Orchid Financial Services Ltd

Annuities

Do annuities remain a viable option for retirement planners?

Annuities are retirement products that guarantee you with a regular income after you retire.

You choose a provider, pick an appropriate annuity to suit your needs and, in exchange for some or all of your pension savings, the annuity provides income until you die.

The use of annuities has declined markedly in recent years, with figures from the Association of British Insurers suggesting sales have fallen by as much as 80% since 2014.

Research from the Financial Conduct Authority reflects this trend, with year-on-year annuity sales down 16% in the six months to April 2017.

This is partly due to the fact that, following former chancellor George Osborne's introduction of pension reforms in 2015, people now have more options when it comes to planning their retirement.

However, are annuities still a viable retirement planning option to consider in 2017?

Types of annuity

Annuities do not just come in one type. Making assessments about whether an annuity is right for you requires you to consider all types. Some may be beneficial for your circumstances, such as fixed term or temporary annuities, others may not be.

The following list describes the most common types of annuity and is not exhaustive.

Lifetime annuities

Lifetime annuities are the most common type of annuity and pay out a regular income until you die.

The annuity rate offered to you and fixed at the outset will be determined by the expected returns on the investments made by the provider and the average life expectancy for people your age.

Enhanced annuities

You may be eligible for an enhanced annuity if you have a shorter life expectancy. These types of annuities pay out a higher income, providing you meet specific criteria.

These criteria include factors that may result in you having a reduced life expectancy, such as:

- being a smoker in the past or present
- being overweight
- having worked in hazardous conditions during your working life.

Impaired life annuities

These are similar to enhanced annuities as they are designed for people with a shorter life expectancy. What sets impaired life annuities apart is they are meant for people with certain medical conditions that may result in premature death.

Annuity providers will require you to disclose your medical history and, in some cases, you will need to undergo a medical examination.

The amount of income you will receive from an impaired life annuity will be based on your predicted life expectancy, which is derived from your medical history.

Thorney Lakes Golf Centre Thorney
Peterborough PE6 0TJ
0844 414 0730 info@orchidfinancialservices.com

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Advantages and disadvantages

Advantages

Guaranteed income

An annuity will provide you with a guaranteed income for the rest of your life. It will pay out the same amount each month until you die, irrespective of movements in the market.

In this way, annuities will give you peace of mind that you're financially supported throughout your retirement.

Protection

By leaving your pension invested in the market, you risk your retirement income depreciating in the event of a downturn.

Purchasing an annuity means your pension savings will no longer be subject to the whims of the market, therefore protecting your pension during turbulent periods.

Disadvantages

Inflexibility

One of the major disadvantages of buying an annuity is you cannot convert it back into your pension. Once you have entered into the contract, you cannot cancel it.

This makes it all the more important to do your research, make yourself aware of the different options and understand the terms of the annuity before agreeing to the contract.

Annuities cannot be inherited

Unless you opt for an annuity guarantee period, your family will not be able to benefit from your retirement savings after you die. Even through an annuity guarantee period, your family and friends will not be able to inherit your savings.

Annuity rates

How are they calculated?

Your annuity rate will be determined by several factors:

Life expectancy

As a general rule, the shorter your life expectancy, the higher the rate you will receive. Similarly, the longer you are expected to live, the lower your rate will be.

These disparities are designed to prevent those with longer life expectancies from getting a larger share of income.

Health

As discussed previously, individuals who are in poor health, who smoke or who have a medical condition will receive more favourable annuity rates.

Interest rates

The Bank of England base rate of interest has a considerable amount of influence over annuity rates. Your pension partly relies on the payment of interest while it is invested in the markets.

Therefore, when rates are low, your annuity rate is likely to be low and vice versa.

Gilt yields

Providers partly fund their annuities by purchasing government bonds (gilts).

The interest rate paid to annuity providers by the government (known as the yield) is intimately linked to the rate of inflation and the Bank of England base rate of interest.

The yield on gilts fluctuates with inflation. Lower base rates result in lower annuity rates.

What are the current rates?

Annuity rates have been under severe pressure over the past few years.

Falling gilt yields in the wake of the pension reforms introduced in 2015 enabled people over the age of 55 to take up to 25% of their pension pot as a tax-free lump sum, causing demand for annuities to fall at the same time.

The vote to leave the EU in June 2016 had a dramatic effect on annuity rates. Falling gilt yields in the wake of the Brexit vote resulted in annuity rates falling to all-time lows.

In addition, the Bank of England cut the base rate to historic lows of just 0.25% following the vote.

These factors have combined to supress annuity rates. However, it is not all bad.

Rates increased to above their pre-referendum levels earlier in 2017 and have experienced the longest period of growth in six years.

Despite this, rates are yet to regain the fall in value seen in 2015 and still present a comparatively poor return on your pension savings.

Is an annuity right for you?

Whether or not an annuity is right for you will depend both upon your circumstances and how much importance you attach to having a guaranteed stream of income for the rest of your life.

Annuity rates are not what they used to be, while the inability to sell them may now be seen as a greater disadvantage.

The government originally intended to liberalise the market and provide pensioners with a way to sell their annuities, but this plan has since been shelved.

Annuities, of course, are not your only option. Thanks to the recent pension reforms, you now have more options than ever before when it comes to saving for your retirement.

Contact us to discuss funding your retirement.

Important information

The way in which tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to change in the future.

Pension eligibility depends upon individual circumstances and you cannot normally take pension benefits until age 55.

This document is solely for information purposes and nothing in this document is intended to constitute advice or a recommendation. You should not make any investment decisions based on its content.

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