

Annuities are a means of converting capital into a guaranteed regular income, by the investment of a lump sum whose value is consumed by the income payments. In consequence of the sacrifice of capital, the income produced by an annuity can be expected to be higher than that from other types of investment. The duration of the income can be for life, in which case the annuity is known as a 'lifetime annuity'; or for a defined period of time, in which case it is known as a 'temporary' annuity.

For tax purposes, there are two main types of annuity: **purchased life annuities ('PLAs')** and **compulsory purchase annuities ('CPAs')**. In both cases, each payment received by the annuitant consists partly of a return of the original investment and partly of the income generated by the remaining fund. PLAs have the advantage over CPAs that the proportion of each payment which represents the return of capital is tax-free. The whole of each payment received from a CPA, by contrast, is subject to income tax. PLAs are purchased from the individual's own resources, whereas CPAs are purchased with the proceeds of a pension arrangement.

The favoured tax treatment of PLAs means that even if the highest possible income is required by the holder of a pension fund, it may be appropriate to extract the maximum permitted tax-free cash from the scheme and invest this in a PLA, because the tax advantage enjoyed by the PLA is likely to produce a higher net income than would have been available from a CPA. This is despite the fact that the gross income from a PLA is likely to be lower, because the people who invest in PLAs are those who expect to outlive the actuarial averages (and in many cases will set their minds on doing so in order to ensure that they get full value from their investment!) and therefore PLAs represent a higher longevity risk for the annuity provider. By contrast, the annuitants in a pension annuity pool will consist of the full range of life expectancies.

CPAs can provide benefits which are either fixed or escalating. They can be written on joint or single lives and payments can be guaranteed for a given period, typically of five years. The greater the number of enhancements included, the lower the initial pension income will be (though the cost of a joint life annuity is typically only between 10% and 30% greater than that of a single life annuity).

If the retiree needs the maximum immediate income, this is likely to be achieved by crystallising the pension policy (which can usually be done at the holder's option at any age between 50 and 75 (this rises to age 55 from 2010)) and purchasing a level annuity. The income from an annuity for a 65-year old male escalating at 5% p.a. would be around 40% less than that from a level annuity. This figure drops to 26% if the rate of escalation were 3%. It would take 11 or 12 years for the payments from the escalating annuity to catch up with that from the level annuity, and between 18 and 20 years for the total income receipts to exceed those from the level annuity. Unsurprisingly, this approximates to the average expected remaining lifespan for a 65-year old male.

What is an Annuity? /Continued

It is usually uneconomic to purchase a lifetime annuity before the age of 60, but if such an annuity is appropriate and one has reached the age of 60 or 65 there is little point in delaying the purchase of an annuity in the hope that the value of the pension fund, and therefore the value of the annuity, might increase. According to The Annuity Bureau, the loss of annuity income in the interim would far outstrip the benefit of leaving funds invested, even if returns were as high as 7% compound. Delaying, therefore, is a high risk tactic for the conservative investor who needs the income.

Another factor is the concept of 'mortality drag': the longer the annuity purchase is deferred, the greater will be the effect on the value of the annuity which can be purchased in relation to the reduction in the size of the pool of annuitants. 'Mortality drag' is the cross-subsidy between those participants in an annuity fund who die early and those who live longer than average. The rates offered to annuitants reflect the benefit of this cross-subsidy; but the older the purchaser of an annuity is, the closer to the average age of death he or she will be and the lower will be the cross-subsidy. It has been calculated that an additional 1.8% pa return would be needed from a pension fund to compensate for the reduction in the value of the annuity which could be bought at the age of 70, compared with one bought ten years earlier; and the rate of reduction is generally assumed to increase after age 71. However, the impact of mortality drag is reducing as an increasing number of less healthy retirees opt for impaired life annuities, thus reducing the sums available in the general annuity funds to subsidise the benefits for others.

The timing of annuity purchases is vital. Interest rates, and with them annuity rates, are subject to continual fluctuation. Prospects of longevity may change unexpectedly. Time will inevitably prove that some of the expensive enhancements for which an annuitant might have paid, such as dependants' pensions and guaranteed periods, have been unnecessary; and changes in personal circumstances might cause the annuitant to regret having parted irrevocably with capital.

In all cases, annuity investors are strongly recommended by the Financial Services Authority to shop around before buying the annuities offered by their pension provider. Better rates will usually be available elsewhere.