Summary
• Annuities have seen a decline in sales since the pension freedoms but there is a still a role for them to play in the decumulation market.
• Data is beginning to show a trend of purchasing an annuity later on in the decumulation phase.
• The market has seen some innovation but experts would welcome further development of hybrid drawdown and annuity products.
• Shopping around for an annuity is imperative for pension savers to be able to secure the best value annuity.

Annuities: Confined to the subs bench?

Annuities were once the only option for most retirees with a DC pot but in a post-pension freedom world, data is beginning to suggest their role in the decumulation phase is largely reserved for the second half

Annuities were once the star player of the decumulation phase, with most savers forced to purchase one upon retirement. That ended, however, when the pension freedoms were introduced in April 2015.

In the seven years since the freedoms were introduced, giving pension savers the choice of what to do with their pots, annuity sales have significantly decreased. The Financial Conduct Authority's (FCA) *Retirement income market data 2020/21* revealed that annuity purchases continued to decline, with the number of pots used to buy an annuity falling by 13 per cent to 60,383 on 2019/20 data. This contrasts with pots entering drawdown which stood at 165,988 for 2020/21.

Brooks Macdonald senior investment director, Andrew Lewis, speaking at a recent webinar on decumulation, noted: "If you looked at the typical client journey, when the client arrived at the point where they wanted to take a pension, over 90 per cent of advisers would recommend an annuity… if we fast forward today, the latest FCA retirement income data shows that that outlook looks very different now…. Annuities now count for a very small proportion of all pensions."

However, 60,000 annuity sales is not an insignificant number and Aviva head of individual annuities, Claire Reed, says that there is "absolutely is a role for annuities for the UK's decumulation market within a retirement portfolio… As a business, we offer a range of retirement products, and we believe annuities remain the right product for some people."

Canada Life annuities sales director, Nick Flynn, explains: "It honestly depends on the client's individual requirements and financial position. Annuities provide a guaranteed income in retirement, which is ideal for covering the bills and providing that peace of mind. Cashflow planning is critical as some people will need 100 per cent guaranteed income while others may be wealthy enough to not need any guaranteed income. For most people, a bit of both will make sense."

Furthermore, research by the Pensions Policy Institute (PPI) from September 2021 found that the potential market for annuities has risen sharply due to the rise in the number of DC pots as a result of auto-enrolment.

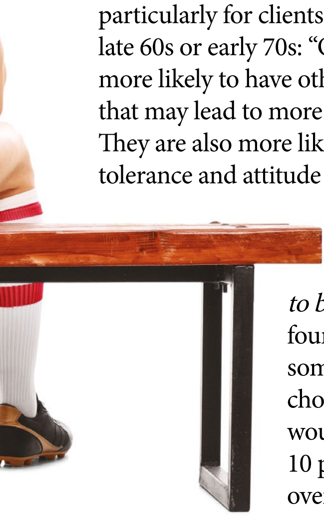
A role in the second half

"One of the big attractions of an annuity is that it protects you against uncertainty around how long you will live," LCP partner, Steve Webb, says, "but this is much less important when you are in your late fifties or early sixties and can expect to live for decades more.

"At this age, flexibility is much more important to people, including the potential for using a DC pot to fund early retirement. Because pension freedoms are only seven years old, we don't yet know what the 'pension freedoms generation' will do when they reach later retirement, but there are starting to be a few signs that annuity purchases among those in their 70s are starting to pick up slightly."

Data is beginning to emerge that shows annuities have a greater role to play later in the decumulation phase. For example, the FCA's *Retirement income market data 2020/21* found that more than half (59 per cent) of the annuities were taken by people over the age of 65.

Flynn too has seen this trend, particularly for clients approaching their late 60s or early 70s: "Older clients are more likely to have other health concerns that may lead to more attractive rates. They are also more likely to have a lower tolerance and attitude towards risk."



Furthermore, an LCP report, *Is there a 'right time' to buy an annuity,* found that although someone aged 60 who chooses drawdown would initially be 10 per cent 'happier' overall than someone who immediately uses all of their pension pot to buy an annuity, annuities become more attractive later in retirement. Its model predicted that a typical retiree would be happier overall with an annuity at around age 67, and the attractiveness of an annuity grows the older they get.

As well as providing more certainty around health and how long you might live for, Webb highlights another draw: "A second attractive feature of an annuity as you get older is that you no longer need to manage an investment pot. It seems likely that people in their 60s are more willing and able to manage a pot and live with the ups and downs of investing, but we don't yet know whether people will still want the same involvement and uncertainty when they get into their 70s and 80s."

Furthermore, Just Group group communications director, Stephen Lowe, notes several other reasons why annuities become more appealing with age. For example, annuity returns become more attractive over time relative to non-pooled solutions due to 'mortality drag and medical underwriting enables declining health to be reflected in higher annuity returns.

Product development

In response to the new trend of combining drawdown and annuities in the decumulation phase, innovation is needed in the market. Webb says: "While savers are free to enter into drawdown earlier in retirement and then use any remaining cash to purchase an annuity later on, experts would welcome innovation in the market that combines the two products."

Webb would like to see a product that combines drawdown with an annuity: "This could be a gradual shift in balance, with slices of annuity bought each year, or a bigger switch from drawdown to annuity at a set age (such as 75). A lot more work needs to be done on how this would be designed, but providers such as Nest and other master trusts are doing some interesting thinking in this space."

Canada Life is one of those providers that has begun to offer products that can combine the two. Flynn says: "We saw that people were interested in having the security of a guaranteed income alongside the flexibility that drawdown can offer. Our flexible drawdown product with an annuity option, allows users to enjoy this hybrid retirement option. We also offer fixed-term annuities that provides the security of an annuity for five, 10, 15 years or more."

Other areas of the market have also seen innovation to make purchasing an annuity a better experience for savers. For example, Just Group has focused on supporting retirees to buy the best annuity with the most suitable features for them that delivers the income they need with the right level of protection (spouse's pensions, guaranteed periods, value protection), Lowe says.

"That means we have seen innovation in terms of improving medical underwriting so each retiree is offered a personalised annuity rate for their circumstances," Lowe adds.

Furthermore, Reed says that since the pension freedoms the market has seen the introduction of improved death benefits on annuities to bring them in line with drawdown.

"Customers can now select guaranteed periods up to 30 years or add value protection, which allows them to select a minimum per cent of their fund that will be returned over the course of the product. Any innovation must still align with HMRC rules to ensure the annuity does not inadvertently create a significant tax liability for the customer."

Shopping around

One area that is important, however, regardless of products, is the need to encourage more savers to shop around for an annuity. PPI research found that a small majority do appear to shop around for an annuity but the levels of shopping around for pension products are lower than for other financial services.

It found that depending on various factors, such as age, geographical location and the type of annuity sought, people, especially those with health problems who could qualify for an enhanced annuity, could gain up to an extra 15 per cent, £800 per year (per £100,000 of purchase price) of retirement income if they shopped around.

Experts say that although the FCA has taken some steps to encourage shopping around, more needs to be done to help customers.

"The regulator has taken some steps to encourage shopping around but this seems to have had limited effect," Lowe says. "Where we have seen a step change in approach is the innovation among providers to offer their customers broking services so it is much easier for customers to secure the best rate in the market. We think this level of support will become the norm rather than leaving retirees to do the work for themselves. Not all providers are offering these services to help their customers."

Written by Natalie Tuck