# J05 Pension Income Options 2020/2021
# Part 3: Money Purchase & Lifetime Annuities

Taking benefits is more complicated for money purchase members than for those with a final salary scheme. Final salary members are paid a set pension from the scheme that will increase each year and include a spouse's pension. Money purchase members must take far more decisions

Assuming they wish to take 25% of the crystallised fund as a PCLS, their next and main decision is whether to get a secured income by purchasing a lifetime annuity or to take a flexible income by using drawdown. A secured income is one that is guaranteed to be payable for the rest of an individual's life with no risk of the income ceasing.

This part will cover the main features of a lifetime annuity (TIP in the exam always use the term Lifetime Annuity. Don't just write "annuity",

The milestones for this part are to understand:

- Pre retirement planning
- How an annuity works
- The different options that can be added to a lifetime annuity
- How investment linked annuities work
- In outline the option of a flexible annuity
- The option of taking a scheme pension.
- The special needs of individuals with "Heritage" products

## Pre-retirement planning

The lifecycle of a money purchase pension can be compared to a long haul flight. As with the plane's take off, a lot of work goes into setting it up. Once it's in flight the crew will make regular checks and adjustments but the real work comes as they prepare to land. In the five years before the date the member takes the benefits, an adviser should be working with them to ensure that the investment strategy is matched to how they plan to take these.

The first check should be whether the fund is sufficient to enable them to retire. Their preferred retirement date may have been 60 but at 55 their funds are insufficient and they may have to continue to work and save until they are 65.

A discussion should also take place as to whether buying an annuity or taking benefits flexibly is the best option as this is a factor in the investment of the fund. For someone who intends to buy a lifetime annuity the normal practice is to reduce the risk of capital loss by moving the fund from equities into bonds.

This will be done automatically in a **lifestyle strategy** where funds are gradually moved to bonds in the five years before retirement. The provider will do this on a timescale based on the individual's preferred retirement age. This may have been selected many years ago and the member may wish (or have to) carry on working longer or wish to take them earlier. This means that the fund will have been de-risked too soon or they are still exposed to to much capital risk at retirement.

An alternative approach is a **targeted fund**. This also de-risks as retirement date approaches but the manager has the power to adjust the timing of the switch depending on market conditions.

Whilst a move to bonds makes sense if the plan is to buy a lifetime annuity, it is inappropriate if benefits are to be taken flexibly. This will be looked at in the next part.

## Lifetime annuities

A lifetime Annuity is more of a purchase rather than an investment since having taken the PCLS, the remaining pension fund is used to buy a guaranteed income payable until death.

It is an insurance product that can only be offered by an authorised insurance company. The insurer takes the risk that the purchaser lives longer than expected so the purchaser is effectively insured against living too long.

Up to 25% of the crystallised fund can be taken as a Pension Commencement Lump Sum or PCLS. This must be paid within an 18 month window starting six months before and ending 12 months after the member becomes entitled to the associated pension.

Annuity income is classed as non-savings income and taxed under PAYE. It will be paid net unless the buyer can show they are a non-tax payer. There is no need to buy an annuity from the provider used in the accumulation phase. Individuals can and should shop around to get the best rate. Department of Work and Pensions rules insist that the provider makes the member aware of this **Open Market Option.**

The rate and therefore income purchased by the remaining fund will depend on four main factors:

- The age of the member
- General life expectancy
- Gilt Yields
- Options taken with the annuity

To understand how these work, we need to consider in simple terms of how annuity rates are calculated.

Part of the return is the purchase price being returned to the member. An actuary might calculate that the average life expectancy of a group of 1,000 60 year olds is 86. Therefore, the life office will expect to repay the purchase money over a 26 year period.

For a group of 70 year olds, the average life expectancy might another 17 to 18 years so the repayment period is lower than a 60 year old and a higher rate can be offered.

Life expectancy for the population is increasing which has had a profound effect on annuity rates. If the life expectancy for a 65 year old was 79, the life company would only expect to pay the annuity for 14 years but if life expectancy was 85 they would have to pay for 20 years.

Whilst the average life expectancy of a 60 year old may be 86 some will die earlier and some later than this. Those who die earlier subsidise those who live longer and enable the income to be paid for longer than the average anticipated life expectancy. This cross subsidy is known as **mortality gain**.

An annuity is a series of regular payments so the company will invest the purchase price and traditionally this has been in Gilts. There is a direct positive correlation between gilt yields and annuity rates. Gilt yields are currently very low so annuity rates are also at record low levels

Since the income from an annuity is linked to a person’s age and general life expectancy it seems fair that those in poor health should get a better rate than one in good health. These are described as **impaired life annuities**. In addition, you can have an **enhanced annuity** which gives better rates for certain lifestyle activities such as smoking. Of course, if the company pays better rates to those in poor health the pooling of risk is less effective and it must reduce rates to those in good health.

## Annuity Options

The other factor that will determine the income is the options that are chosen when the annuity is purchased. The choice of options can only be made at the time of purchase. Nothing can be changed after the annuity has been bought.

The most basic or “plain vanilla” annuity would be payable on the life of the purchaser only and would not increase in payment. This would give the highest income and as various options are added these have the effect of reducing the income.

The three main options are:

- Is the annuity to be in single or joint names?
- Is it going to increase in payment?
- Is there to be any type of guarantee?

## Joint life annuities

The income from single life annuity will end on the member’s death. With a joint life annuity if the member dies all or a percentage of will continue to be paid until the death of a named beneficiary. Whilst you must be 55 or meet the ill health criteria to buy an annuity there is no minimum age to receive a pension as a beneficiary.

Pensions paid to a beneficiary from a joint life annuity also vary from those paid to the member in other ways.

- There is never a PCLS with a beneficiary’s pension even if the member did not take one themselves.
- You cannot have a further beneficiary so if the beneficiary inherits the member’s pension they cannot pass it on to anyone else.
- You cannot have any guarantees with a beneficiary’s pension.

Taking a joint life pension will normally result in a lower initial income than a single pension depending on their relative ages and the percentage of the original pension paid to the beneficiary. The member takes the risk that if the beneficiary dies first, they will have had a lower income and the pension will cease on the member’s death.

Before April 2015 only a dependant of the member could inherit the pension. This is defined as a spouse or civil partner, a child under the age of 23 or a child over 23 who was financially dependent because of mental of physical infirmity. Now anyone can be the second life and they are referred to as a nominee if they do not meet the definition of a dependant.

Helen considers her husband has excellent pension provision so nominates her adult daughter who is 45 to receive part of her pension when she dies. If her daughter is still alive when Helen dies, she will receive a nominee’s pension. This can include a condition that rather than be payable until the daughter’s death, it must cease if she marries.

A joint life annuity is a continuation of the member’s original contract with the annuity provider and is subject to the same terms and conditions. Alternatively, it can be purchased as a separate contract to the member’s annuity if it was purchased in the seven days before or after the purchase of the member’s lifetime annuity. This is known as a “related dependant’s annuity.”

The pension paid to a survivor will be tax free if the first payment is made on or after April 6 2015 provided the member was under 75 at date of death and the scheme was notified within two years of the member’s death. If the member was over 75 the income would be taxed as the recipient’s non-savings income. Note that it is the age of the member and not the recipient that is significant.

Dan dies aged 74 and his wife Doris who is 78 receives a dependant's pension. As he was under 75 she will not be liable for income tax on this.

Annuities that made their first payment before April 6 2015 will always be taxed as the recipient's non-savings income regardless of the age of the deceased member.

## Indexation

If the pension doesn't increase in payment its value will fall in real terms. An annual increase can be built into the annuity but it comes at the price of a lower starting income than a level annuity. This means it will take several years for the income to catch up and even longer for the total amount of money received to match what they would have received if they had chosen a level annuity at the outset.

## Guarantees

A common objection to buying an annuity is the fear that death may occur shortly after purchase but this can be mitigated by including one of two guarantees. The first is to guarantee the payment for a set period. Prior to April 2015 the maximum period was 10 years from date of purchase but annuities bought since then can be guaranteed for any period although in practice insurers may not be keen to offer longer terms.

Raj dies 6 years after buying an annuity which paid an annual gross income of £10,000 with a 10 year guarantee. It would then pay £10,000 for a further four years.

The guarantee payment is paid into the deceased's estate and can be paid to anyone per the deceased's will or through intestacy rules. This means the member could have their spouse receive the benefits of a joint pension but have their son receive the guarantee payment

Guaranteed payments can also be taken as a cash lump sum using trivial commutation. To qualify the remaining guaranteed payments must be £30,000 or less. This option is available no matter when the member died or when the annuity was purchased. If the future guarantee payments were greater than £30,000 once they have been reduced below this figure it will qualify for trivial commutation.

Greg is the recipient of a guaranteed payment following his brother's death. The first monthly payment of £500 is due in May 2016 and he will receive this for 6 years. This amounts to £36,000 so doesn't qualify at that stage for trivial commutation. However, after taking payments for a further 12 months the future payments will be £30,000 and trivial commutation can be used.

Someone in receipt of a dependant's or nominee's pension can also use this but as it's not known how long the recipient will live there must be an actuarial valuation to establish the current cost of providing future benefits. If this is below £30,000 a trivial lump sum commutation can be made.

The taxation of the income follows the pattern of the joint life annuity, tax free if the member died aged under 75 and taxed on the recipient if over 75.

An alternative guarantee is **capital or value protection**. This can guarantee that the annuity will always pay a percentage of the purchase price.

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| Roger bought an annuity with £200,000 and included a 50% guarantee.<br>He died some years later and had received £70,000 in gross income.<br>The guarantee would result in a cash lump sum of £30,000 being paid. |

This can be paid to anyone nominated by the member and will be tax free if the member died below 75 but taxed at the recipient's non-savings income if the member was over 75 at date of death. Value protection can only be taken on a single life annuity with no guaranteed payment.

### Other options

The guarantee period can be combined with a joint pension for a further option. This is **with or without overlap**. Take a joint pension that pays the second life 50% of the member's pension with a 10 year guarantee. If it is bought "with overlap" and the member dies after 6 years the second life will start to receive 50% of the pension immediately and the pension the member was receiving will continue to be paid for a further 4 years under the guarantee provision.

If it is bought without overlap the member's pension will continue will continue for a further 4 years and when this ends the second life pension will start.

There are a few other minor options. The purchaser can choose how often the payment is made, whether this is monthly, quarterly, half yearly or annually. Payments can also be paid in arrears or in advance. If they are paid in advance the first payment is made on the date the annuity is purchased. If it is paid in arrears and the frequency is monthly, the first payment will be made one month after purchase.

## Investment linked annuities

What we have described is usually called a conventional annuity. The key feature is that the income is fixed (apart from any escalation option). The alternative approach is to offer an investment linked annuity.

These produce a variable return based on the underlying assets behind the annuity. The purchaser hopes that the income will increase but unlike a conventional annuity the income can also fall.

Investment annuities are either based on with profits or unit linked funds.

Under the with profit version.

- An assumed bonus rate is selected at the outset.
- Income can vary depending on whether declared bonuses are higher or lower than the assumed rate.
- Income level is reviewed periodically.
- There is normally a guaranteed minimum level of income.

Under a unit linked version

- An assumed growth is chosen at outset.
- A set number of units are cancelled to provide the income.
- Income will vary with unit price or fund performance.
- There is not usually a guaranteed minimum level of income.

In both cases the usual factors of age and options taken will also be crucial in determining the initial level of income.

## Flexible annuities

It was always a principle of annuities that the income from them was fixed unless indexation had been selected. The raft of reforms under "pension freedom" allows insurers to offer an annuity where the member can choose to vary the income.

It may seem perverse that someone might want to reduce their income but the thinking behind it is this. When someone retires in their 60's they may be quite active and healthy and want a high income to spend on travelling and other activities. As they get older they may cut these down and can manage with a lower income. Few companies offer these.

## Scheme Pension

It is possible to take a scheme pension from a money purchase arrangement and this can have significant advantages.

The key point about a scheme pension is that the income is paid directly from the fund but is not classed as drawdown income. The amount of income is determined by an actuary taking into account the member's age and health together with potential fund performance.

A predetermined term of 10 years is available at the outset and will be paid for that time provided there are sufficient funds to make the payments. One provider also builds in a three year review period.

One benefit of this approach is that for someone in poor health a larger income can be paid than through a lifetime annuity since the actuary is able to calculate a figure on the basis that the fund will be exhausted at the expected date of death.

## Do annuities have a future?

Annuities have had a poor reputation in recent years mainly because of the low rates currently being offered. However, they have two big advantages.

First it is probably the only investment that guarantees an income payable for life that will never fall regardless of investment conditions.

Secondly whilst there is a lot of initial work in setting up the annuity once purchased there is no further administration for the member. The payment will be made directly into the member's bank account.

The factors that should be considered when advising on the choice between a lifetime annuity and taking benefits flexibly will be considered after looking at flexible benefits

That concludes this part so you should now know:

## Heritage products

The pension reforms of 2006 standardised the rules for all money purchase arrangements. The exam may test you on some older products that are no longer available are rarely used. These are:

- Retirement Annuity Contracts (RAC)
- Section 32 policy
- Free Standing Additional Voluntary contributions (FSAVC)

**Retirement Annuity Contracts**

These were the forerunner of the Personal Pension and were withdrawn in 1988. They are now treated in the same way as a PP with a PCLS of 25% of the fund and all the usual options for the remainder of the crystallised fund.

One feature they sometimes have is a **Guaranteed Annuity Rate** which can be very attractive in today's world of low annuity rates.

If they have this feature they are classed as **safeguarded benefits** and advice must be taken if the fund value is more than £30,000.

Whether the policy has this must be checked but it may not be attractive as it sounds

- The right to get the guaranteed rate can usually only be exercised at a set age and often with a very narrow window to exercise it.
- It may only provide a single life annuity with no guarantees or inflation protection

There are other issues that should be considered, particularly if crystallisation is planned to be done at a later date.

- Many of these plans used a "with profits" fund and the nominal value of the fund may be reduced when the plan is crystallised. This wouldn't usually apply if this takes place on certain dates.
- Death benefits may be lower than the fund value
- It may also carry higher charges than most modern plans

**Section 32 plans**

These enabled members of DB schemes to transfer their pension rights into these plans. If the ceding scheme had a GMP, the insurance company had to guarantee that this would be revalued so that it matched the benefit if no transfer had taken place. Its key features that are relevant to whether or not it is suitable are:

- GMP is revalued as it would be in the ceding scheme but can only be taken at State pension age
- It is usually a with profits fund which tends to take a cautious approach with the bulk of the investments in bonds.
- On death before retirement the death benefit will be paid into his estate
- If death occurs after retirement the GMP element can only pay 50% of the GMP income to a spouse

**Free Standing AVC**

Prior to A day this was one of the few ways in which a DB member could increase their pension. They are now treated exactly like a PP

That concludes this part so you should now understand:

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- In outline the option of a flexible annuity
- The option of taking a scheme pension.
- The special needs of individuals with "Heritage" products