The battle for savers' retirement pots

Despite industry warnings, consumers are still abandoning annuities in droves. Could hybrid products bridge the gap between flexibility and security? Sara Benwell explores

Summary
- The take up of annuities has continued to fall since 'freedom and choice'.
- However, some retirees are working with advisers to blend products in retirement.
- Hybrid products are failing to gain traction due to cost and complexity, but may become more popular as fewer retirees have DB savings to fall back on.

Pension savers are continuing to embrace freedoms, with more people cashing out or going into drawdown than ever before.

A Financial Conduct Authority (FCA) sector report finds that in 2017, 55 per cent of people took full cash withdrawals, 30 per cent went into drawdown and only 15 per cent bought annuities.

These figures aren't particularly shocking. The consumer trend towards abandoning annuities has steadily increased since the pension freedoms were introduced, leading many large insurers to withdraw from the insurance market altogether.

It's been more a flood than a trickle, and one driven by low interest rates, Solvency II requirements and most critically 'freedom and choice'.

Part of the driver is a demand for flexibility. Aegon pensions director, Steven Cameron, comments: "The sharp increase in transfers from defined benefit to defined contribution schemes, coupled with an ongoing preference for income drawdown over annuity, points to a desire for flexibility over how to draw retirement income.

"This is consistent with Aegon's latest research, which found that half of over 50s want a fluid transition from work into retirement, which requires greater flexibility over how and when to draw pension income, often alongside reduced earnings."

However, the industry remains deeply concerned by fears that consumers are making poor decisions and could run out of money.

These fears are not totally unfounded. Of the 55 per cent of people taking all their pots as cash, over half are putting the money into cash, investments in ISAs, savings or bank accounts.

Clearly the lack of trust and understanding in pensions remains. After all, it is rare situation where taking money from a workplace pension only to stash it in a bank account or ISA is a good decision, either from an investment or a tax perspective.

Balancing flexibility with security

When you ask people what they want from their retirement income, the answer tends to be unequivocal – if conflicted.

They say they want flexibility but also that they want a secure and guaranteed income for life – or in other words, an annuity.

One way to achieve this balance is to combine different products (sometimes from different providers) in order to get elements of both stability and flexibility.

Standard Life head of global savings policy, Jamie Jenkins, says: "There is a great deal of merit in considering a combination of flexible and fixed income products for retirement planning, particularly given the uncertainty of future needs, health and life expectancy.

State Street Global Advisors head of pensions and retirement savings strategy, Alistair Byrne, adds: "Those with a financial adviser can have the adviser structure a mix of savings, drawdown, and annuity income for them. In addition, a number of products exist that put drawdown side by side with annuity, and enable future tranches to

be annuitised. As it stands, the annuity element tends to be relatively underused."

That's borne out by the figures, annuity take up remains poor, even for it to be used as security against poverty in later life.

This may be because retirement decisions are complex enough, without having to go to providers and get two products, with two sets of fees.

Intelligent Pensions technical director, Fiona Tait, says: "The potential downside of a mix of retirement products is complexity and cost, whether that be an increase in the cost of advice or additional product costs. If one element of the mix, particularly if it's drawdown, is relatively small, costs can become prohibitive."

Barnett Waddingham self-invested technical specialist, James Jones-Tinsley, adds: "The cost of effecting two or more arrangements as part of an individual's overall retirement planning strategy could be more expensive than effecting one arrangement… and may involve using two or more different providers, which may increase the complexity and ongoing administration of the overall strategy."

One alternative is a hybrid product that combines annuities and drawdown in a one-stop-shop product for retirees, a solution that is gaining enthusiasm among providers.

But even though the industry has appetite for hybrid products, consumer demand for these innovations remains low.

Jenkins says: "All of this flexibility can be achieved within the current framework of products. While hybrid products may appear attractive, they haven't proved popular in practice."

One reason for the low take up of hybrid products may be that a large majority of people retiring today have DB pensions.

For anyone with a substantial DB pot, this can provide the stability and security one needs, and means that smaller DC pots can be used for discretionary and flexible spending.

And for those on lower incomes, the state pension should provider a sensible replacement rate and guaranteed income for life – again leaving any DC savings to be used as one wishes.

Looking to the future

The lack of appetite for blended products, or indeed mixing and matching drawdown and annuities, makes sense against a backdrop of DB-led pensions.

But as we see the next cohorts retiring, who have the vast majority of their savings in DC, is this likely to change?

Byrne argues that deferred annuities could play a role in helping retirees secure income throughout later life.

He says: "So far there is a limited supply of deferred annuities in UK, but that may change with greater demand. In the US, we are working on implementing such a model for a large client, and initially the supply of annuities was limited but insurers are now becoming more interested."

However, JLT Employee Benefits head of pension decision service, Richard Williams, argues that cost may mean that hybrids never reach their full potential.

He explains: "Many hybrid products come with extremely high fees. These hybrid products are also especially complicated, and many clients are not capable of understanding all of their technical features or limitations.

"This becomes a vicious cycle, as higher costs put advisers and clients off, which in turn stops providers from reaching a critical mass where they can reduce the costs."

And some advisers are questioning whether annuities have any role to play at all in a sensible income strategy.

Portafina managing director, Jamie Smith-Thompson, says: "We believe in many scenarios annuities currently offer really poor value and have done for some time. A big part of this is down to year-on-year increases in life expectancy.

"Depending on your circumstances, they may only guarantee a 3 per cent return if you chose to add other benefits such as inflation protection, guaranteed periods or spouse benefits.

"You could look at a hybrid option of a guaranteed annuity and pension drawdown but why would you if annuities are such poor value?"

Even where savers do want to add in an insurance-based solution, there are questions as to whether a hybrid is the right way to go.

Williams argues that a mix and match DIY approach might make more sense. He explains: "The hybrid's ability to combine two complete products into one vehicle is their greatest selling point, but the jury is still out on whether they are genuinely able to provide a level of benefits that cannot be matched by their traditional alternatives." And while a hybrid might make it easier for a consumer, in that they only have to decide on one product, the increased cost and complexity may be off-putting.

Tait adds: "Combination products are simpler to set up as there is only one application form and one income payment, even if money is effectively withdrawn from both parts of the plan.

"The downside is that the underlying product is more complicated to understand and usually more expensive to cover the cost of the guarantee."

But DIY solutions are usually the result of independent financial advice, something for which many people are unable or unwilling to pay.

This suggests there may still be a role for hybrid products, in meeting the needs of middle-income savers. Those people for whom the state pension is too low to provide enough security, but who feel that their pots are not large enough to warrant advice.

Tait concludes: "Combination products can be more effective for smaller pot sizes where the cost of having a separate annuity and drawdown product are harder to justify."

Written by Sara Benwell, a freelance journalist