



Buying an annuity – some pointers

Buying an annuity so often comes as an afterthought! This really should not be the case. Converting a pension fund into an annuity is, for most people, the most important single transaction of their lives. And, to be clear, most members of defined contribution (DC) schemes will purchase an annuity. For most it is not only the sensible option, it will become the only option. "Buying an annuity provides certainty in a very uncertain world" comments Alan Pickering, Chairman of the Life Academy. He went on "Annuities are right for many. They are better than other financial products which will peg out before I do".

Currently, we are waiting to hear from the Coalition Government on the detail of what will replace compulsory annuitisation at 75. As a temporary measure the Government has raised the age for compulsory annuitisation from 75 to 77. This brings a breathing space whilst the details of the new regulations are determined. But, what should we expect in the detail? First, the Government is likely to ensure that those retiring meet a minimum income requirement. Having met the minimum income requirement there will be greater freedom to drawdown on the remaining pension pot.

Most people will still need to purchase an annuity in order to meet the minimum income requirement. The days of compulsory annuitisation are not dead – the obituary for the annuity was written too soon! Trustees need to give time and focus to optimising the annuitisation processes as never before.

A once in a lifetime decision

I began this piece by saying that for most people the conversion of a pension into an annuity is the most important single transaction of their life. For most it is a once in a lifetime transaction. "Buy in haste repent at leisure". Indeed, repent for the rest of your life is a phrase many have come to learn in old age. It is so important that trustees see education concerning the annuity process as fundamental to the whole issue of pensions education and communication. Members need an awareness soon after joining a DC pension scheme on how the "end-game will pan out".

Buying an annuity is truly a non-reversible transaction. Once an annuity is bought a binding lifelong commitment is made between the annuity provider and annuitant. This is a good thing. It assures the annuitant that an income at an agreed level is in place for the rest of their life. But, it is a two-edged sword. The annuitant has his or her guarantee and in return hands over their pension pot. There is no going back. This means that buying an annuity is a special type of transaction. By value, the annuity purchase is likely to be worth more than the value spent on a house. But there is a difference – if one buys a house and decides it doesn't fit the bill then one can sell it and move on. OK, buying and selling houses is expensive and one would expect to have considerable costs if one changes one's mind. Buying and selling an annuity is simply not possible – once bought, you are stuck with it until the day you die. This is why research is so vital and why trustees "acting in the best interest of the beneficiaries" are duty bound to assist the member.



The question of research

So how does the member do his or her research? First, they need to review their assets and other income streams and decide the shape of the income they require in retirement. Do they want an annuity that will continue to pay out to their spouse if they die first? Do they need annuity protection against inflation or are they protected in some other way? Can they afford to take a level annuity and forgo indexation? All these questions need careful thought and consideration. Patrick Sheard, a long standing Member Nominated Trustee of the flagship Logica DC Pension Scheme believes "most members don't appreciate that if you select an increasing annuity it takes 15 years to catch up. On the other hand if you live 30 years into retirement, as many will, you are quids in by going for indexation".

Sheard continues "It's difficult, difficult, difficult deciding how much you need. My parents kept working as they never believed they had enough pension. In fact they were never short of money".

A rushed decision will almost certainly be wrong – time, usually many months, needs to be set aside and the trustees can help by providing information as early as 12 months before someone retires. The military adage "Time spent in reconnaissance is seldom wasted, time spent during reconnaissance is frequently wasted" comes to mind. The full 12 months are needed for research – they should not be wasted with decisions left until a month before retirement.

Buying an annuity often coincides with substantial lifestyle changes and the stress that that involves. Trustees with the sponsoring employer should engage in good pre-retirement education. Excellent courses are run by a number of organisations, one such being The Life Academy.

Having decided on the type of income stream, the aspiring annuitant needs to find the best source of secure income at the best rate. But how? Trustees are obliged to offer those looking to buy an annuity the "Open Market Option" (OMO). Most people buying an annuity still don't use the OMO. Why not? Are they mad? No, not mad, simply ill informed of what the OMO means. Alan Pickering commented that "a frighteningly high proportion don't take advantage of OMO". He continued "Many won't go through the hassle of signing a few forms. Trustees must make it easy not to throw away money. I'm frustrated that members see it as hassle".

Securing an increased annuity

Members need to understand the merit of OMO. Too often, lost in the middle of an annuity options pack, one finds a throw away line saying "You are entitled to seek an annuity through the open market option" without any further explanation. Trustees must explain, explain and explain again! Pickering challenges Trustees "to improve the annuity outcome by making members shop around".

Making use of the OMO is one way to increase the size of an annuity - there are two others which trustees would do well to promote. Not everyone buying an annuity is in excellent health. What an understatement! Those suffering from a chronic condition such as diabetes and those who have had a stroke, cancer treatment or undergone a transplant or other significant surgery such as a heart



by-pass can secure an impaired life annuity. Those who are overweight or long-term smokers can secure an enhanced annuity. These annuities pay out significantly more than a standard annuity and are there for the asking. Trustees must encourage aspiring annuitants to disclose any conditions on a confidential medical questionnaire. The importance of the questionnaire must be highlighted. The fact that good health is not a good thing when buying an annuity must be stressed. Far too many people tick the box to say they are in "excellent health" when they smoke, drink too much, are overweight or take no exercise!

The other less well known way to increase annuity income is to split the pension pot and buy two annuities from different providers. A review of the markets will often show that the annuity secured on a pot of, say, £100k is more than half that secured on a pot of £200k. If the aspiring annuitant has a pot of £200k then splitting the purchase can be seriously beneficial. This may seem odd but to the actuaries looking at their risk this makes good sense. From the provider's perspective a risk that is spread is a risk reduced. So, go the extra mile and do the extra research.

Decisions around annuitisation are complex. "Family dynamics are changing and the whole issue of retirement is difficult to think about" says Pat Sheard. Trustees can and must help their members make the best choice for them. The decision rests with the member but the Trustees can do a great deal more to help.

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Further reading:

"Making your retirement choices – Think before you choose" ©The Pensions Regulatory November 2010