FSCS Podcast - #26 Mini-Pod: What's an annuity?

Jess Spiers 00:01

Welcome to Protect your money with FSCS, the podcast from the Financial Services Compensation Scheme. Today we've got a mini-pod for you, a special bite-sized episode, where we talk through a particular topic to explain it all simply. In this series, we explain how we can help to protect your money, so that you can feel confident your money is safe. Let's get into the conversation now.

Richard Freeston-Clough 00:26

Welcome to this mini-episode of the FSCS podcast. I'm your host Richard Freeston-Clough, Communications and Stakeholder Business Partner at FSCS. Listeners may or may not know that FSCS exists to protect customers of authorised financial services firms that have gone bust. Today, we're talking about annuities, and I'm joined by Eddie O'Brien, Head of Strategy & Insights at FSCS. Welcome, Eddie.

Eddie O’Brien 00:50

Thank you, Richard. It's great to be here today.

Richard Freeston-Clough 00:52

Now, people may have seen the term annuity mentioned in the news, particularly as rates have been rising over the past year or so. But how many people are actually clear about what an annuity is, and whether it might be something they would like to consider? Today, we are going to discuss what an annuity is, and the protection annuity-holders have from FSCS.

Now FSCS doesn't give advice, so today, we're simply going to discuss what an annuity is, and the protection that annuity holders have from FSCS and before we get into this, it's also worth mentioning that if you do want some advice, it's important to get regulated independent financial advice, which takes account of your needs, and really think through what it is you need your retirement income to do for you. So, first things first, Eddie. What is an annuity?

Eddie O’Brien 01:34

So, essentially an annuity is an insurance product that allows you to swap your pension savings for a guaranteed regular income that will last for the rest of your life or a set number of years. You can buy an annuity with some, or all of your pension pot, or with any other money that's not in your pension pot.

Richard Freeston-Clough 01:51

Thanks, Eddie that's good to know. Many of our listeners will also be wondering, are all annuities the same?

Eddie O’Brien 01:56

So, that's a really good question. They are not. There are various different types of annuities. Let me explain a little bit about some of the main options. First, let's look at the different types of lifetime annuities. You can choose an annuity which pays you a fixed income. This is called a level annuity. Or set your income to increase every year by a set percentage or in line with the inflation rate, with what's called an escalating annuity. However, it's worth being aware that the higher the increase you choose, the lower your starting income will be.

Another option is a joint-life annuity. These will pay you an income, then, after you die, they will pay your partner or your spouse an income until they die, or vice versa. You can set the amount that's paid after the first death at different levels. Then there are guaranteed annuities which will pay out for a certain number of years, even if you die, allowing you to pass the money on to dependents if you die within that time.

Another type of annuity is a fixed-term annuity which pays out a standard amount of income every year, but only for a set period of time and usually, this is about five to 10 years. At the end of this period, they pay out a capital sum, which you can use to buy a standard annuity or invest in another product. With these, you are not locked into a single rate for life, so you can shop around for a better deal in the future. So, there are lots of things to think about when considering buying an annuity and getting tailored independent advice can be really important, as they're not necessarily an option for everyone.

Richard Freeston-Clough 03:28

It's really useful. How do insurance companies actually work out how much money someone buying an annuity could get as an income, Eddie?

Eddie O’Brien 03:35

Yeah, so this will be determined by the rates the annuity providers offer. The insurance company will consider factors such as any health conditions or lifestyle risks which make someone less likely to live a long life. It’s likely they'd offer these people a higher rate than someone who is likely to live for many years. When you get a quote from an annuity provider, they'll give you an annuity rate as a percentage. This determines the annual income you'll receive. So, to give you a simple example, if you've got £100,000 in your pension pot, and you're offered an annuity rate of 6%, you'll get an annual income of around £6,000 per year.

Richard Freeston-Clough 04:13

Okay, so I suppose it's a bit like the annuity provider is making a bet that someone who takes one out won't live long enough to use up all the money in their pot or more.

Eddie O’Brien 04:22

Yeah, and in its simplest terms, where someone takes out an annuity to pay them an income for life, that is exactly what the provider is doing, Richard.

Richard Freeston-Clough 04:30

So, Eddie, is there anything else that is worth knowing about annuities?

Eddie O'Brien 04:34

Yes, and this is a really important point to remember. If you're thinking of buying an annuity, you need to bear in mind that you only get one chance to buy one - you can't really change your mind. It's really important that you take your time and make sure that you're making the right choice and consider getting independent regulated advice.

While annuities may be a good choice for some people who prefer to have a guaranteed regular income, they may not be right for everyone. For example, if you buy an annuity which doesn't take into account the rate of inflation, the value of your annuity income will adjust in real terms, so you'll be able to buy less with your money as a result of inflation. So, it's important to get regulated advice to help you make financial decisions that are right for your circumstances. Also, free and impartial guidance is also available from services such as MoneyHelper.

Richard Freeston-Clough 05:25

Thanks, Eddie, that's really useful to know. Now, shall we take a look at the protection you would get if you actually took out an annuity? What sort of protection does FSCS offer annuity holders if their provider goes bust?

Eddie O'Brien 05:35

So, annuities that are provided by UK-regulated insurers are fully protected by the FSCS, so the scheme can pay compensation to eligible customers with no upper limit if the annuity provider goes bust, subject to set requirements being met.

Richard Freeston-Clough 05:51

That's right, assuming the firm failed on or after 3rd July 2015. If it failed before that, claims are 90% protected.

Eddie O'Brien 05:59

And if you were wondering how this compares to the amount FSCS can compensate pension customers, this does vary. So, to find out more, why not have a listen to podcast number 3 in our series where we discuss pensions and much more detail. Overall, it's really important to check with your advisor when deciding if annuities are right for you.

Richard Freeston-Clough 06:20

Thanks so much for talking to me today, Eddie. Hopefully, we've answered all those key questions that people might have about annuities. However, if you want to find out more about annuities and the things to consider, it's worth having a look at the MoneyHelper website, and Eddie’s mentioned this before www.moneyhelper.org.uk. We also have more information and background on our website, that's www.fscs.org.uk. We hope everyone listening has enjoyed this mini-podcast. You can find all our podcasts on the website and the usual places you find your podcasts, but please do follow us so you never miss a new episode. Thanks very much again for listening.