PENSION ANNUITIES

APRIL 2025

This note is part of our Retirement Income series and looks in depth at all things '**annuity**'. The annuity is the **traditional retirement income contract**, and may be both the **safest**, but potentially also the **least flexible**.

Before making important decisions on the type of retirement income most appropriate for you, it is important to be fully aware of all the options available.

Please see our other Research Notes in this area for a high-level overview of your choices at retirement, and a deep dive on each specific type of contract available.

SUMMARY

- An annuity is the traditional method of providing retirement income.
- There are various types of annuity, the cheapest being a single life annuity with no escalation in payment. Additions such as escalation in payment and spouse's benefit will increase costs.
- Whilst a level annuity provides the maximum initial income, inflation has the potential to devalue the income in real terms within a relatively short period of time.
- Once purchased, a traditional lifetime annuity cannot generally be changed or surrendered.
- Index-linked annuities provide a "safe" option, in terms of inflation protection, by increasing the annuity payments in line with an index - typically RPI.
- This Research Note should be read in conjunction with our Note giving a broad overview of Pension Withdrawals.

WHAT IS AN ANNUITY?

Annuities are purchased using a lump sum, for example your pension fund at retirement, and **provide a guaranteed regular income for the rest of your life**. This income is taxed as earned income.

Annuity rates are dependent upon three main factors: the age at which you purchase your annuity (and sometimes your postcode); projected life-expectancy; and the general level of long-dated gilt (UK government bond) yields at this time, upon which annuity rates are based. In turn, gilt yields are influenced by general interest rate and inflation levels.

Annuities are **easy to understand**, and can be good value if you live longer than the average. However, if you die soon after the annuity purchase, or if you purchase spouse's benefits (see below) and your spouse dies before you, they can be poor value. There are various options you can build in to reduce the potential downsides, but at a cost.

Annuities have historically been seen as inflexible as, once purchased, the benefits cannot usually be varied. However, slightly more flexible annuity products are now slowly becoming available. For example, capital protected annuities can return any capital not already received as income on death, but of course at a cost. In addition, annuities can now provide longer guaranteed periods, or be for a fixed term only.

PENSION ANNUITY OPTIONS

There is a wide range of annuity options available at outset, including:

- **Single or joint life annuity**: joint life payments typically include 50%, 2/3rds or 100% of the annuity as at death. The joint life need not be a spouse, but usually needs to be a named individual at outset (rather than, say, a general class of beneficiary).
- **Guaranteed minimum payment periods**: typically 5 years or 10 years but can be longer. If death occurs before the end of the period, payments continue to be made into the deceased's estate for the remaining period (with potential IHT consequences unless the payments are made under discretionary powers; and for deaths from Apr27 it may be that IHT applies to all payments, we await details).
- **Timing of the pension payments**: e.g. monthly or annually in arrears or advance.
- **Capital/value protection**: the original annuity cost less income payments made can be paid on death.

The more 'add-ons' you choose, the lower the initial annuity rate received is likely to be.

It is also possible to receive significantly larger annuity payments if you are in ill health (e.g. diabetic, or have a heart complaint), or meet certain 'lifestyle' criteria (e.g. smoker) at the date of purchase. These are termed **impaired life annuities or enhanced annuities** and should always be considered as they can cover a surprisingly wide category of individuals.

Together with the various choices above, one of the main decisions is whether the annuity will increase in payment, and if so by how much. The main options include:

1 Traditional Level Annuity

The annuity is a regular payment, which remains level throughout the term of the contract. There is no protection against inflation, so whilst there is a high initial return on capital, even moderate levels of inflation will significantly reduce the real value of the payment over time. Most people will require at least some portion of their retirement income to have inflation protection to cover basic living costs as they rise.

2 Traditional Escalating Annuity

To avoid the problem of inflation eating away at the value of the annuity, there are escalating annuities, which are able to increase by fixed percentages, typically 3% or 5% per annum. The insurance company is effectively taking the amount of money it would have paid over your normal life expectancy and rescheduling the payments. Therefore, in theory, if you achieve the average life expectancy, you should receive broadly the same total payout as a level annuity.

3 Traditional Index Linked Annuities

When the Government starting issuing index linked gilts in 1981, insurance companies were able to start issuing annuities that fully protected the annuitant against inflation. These are the most suitable annuity type for those who wish to ensure their annuity maintains its value in real terms throughout their lifetime.

4 Investment Linked (With-Profit/Unit-Linked) Annuities

This form of annuity allows the investor to potentially remain invested in equities throughout retirement. This type of annuity is not currently available on the open market.

TIMING OF ANNUITY PURCHASE

As noted above, annuity rates are influenced by:

- Average life expectancy (mortality)
- Underlying gilt yields, which in turn are influenced by interest and inflation rates

Recently, life expectancy increases have stalled, and annuity rates have been much more influenced by inflation and interest rate expectations. Short term fluctuations in rates are difficult to predict. Those delaying annuity purchase until later in retirement also need to consider if they can overcome mortality drag.

MORTALITY DRAG

An annuity rate will increase if you defer the purchase of annuity, assuming gilt yields remain the same. This merely reflects the fact the insurance company, on average, has to pay out the annuity for a shorter period of time.

However, statistically, as you grow older, you are also expected to reach an older age than average. For example, a 55 year old might be expected on average to reach age 80, however, a 70 year old might be expected to reach age 85. When the 55 year old buys his annuity, the rate is subsidised by those other 55 year olds who die before the expected age of 80. The rate for the 70 year old is also subsidised by those of his group who die before the expected age of 85. However, the amount of this mortality subsidy is greater at age 55 than at age 70, as there is a larger pool of people generating the subsidy. This can be referred to as **mortality gain**.

Thus, in **absolute** terms, **the rate you receive, as you grow older, becomes worse** – this is known as **mortality drag**, which is the opposite of mortality gain. If you are deciding to take your annuity at a later date, your pension fund will therefore have to increase in value in real terms in order to “beat” mortality drag. The extent of the extra growth needed increases with age, and, whilst it is difficult to state this exactly, the Chartered Insurance Institute estimates that, at age 50, it is under 0.50% p.a., at age 60 it is around 1% p.a. and by age 70 it is close to 3% p.a., in addition to the return required to match the annuity income (although this clearly depends upon the type of annuity used for comparison, and if you compare to a capital protected annuity, then the mortality difference is clearly much reduced).

The only way to try to “beat” mortality drag is make investments that will give you the potential for real growth, i.e. a return over those from gilts. Most investors use equities to try to achieve these higher returns, although this strategy in itself comes with investment risk and should be considered carefully to ensure that the individual can tolerate the risk involved.

CHOICE OF ANNUITY PROVIDER

The provider of your retirement income can usually be a different provider from that used for building up your retirement fund. For a lifetime annuity, in almost all cases, the best value income will be given by a different provider from the one you are currently with. You therefore have three options when purchasing an annuity:

- Take an annuity with your **existing provider** – this may be poor value. Care should be taken, however, when **guaranteed annuity rates** are attached to the existing policy, as these can offer very good value.
- **Transfer** your fund to a more competitive provider to purchase your annuity – this is called an immediate compulsory purchase annuity. Any tax-free cash and the annuity are paid by the new provider. This is usually administratively easier than the open market option below; however, beware of any charges that may be incurred.
- Use your '**open market option**'. This enables your fund to remain where it is. However, your existing provider must use the fund to purchase an annuity from your chosen provider. Any tax-free cash and the annuity are paid by your existing provider, but using the chosen provider as the underlying annuity provider. This can be administratively difficult, and is infrequently used, but can be useful, for example, if funds need to remain within a particular policy.

TAX

Annuity income is taxed as earned income at the annuitant's marginal rate of income tax.

Annuity death benefits, which include the remainder of payments made under a guarantee period, joint life annuity benefits, and capital/value protection benefits, are paid to the beneficiary **free from income tax if the annuitant died before age 75. If death was after age 75, they are taxed at the beneficiary's marginal rate of income tax**. Payments made under a guarantee period, where death is after age 75, are paid into the estate subject to the personal representatives' rate of tax which is basic rate. If then distributed onwards to higher or additional rate taxpayers, they will be liable to further income tax.

It is proposed that for deaths occurring from 6 April 2027, Inheritance Tax will apply to all pension death benefits. This may include any payments made under guarantee, although we await full details of how this may be implemented.

Important Information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.