

Open annuity

Technical background

I Introduction

I.1 Securing pension benefits

In order for a tax-approved pension scheme to discharge its liability to make pension payments to a beneficiary (other than by making a transfer to another scheme), it must do so either by paying the pension from its own resources, or by purchasing a lifetime annuity. For all but the largest schemes, annuity purchase is the normal route, and for *small self-administered schemes* and *personal pensions*, it is obligatory once the beneficiary reaches 75.

I.2 The annuity concept

The essential characteristic of an annuity purchase is the exchange of capital for income, which is then taxable as such. The capital then becomes the property of the annuity provider and is invested and used as a fund, usually pooled with capital from other annuitants, from which to pay the agreed annuity. The annuity can be fixed or variable, but will conventionally be either for a fixed annual amount, or increasing annually by a given percentage. It can also be for a specific term, or for life; in the context of pension provision it will be for life (or in the case of a surviving dependant, perhaps until some event happens, eg reaching majority or remarriage).

I.3 Annuities and defined contribution schemes

For the beneficiaries of a defined benefit scheme, the purchase of an annuity is normally of little concern, as the amount and type of annuity must reflect precisely the benefit payable under the scheme's rules, regardless of cost. However, the beneficiaries of defined contribution schemes (including personal pension plans) are in a different position; the amount of annuity they can secure depends both on the amount of capital they have accumulated, and on the cost of the annuity.

I.4 Poor annuity rates

The cost of an annuity reflects the cost of the underlying investments. Because annuities have been traditionally designed to provide a steady and secure income, they have conventionally been underpinned by investment in gilt-edged securities. As is well-known, gilt prices are currently very high in relation to their nominal yields, and considered by many as likely to remain so for the foreseeable future. This has had the effect of raising the cost of annuities proportionately. This is a concern for those scheme beneficiaries who face having to buy a conventional annuity in today's market, and are finding that their capital is only able to buy two-thirds of the income which it could have secured only five to ten years ago.

I.5 Defined benefit funding gap

The increasing cost of annuities is also becoming a source of concern to the employers who

sponsor defined benefit schemes and who bear the ultimate cost of the defined benefit promise. There is a considerable (and widening) gap between the basis on which a benefit is valued for funding purposes, and the cost of securing that benefit by means of annuity purchase.

1.6 Mitigating effects

It is argued by some that the same factors that have raised annuity prices have also increased the amount of capital available with which to purchase them, to such an extent that the net effect for the consumer is no worse. This may be true for those whose pension schemes have been fully and directly invested in equities over the period, but the majority will have either been invested in with-profits contracts, or mixed managed funds, where the beneficial effects of strong investment performance and low inflation will have been diluted. In fact, members of some cautiously-invested schemes will have suffered twice from the same factors.

1.7 Mortality risk

The amount of a conventional lifetime annuity is calculated actuarially, and is broadly intended to equate to the capital sum (after taking into account investment returns, management charges and a suitable 'safety margin' for the provider). This is achieved through a process of *amortisation*. However, the arrangement is inevitably something of a gamble, since the annuity terminates on the annuitant's death. Premature death means that the annuitant does not get full value, in income terms, for the capital spent, whereas survival beyond life expectancy can in theory prove expensive for the annuity provider. In practice, there is a safety margin built into the calculation by the provider, which means that the gamble is somewhat one-sided.

1.8 Pooling

It is argued in defence of the conventional system that the element of gamble is essentially an insurance risk; the provider agrees to pay the annuity for life, however long that may prove to be, whereas any windfall surpluses arising from premature deaths are retained in the 'pool' to reduce costs generally. The arrangement is similar to that in a large self-administered defined benefit scheme, where the scheme itself acts as the 'pool'; however, in that case the benefits of pooling serve to reduce the cost of the scheme. Any reduction to the cost of an annuity is more than outweighed by the current poor investment profile of the conventional annuity fund.

1.9 Increased risk

There is currently a strong trend towards earlier retirement. The earlier an annuity is purchased, the longer the period over which the capital sum must be amortised, and the greater the potential there is for loss of value on premature death. Guarantees are available, at a price, but existing Revenue practice does not permit guarantees of more than ten years, and five is more usual.

1.10 Poor comparison with simple deposits

When the current high cost of annuities is added to the mortality risk faced by annuitants, it is unsurprising that annuities are increasingly being unfavourably compared with simple building society deposits, which appear to offer comparable rates, but without the loss of capital.

1.11 Income withdrawal

The ability of scheme beneficiaries to defer annuity purchase to age 75 and opt to withdraw income from the scheme in the interim was introduced for personal pension planholders in 1995, as a means of mitigating the effects of poor annuity rates. However, the rules (which

were later extended to defined contribution occupational schemes) are complex, and the beneficiary is still faced with the annuity requirement at 75.

1.12 Open annuities

Open annuities are a form of investment-linked annuity that is intended to alleviate these problems by achieving the following objectives:

Better returns: by investing the purchase capital in an underlying fund that is not restricted to gilts, the prospect of having to 'lock into' a poor annuity rate is avoided.

Flexibility: by creating a notional fund which is allocated to the individual annuity, the value of which can be derived from its investment profile (after deducting income and expense payments), and by linking income payments under the annuity to the fluctuating value of that fund, the annuitant can take advantage of any increase in value resulting from good performance, while at the same time the fund is protected from the risk of premature depletion.

Value protection: the concept of a notional fund also allows the annuitant to take separate steps – outside the scope of the annuity – to protect the value of his investment, either by the traditional method of insurance, or some other means (such as investment in a 'cell' structure, described below).

Open annuities in their fully-developed form are a sophisticated concept that is unlikely to have mass appeal. They are best suited to individuals with significant pension funds (perhaps in excess of £250,000), for whom an element of professional financial management is normal. However, the concept of investment-linking has a potentially much wider appeal. Open annuities can provide a valuable additional option to the holder of a defined benefit entitlement who is anxious to avoid what is becoming known as the 'annuity trap'.

Similar annuities are available in other jurisdictions, most notably in South Africa where they have been available for over a decade and where they are known as 'living annuities'.

2 Design constraints

2.1 Introduction

Any annuity intended to secure benefits under a personal pension plan that has been approved under the Income and Corporation Taxes Act 1988 (ICTA88) s631 must meet certain requirements:

- ▶ It must be an annuity as defined in *Foley v Fletcher (1858)*, and followed in *Perrin v Dickson (1929)*;
- ▶ It must comply with the restrictions set out in Section 634 ICTA88, ie:
- ▶ It must be payable by an EEA insurance company, which may be chosen by the member;
- ▶ Incapacity rules apart, it must not commence before the member attains the age of 50 or after he attains the age of 75;
- ▶ subject to the rules concerning survivors, and to the ten year guarantee facility, the annuity must be payable to the member for his life;
- ▶ it must not (apart from the guarantee, if any) be capable of assignment or surrender.

- ▶ It must comply with IR76 PN 6.1 - 6.8
- ▶ Although not a formal requirement, but underlying the approach of the Inland Revenue to the exercise of its discretionary powers of approval, is the Revenue's wish to ensure that the pension payable from an approved pension plan (of whatever type) is secure, and payable for life (excluding survivors' pensions payable until certain contingencies, eg remarriage). This might be seen to imply a requirement that the level of payment should be one which the insurer is prepared to sustain over the remaining expected lifetime of the annuitant, but the Practice Notes are clear that the annuity may be variable. It would seem that the prime concern is to prevent a situation where the amount of the annuity is limited by the value of a fluctuating 'personal' (ie non-pooled) fund which becomes depleted to nothing in the lifetime of the annuitant – in short, a situation where the money runs out.

2.2 Taxation

On the footing that the annuity meets the foregoing requirements, then all payments made under it are taxable as income of the annuitant in the normal way.

3 Product design

3.1 The annuity

The annuity policy is available separately. Its main features are:

- ▶ Investment-linking; the insurer establishes a fund with the net policy monies, the value of which can be readily determined and which reflects gains, losses, payments to the annuitant and costs and expenses. The insurer invests the fund in one or more designated managed funds, and in much the same way as investment options are given to personal pension plan members, the annuitant may select the fund or funds in question, and may make switches from time to time. However, the fund remains the property of the insurer. 'Managed funds' for this purpose is restricted to collective investment schemes (either managed by the insurer or by someone for whom the insurer assumes responsibility), loans to/deposits with approved bodies and cash. These categories are described in the Insurance Companies Regulations 1994, Schedule 10, Part 1.
- ▶ Provision for an annual payment of such sum as the annuitant may select annually, between a minimum and maximum figure. The payments are debited against the fund.
- ▶ A minimum annual payment which satisfies the Revenue requirement for a 'value for money' test. This provides that the minimum amount is that which is broadly equivalent to the best rate offered in the annuity market for an equivalent annuity.
- ▶ A maximum annual payment limit; this is more a matter for the insurer than for the Revenue, as the insurer will wish to prevent the fund from being depleted prematurely. The limit (which varies with each review) is set by the insurer's actuary. This also allows for special risks (eg poor health) where appropriate.
- ▶ The option to switch the basis of the annuity to a conventional level or escalating basis at any time, by reference to the value of the fund (and prevailing annuity rates) at the date of switch.
- ▶ Compliance with general Revenue requirements (as noted above).

3.2 Value protection

As has been mentioned, there is no reason why an annuitant should not seek to protect his estate against the possibility of premature death, and the conventional way of doing so is by life insurance. In the case of a conventional annuity, the risk is fairly easy to compute, as the amount of the annuity is (indexation apart) foreseeable; this makes it possible to calculate (and insure against) the loss in the event of death at any particular age. However, where the annuity is investment-linked, the value of future annuity payments is not foreseeable, with the result that insurance is either not available, or is not cost-effective. To deal with this problem, a new method is available, namely the segregated cell concept. It is stressed that it does not involve the repayment of capital from the annuity, nor does it require any pension fund assets to be used other than for the provision of *relevant benefits*.

A segregated cell is a structure whereby the insurer allows the policyholder an interest in the insurance company, in the shape of a preference share, the value of which is linked to the value of the 'business' constituted by the annuity policy (although no interest arises in the actual monies being used to support the policy). Thus, no pooling with other policies arises; any deficits are limited to funds in the cell (in practice there will be none; the insurer will underwrite the arrangement), and any surpluses serve to increase the value of the cell. On the death of the annuitant, the owner of the cell can call on the insurer to allow a share buyback or redemption, by reference to the unused value of the cell, if it has one. The value in the cell is only realised when the policyholder dies.

Separately available is the Subscription Agreement for a share in a segregated cell of the insurer providing the annuity. The subscription cost of the share in effect equates to the premium cost of insurance in a conventional arrangement, and will be set by the insurer at a commercial level. The cost must of course be met by the annuitant from other funds than the annuity capital, although there is no reason why it cannot be met from the tax-free cash element of the pension plan.

3.3 Tax

Tax is paid:

- ▶ on the annuity drawn by the policyholder, under Schedule D or E in the normal way; and
 - ▶ on the gain derived from any cell arrangement. Through the application of inheritance tax.

Whilst the ultimate tax recoverable by the Inland Revenue is thus likely to be higher than if the annuity surplus were retained by the insurer, which normally pays tax at preferential rates, benefits do not accrue to the insurer, other than fees, which it charges on an open and transparent basis.

4 Consumer protection / compliance

4.1 Introduction

Open annuities, in common with income withdrawal, require an understanding of investment performance and continual management techniques are needed to produce a stable and increasing income over the life of the fund. They are more attractive to the consumer than conventional annuities because they offer the prospect of greater returns on the capital

invested, with a degree of investment choice, coupled with a transparent, fee-based charging structure.

4.2 Compliance

FSA requirements (now being revised) apply to the sale of annuities no less than to any other financial services product. The factors to be considered in relation to open annuities are similar to those relevant to income drawdown, including:

- ▶ the income needs of the annuitant;
- ▶ the investment performance needed to maintain an adequate annuity; and
- ▶ the size of the underlying fund, relative to the management and advice costs needed to sustain the arrangement.

Accordingly such annuities should only be sold with competent advice.

This note is a general introduction to the concept of open annuities; London & Colonial does not warrant any statement as to law, tax or practice which in any event subject to continual change.