Annuities – your route to retirement

'What is an annuity?' is one of the most common questions asked by people contemplating their retirement. Well it isn't complicated – an annuity is what you have probably been thinking of as a pension; i.e. a series of payments made to you regularly from the time you retire until you die. The reason it is not just called a pension is that it is provided by an independent insurer and not by the pension fund you have been saving with throughout your working life.

What happens when you retire is that the pot of money you have been saving up is used to buy an annuity with an insurer, who will then pay you regular payments for the rest of your life (and in the event of your death, for the life of your spouse if you choose a joint life annuity). Most people also take a cash lump sum on retirement, which generally can be up to a maximum of 25% of your fund and is currently available tax free; any tax free cash sum amount is paid to you directly by your pension scheme and the remaining amount is paid to the insurer in exchange for an annuity.

Because of this, annuity rates (i.e. the cost of converting your pension pot into a regular income) are very important. Buying an annuity when rates are high can have a big impact on the amount of money you receive during your retirement – if you buy when rates are high, you'll get a smaller income during your retirement. And once you've bought an annuity, you are tied into it for life – so it's worth making sure you get a good rate.

The factors that affect annuity rates are very complicated, but to summarise they include:

- Long-term bond yields

and

- Longevity expectations

<u>Long-term bond yields</u>

The way an insurance company ensures it has enough money to pay your regular income payments is by investing the purchase price paid of the annuity paid to them by your pension scheme in long-term bonds. A bond is essentially a debt which the bond issuer owes to the bond holder – the company issuing the bond promises to pay a series of interest payments to the bond holder for a set period of time, and / or a certain amount of money at the end of this period of time (the maturity payment). In this way, the insurer (the holder of the bond) has an income stream out of which it can pay your annuity payments. The most secure (and therefore most sought after) type of bonds are 'gilts' – these are bonds issued by the Government.

The bond yield is the amount of money (interest and maturity payments) the insurer receives compared to the bond's purchase price. The price of a bond varies according to supply and demand, and also according to how secure the bond is perceived to be. The higher the purchase price of the bond, the lower its yield.

<u>Longevity expectations</u>

Essentially, the insurer needs to estimate how long you will live in order to work out the annuity rate it can offer you – the shorter your life expectancy, the shorter the period your annuity will be paid for, and so the larger your regular income payments will be. Two factors are relevant here – general expectations of how long people are living on average, and also your own lifestyle, which can give a more specific indicator about your life expectancy. For example, if you live in an area where the life expectancy is lower than the national average you may receive a more favourable annuity rate.

<u>Effects of recent policy on annuity rates</u>

The Bank of England's recently adopted quantitative easing policy has an impact on annuity rates – because the way 'new' money is created under the current method of quantitative easing is that the Bank of England buys assets such as corporate and Government bonds, electronically creating money to pay for these. This injects capital into the system and increases liquidity, thus helping the economy. It is hoped that by selling their bonds, companies will be able to plough money into other areas of the economy.

But, as we identified above, long-term bond yields are a crucial factor determining annuity rates. And supply and demand affect bond yields – when a lot of bonds are being bought, as in the case of quantitative easing, the bond price goes up, and the bond yield goes down. As a result, long term bond rates saw their biggest fall for 17 years as the Bank of England announced the introduction of quantitative easing in March.

This fall in bond yields quickly filtered through to insurers. Tom McPhail of Hargreaves Lansdown commented "The speed of response from annuity providers was significant... If you're going to buy an annuity today or in six months, do it today."

There is considerable debate about the long-term effect of quantitative easing on annuity rates. If the market is flooded, it is possible that bond prices will fall, bringing the yield back up again. Obviously this uncertainty is not very helpful for members considering retirement in the next couple of years – if you're in this situation, it might be a good idea to seek independent financial advice. You can find an adviser in your area by visiting www.unbiased.co.uk. or telephoning 020 7833 3131.

Other factors affecting your annuity rate

There are a lot of different types of annuity available – and as you'll be tied into it for life once you've bought your annuity, you need to buy the one that's right for you. Different features of your annuity will have cost implications – so to get good value you should only choose the annuity with the features you really need. You will be sent plenty of information about your choices as you approach retirement, but here's a brief list of some of the things you should consider:

- Do you need a single life annuity (which just provides income for you) or a joint life policy, which will provide for your spouse if you die before he or she does?
- Do you want your income payments to be linked to inflation so that they increase over the course of your retirement in line with the cost of living?
- Do you want there to be a 'guarantee period' – so that if you die within, say, five years of retiring, your dependants will receive a lump sum equal to the payments you would have received for the remainder of that period?
- If you have any health issues which could shorten your life expectancy you might be able to get an 'impaired life' annuity which may give you a higher income level.

But you don't need to worry about all these choices because you will be sent all the information you need when you are approaching retirement. The Scheme Administrator will guide you through the process, and will obtain various different annuity quotes for you depending on the information you provide.

If you have any queries about anything in this article or your benefits, you can contact the Trustee appointed Scheme Administrator, Capita Hartshead.

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