



THE CASE FOR FIXED TERM ANNUITIES

Fixed term annuities are suitable for a wide range of investors, but they will be particularly attractive to those who have the twin objectives of gaining a fixed level of guaranteed income and the flexibility to change the structure of their annuity if circumstances change.

The background to fixed term annuity

The majority of annuities sold in the UK pay an income as long as the policyholder, or their partner, are still alive. Not surprising these are called lifetime annuities. However there are annuities that pay an income for a set period, normally 5 or 10 years and these are called temporary or fixed term annuities.

Fixed term annuities were popular in the late 80's and early 90's when they were used as part of back to back schemes. Typically an investor would use part of a lump sum to buy a temporary annuity which would pay a high level of income but erode the capital. The other part of the lump sum was invested in something like a distribution bond with the aim of replacing the capital used to purchase the annuity. Most investors enjoyed the high income but not all got their capital back when the temporary annuity stopped paying out.

Temporary annuities appeared in the Government's paper "Modernising Annuities" in 2002 when it was suggested that they could be used to provide investors with more flexibility in their annuity options. The new regulation finally appeared as part of pension simplification, an unsecured pension plan could invest in a fixed term annuity.

It is fair to say that fixed term annuities did not really take off until Living Time launched their innovative range of pension income products in 2007, however fixed term annuities were first used in pension income products when Canada Life introduced the Annuity Growth Account (AGA) in 2000. This policy typically uses part of the initial pension fund, typically 30 – 40%, to purchase a 5 year temporary annuity and the remainder of the fund is invested in equity based

funds. The living time proposition offers guaranteed income structures and guaranteed maturity values.

The Living Time fixed term annuity provides an agreed level of guaranteed income which stops at the end of an agreed period, say 5 years. At that stage the remaining funds are available to the policy holder to decide once more upon the most suitable shape of future income provision, and the most appropriate vehicle. This may be another fixed term annuity; a lifetime annuity; USP; ASP; or scheme pension. As with any unsecured pension framework the client choice is restricted by regulation at age 75.

Who Offers fixed term annuity?

Canada Life: The Annuity Growth Account – a unit linked short term annuity product.

Living Time: 75 Plan – a guaranteed annuity payable to age 75, with a guaranteed value payable at 75, for reinvestment in the most appropriate post 75 solution.

Living Time: Income Plan – a guaranteed annuity, payable for an agreed fixed term, with a guaranteed maturity value available for reinvestment at the agreed term end date.

Canada Life Annuity Growth Account

The Canada Life proposition is not guaranteed. It offers underlying unit linked investments.

One of the unique aspects of the AGA is the use of Survivor Bonuses. As the AGA is an annuity, an exchange of capital for income, there is no lump sum death benefit when the annuitant dies. However to compensate for this, the AGA pays a special survivor bonus at the end of each 5 year period. This is a very transparent way of passing on the benefits of mortality cross subsidy.

Living Time Fixed Term Annuity

Living Time is an investment within a USP structure, which provides guaranteed income payments for a set number of years, or until you reach age 75. At the end of the period there will be a guaranteed maturity payout which can be reinvested in a drawdown plan (unsecured pension) or an annuity if the investor is



under the age of 75. After age 75, an alternatively secured pension is available instead of drawdown

The main advantage of the Living Time Plans is that it provides the following guarantees:

- Living Time Plans guarantee that your income is secure, subject to Government income limits not being exceeded
- The Plans guarantee to provide a predetermined maturity amount at the end of the Plan term. Depending on your age at that time, this amount can either be used to buy a lifetime annuity from an annuity provider of your choice, or a further post-retirement pension product. Unfortunately, pension rules mean that you cannot take the cash!
- Should you so choose, the Plans guarantee that your investment will not die with you. Your spouse /civil partner can receive an income or lump sum or it may be possible to provide a lump sum to a nominated beneficiary

There are two versions of the Living Time Plan:

The Living Time 75 Plan

Your pension fund is invested with Living Time and in return you will receive a regular income until you reach the age of 75. At this time Living Time will pay a maturity amount which must be used to buy a lifetime annuity or 'alternatively secured pension' with a provider of your choice. If you die before you reach 75 Living Time

income payments will continue if death benefits had been selected. The Living Time 75 Plan provides:

- A regular income up to the age of 75, between nil and the maximum allowable by legislation
- A guaranteed maturity amount on the day before your 75th birthday. This must be used to purchase an annuity or it can be invested in an alternatively secure pension.
- You can choose guaranteed death benefits from a minimum of £nil to a maximum of the return of your initial investment, less any income payments made before tax

The Living Time Income Plan

The Living Time Income Plan shares the same product features as the Living Time 75 Plan, but with greater flexibility. Living Time still provide you with an income and death benefits if required, as well as a guaranteed maturity amount. These can be tailored to suit your needs.

The key difference is that you can choose the term of the investment, anything up to the day before your 75th birthday with a minimum of 3 years. In contrast the Living Time 75 Plan always runs until the day before your 75th birthday subject to a minimum term of 9 years.

As with the Living Time 75 Plan you are free to reinvest your money at the end of the term in another pension product with a provider of your choice. If you are under age 70 when your Living Time Income Plan matures you can buy another Living Time Plan.





Advantages of Fixed Term Annuities

1. The client may benefit from the opportunity to purchase an enhanced annuity if their health has deteriorated during the term of the plan. E.g. Smoker rate variance from the standard increases with age.
2. Income can be set high or low for the fixed term, and re-set in line with new lifestyle requirements at the review date. E.g. a client continues part-time work for five years, and just needs a top up income from the pension.
3. If the client's future circumstances change you have the flexibility to choose the appropriate options at the 5 year review (AGA) or when your plan reaches maturity (LT). Examples of changing circumstances may be: The early death of a spouse; poor health; changing income requirements.

Product specific advantages:

The AGA is an annuity which explicitly benefits from survivor bonuses. It also allows for equity investment and therefore the opportunity to benefit from a growing income in the future.

The Living Time 75 plan and Living Time Income Plan provide guaranteed maturity amounts therefore eliminating any investment risk. They are also written as unsecured pension plans (drawdown) so provide the additional flexibility.

The Risks of fixed term annuity

- These plans are not suitable for those who want the certainty of a guaranteed fixed income for the rest of their lives.
- The amount of annuity income at the review date or maturity will be dependent upon annuity rates at that time, which may be better or worse than current rates
- With AGA, the value of future income will depend on investment returns would be higher or lower than expected.

- With LT, if you die before the end of the plan term, the return of capital may not be payable unless you have selected a death benefit option.
- AGA carries direct investment risk.

Suitability

Fixed term annuities are suitable for a wide range of investors, but they will be particularly attractive to those who have the twin objectives of a fixed level of guaranteed income and flexibility to change the structure of their annuity if circumstances change.

The following scenarios highlight some of the situations where fixed term annuities will be suitable:

Where an investor requires a high level of income for a given period, but is prepared for a small reduction in income at the end of the period.

Living Time and AGA allow the client to take a higher income than a lifetime annuity for the period of the policy (normally 5 years) and then, in the case of Living Time, pays back a guaranteed maturity amount. This income is set according to unsecured pension rules and is therefore 120% of GAD limits.

Where an investor expects their personal circumstances will change in the future

One of the disadvantages of standard annuities is that once set up, the annuity cannot be changed. Buying a lifetime annuity is irrevocable. With a fixed term annuity you have the flexibility to change your options if circumstances change. So if for example your health were to deteriorate it may be possible to qualify for an enhanced annuity, and therefore benefit from a higher income. Also if your spouse or partner pre-deceases you there will be no need to provide joint life benefits.

Where an investor wants a diverse or balanced portfolio of retirement income products, in other words a cocktail solution.

Many investors end up buying one annuity or setting up one drawdown plan. However there is no reason, providing the pension pot is big enough, why more than product cannot be purchased.



In the same way that you might invest in a diverse portfolio of stocks and shares, you can invest in a portfolio of annuity and drawdown products. There are many ways in which this can be done including the following:

- Investing in Living Time as part of a larger drawdown plan
- Splitting the investment between a lifetime annuity and a fixed term annuity

Where a client is looking for the surety of guaranteed capital growth, without investment risk.

Many clients in unsecured pension have taken their PCLS, and are not taking income, or perhaps have a part or all of the fund with which they do not want to carry any investment risk. The Living Time plan allows a zero income to be selected, which translates into an increased guaranteed capital value (maturity amount) at the end of the term.

Future Opportunities

The fixed term annuity market is in our view going to develop further as this facility offers clients the often desired flexibility in future income structures that is needed, with the option of guaranteed income and values if desired.

Initial developments may allow the use of this facility through trustee investment vehicles and as simple cash alternative investment options in unsecured pension arrangements.

As this market develops we expect the innovation to continue and the benefits to grow.

Conclusion

Advice should always be specific to the clients own circumstances, however this advice will be influenced

by some common factors, which we have addressed in our paper 'The case for change'.

Many of us should now expect to have a healthy period in retirement followed by a period of illness or disability. For those that smoke the probability of earlier death, and illness are much higher.

Our circumstances in retirement will probably change. Yet the purchase of a lifetime annuity is based upon our personal circumstances at a given point in time, when for instance health issues may not have even begun to show themselves. Fixed term annuity presents all clients with the opportunity to review and change income structures and levels at a future date. It is not all guaranteed and introduces some uncertainty, but it is an option that all clients should be at least aware of in their decision making.

In these changing times professional advisers must review the way in which they advise clients about their retirement options and investors must think clearly about their true objectives. The result of this will be more focused and sophisticated advice and decisions, resulting in an increased use of new products such as fixed term annuities.

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