the Annuity Bureau, 'There is a small minority that don't like annuities. If you die in the short-term, you get a bad deal. That is bad news, but that money cross-subsidises others. It is a strong system for supplying people with a guaranteed income.'

For those set against annuities, income drawdown allows individuals to keep full investment control over their pension assets. Under drawdown, also known as unsecured pension, an individual can take an annual income between zero and 120% of a limit set by the Government Actuary's Department, which is roughly comparable to the market annuity rate, from their pension fund.

If an individual using drawdown dies before the age of 75, their pension benefits can be passed as a lump sum to their beneficiaries, less a 35% tax charge. Alternatively, their dependents can continue with drawdown or purchase an annuity.

Until 2006, anyone in drawdown had to purchase an annuity by the age of 75. Now, though, individuals over 75 can take an alternatively secured pension (ASP). Under ASP, the income limits are tighter than with drawdown and an overall tax charge of 82% applies to any remaining assets on death, making it a very unattractive as a way of passing on assets.

Some pension providers offer a facility called scheme pensions to individuals over 75. With scheme pensions, an actuary calculates the income that can be taken, taking into account an individual's health, with the aim of exhausting the pension fund over the individual's estimated remaining life.

This gives a higher income than ASP, particularly if life expectancy if poor. Similar tax charges to those under ASP will apply to any remaining assets on death.

For anyone considering drawdown and its post-75 variants as an alternative to annuity purchase, the risks involved should be fully understood. WH Ireland Financial Services managing director Simon Pritchard-Jones said, 'A lot of people who went into drawdown in the last ten years really regret it because a) the value of their funds has dropped due to poor investment returns, and b) annuity rates have got worse.'

And Rowanmoor director David Seaton said, 'You can't really look at drawdown with pension assets under £250,000; the charges are too high.'

Many people see the choice at retirement as being a simple one between traditional lifetime annuities and income drawdown, but there are other options.

James Biggs, associate director at Jelf Group, says, 'If you asked anybody in the industry under hypnosis what is the best way to convert a pension into income

they would say staggered vesting, but it is rarely used because is pays less commission. It is one of the biggest scams in our industry.'

Under staggered vesting, benefits from a pension fund are taken in slices.

Imagine a £1m pension fund. One quarter of this, £250,000, can be taken as tax-free cash. The remaining £750,000 could buy an annuity at a rate of around 6% for a 65 year-old, according to Biggs, giving an income of £45,000.

Alternatively, using staggered vesting, £150,000 of the pension fund is vested, with the rest of the fund untouched. This gives tax-free cash of £37,500 and the remaining £112,500 buys an annuity giving approximately £6,750 in income, giving a total income just under £45,000.

In year two, another smaller slice of pension benefits is taken as tax-free cash and another annuity is overlaid on the existing annuity, to maintain total income at the chosen level. Biggs said, 'Staggered vesting is clever because it produces a sum on death from the unused pension assets.'

It should be remembered that there is now a wider range of annuity products than in the past. Protection can also be added to annuities, to safeguard against the loss of capital from an early death.

For example, a spouse’s pension means that if the annuity holder dies, their spouse will benefit from the annuity at a set rate, say 50% of the initial annuity. Another form of protection is a guaranteed period, which can be for up to 10 years. This pays the annuity income to the beneficiaries for the remainder of the guarantee period, if the annuitant dies during it.

However, adding these forms of protection to an annuity has a cost and decreases the starting income, as does buying an inflation-linked annuity, rather than a level annuity.

As well as conventional annuities, retirees could consider a temporary annuity for periods of five years upwards to a maximum of the time taken to reach age 75. Living Time chief executive Kim Lerche-Thomsen said that fixed term annuities allow retirees to ‘test-drive’ their retirement rather than making an irrevocable decision at a relatively early age.

Other alternatives to conventional annuities include investment-linked annuities and the so-called ‘third way’ annuity products. With investment-linked annuities, the annuity fund is investing in unit-linked assets or a with-profits fund. This means that there is an element of investment risk associated with the annuity. Prudential business development director Aston Goodey said there has been a resurgence of interest in with-profit annuities and noted, 'They are a natural stepping stone from lifetime annuities and are middle to low risk.'

Third way annuity products, or variable annuities, from providers such as the Hartford, Met Life and Lincoln, seek to offer guarantees and more flexibility than a conventional annuity. However, Hargreaves Lansdown pensions analyst Laith Khafas said, 'The problem is that these products are very expensive. In terms of product design, there are certain holes in the guarantees. It may not be an absolute, cast-iron guarantee against all risks and you don’t always get full equity exposure.'

For many retirees with small pension pots, an conventional annuity may be the most sensible choice. For others, a combination of conventional and investment-linked annuities could give the foundation of a stable income with the chance of a rising income if the investment element does well.

For those determined not to annuitise, there is still income drawdown and its post-75 extensions. In this complex area, seeking good financial advice is wise.

But not all advisers are up to speed on the increasing choices and many are waiting to see how newer annuity products fare before they recommend them.

To calculate whether you will have enough money to retire on, click here

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James Biggs *Jelf Group*

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