The age of certainty

Recent market volatility has boosted the appeal of annuities as a guaranteed source of retirement income. Maggie Williams explores whether the trend is set to last

Summary

- Annuity rates hit a 14-year high in late 2022, pushing up rates by around 40 per cent.
- Market volatility has made the certainty of annuities more attractive for retirees.
- There is still a significant gap between best and worst rates so shopping around is important.
- Annuities will continue to play an important part in DC saver's long-term plans.

What a difference a year makes. Annuity rates hit a 14-year high in December 2022, a stark comparison to the poor value that they offered just 12 months earlier.

Before the introduction of freedom and choice in April 2015, almost all DC pensions were converted into annuities. But newer flexible options such as drawdown, coupled with historically low annuity rates until this year, constrained the fortunes of the annuity market.

But last year showed a more positive picture. Financial Conduct Authority figures showed sales of annuities rose 13 per cent in 2021/22 compared to 2020/21. And research from Legal & General Retail found that close to a million (990,000) over-55s who are still working are considering an annuity for the first time as they prepare for retirement. Could annuities see a longer-term resurgence?

"Incomes remain around 40 per cent higher than they were a year ago, although annuity rates have now come down a bit from the heady heights they hit after the mini-Budget in October 2022," says Hargreaves Lansdown senior pensions and retirement analyst, Helen Morrissey.

October's market chaos also brought home the impact of fluctuating asset values on scheme members' retirement prospects, says Just Group group communications director, Stephen Lowe. "Recent economic and political events have been a sharp reminder that asset prices both rise and fall and no retiree should be risking money they can't afford to lose."

Legal & General Retail Retirement managing director, Lorna Shah, adds that its research found drivers other than market performance are increasing interest in annuities: "People were also drawn to annuities by the stability a guaranteed income offers, as they felt it made it easier to plan their finances (78 per cent) and lessened the impact of market volatility on their money (36 per cent). This is unlikely to change in 2023," says Shah.

Building awareness

However, Shah says that L&G's findings also shone light on knowledge gaps surrounding annuities, risking retirees opting for an 'either/or' approach between annuities and drawdown. "But the decumulation journey can take many years and people's needs can change multiple times over this period."

Wealth at Work director, Jonathan Watts-Lay, agrees. "The key priority is to make sure that people understand the choices available to them at retirement, and that an annuity is one of many options. It's also important to make the connection between those options and investment choices. Automatically lifestyling people into bonds might not be appropriate if they change their mind and want to stay invested."

As part of a range of retirement options, annuities have the obvious advantage of offering a predictable income for life, especially if they are index-linked. "No-one has come up with a rival solution to the problem of guaranteeing retirees don't run out of money during their lifetime. That suggests annuities are here to stay, with some good reasons to think the immediate future is positive," says Lowe. But that consistency of income can give less flexibility in tax arrangements than using drawdown, and it's not possible to pass on an annuity after death in the same way as an investment portfolio.

Morrissey argues the importance of recognising that retirees' needs will change over time. "It's also worth making people aware that they are under no obligation to annuitise all at once – annuitising in slices throughout retirement means you can keep the remainder invested and you can also get better rates as you age."

Future directions

The next decade will see more people retire with the bulk of their pension in DC savings. Trends will also show how DC retirees' income needs change over time in retirement, how well their pension pots are able to support those changes, and where gaps exist both in guidance/advice and retirement product portfolios. That could help to shape future innovation in annuity design, as well as associated advice.

Aviva workplace pension policy manager, Dale Critchley, says that at present he is seeing interest in annuities increase across all age groups – from the beginning of retirement, through to older saves who want to convert a drawdown fund into a guaranteed income. "We are increasingly seeing annuity products used to provide a baseline fixed income, with customers investing the rest of their fund in drawdown."

"We're likely to see greater innovation and flexibility as the annuity market evolves over the long term, to meet members' changing retirement needs," says Legal and General Investment Management (LGIM) co-head of DC, Stuart Murphy. "For instance, we're seeing fixed-term annuities becoming increasingly popular to help bridge the gap for those finishing work before they reach the state pension age – or, for the current generation, the point at which any defined benefit schemes they have access to begin to deliver an income."

He adds that LGIM sees "significant potential for later life annuities – allowing members to spend more flexibly in the early years of their retirement, before locking in a guaranteed level of income further down the line".

"The combination of the flexibility of drawdown with the certainty of annuities can meet people's needs in a wide range of circumstances – it's just a question of getting the blend right, which is why professional advice and guidance is so important. Solutions that tried to deliver both haven't been successful probably due to the extra cost and complexity for little extra benefit," adds Lowe.

GOAL! Four essential tips for choosing an annuity

Guarantees: "Check whether an existing pension has any valuable guarantees that would be lost if they transferred it elsewhere," says Critchley. "These are usually referred to as a Guaranteed Annuity Rate (GAR). It is important to understand when these guarantees take effect, for example, at what age and date."

Open market option: Taking a pension to a different provider on the open market can improve a member's income. "Different providers offer different rates so the use of annuity comparison tools is important," says Morrissey. MoneyHelper, from the Money and Pensions Service, has a free comparison tool. An annuity bureau or comparison tool can't say if an annuity is the right option, but they can help find the provider who offers the best rate.

Advice and guidance: Help members to access financial advice or guidance to understand whether an annuity is an appropriate option for them, or might be in the future. Watts-Lay says this means thinking of annuities as part of a wider retirement planning picture. "Retirees need to take a holistic view and understand the pros and cons of different approaches, rather than looking at annuities in isolation."

Lifestyle: Answering lifestyle questions and fully disclosing medical conditions is vital to helping members get the best possible rate. "Without these, a saver is unlikely to obtain the best rate," cautions Critchley.

The right product, at the right time

Although annuity rates have risen across the board in the last year, there remain significant differences between the best and worst paying products. Research by Just Group in October 2022 found a 16 per cent difference between the highest and lowest Guaranteed Income for Life (GIfL) annuity based on a healthy 65-year-old. This equated to a difference of £505 per year.

"Shopping around is key to getting the best deal from an annuity," emphasises Morrissey. "Other important messages can include helping people get the best type of annuity for their needs. Are they married? Do they need a joint life annuity? Do they have a medical condition that qualifies them for an enhancement? These things can have a huge impact on how much income someone receives."

Last year's boost in awareness and improvements in value may prompt more people to take a look at annuities, as part of a toolkit of retirement options. But making sure scheme members choose the right product for their needs, at the right point of their lives and get the best rates available in the market still means equipping members with access to good quality information and support for their evolving decision making.

Written by Maggie Williams, a freelance journalist