LONDON & COLONIAL
INNOVATION IN PENSIONS

Press Release

Guaranteed income – is the price always worth paying?

As we all know, traditional annuities normally guarantee income either for the life of the annuitant or possibly for a minimum term or continuing to a second life. For many annuitants, particularly those with relatively small pension pots and little in the way of other assets or income, the security and peace of mind offered by these annuities is invaluable. But this security comes at a price in that the levels of guaranteed income offered by insurers are currently relatively low in relation to the size of the accumulated pension pot.

Some are suggesting that insurers may be making unduly large profits from their annuity book and even want the FCA to require disclosure of factors underlying annuity rates. It may well be interesting to be able to compare insurers on the basis of some universal yardstick but it is difficult to see what measure – other than the annuity rate itself - could be applied that would provide anything very useful for consumers or advisers in selecting an insurer. It would however be guaranteed to add yet further regulatory costs to our industry – all of which are ultimately borne by the consumers.

Before condemning annuity insurers one has to take into account the reasons why lifetime income guarantees appear so expensive. At a very fundamental level an insurer has to ensure that its assets will always be sufficient to meet its contractual liabilities. In doing this and in setting its annuity rates, assumptions have to be made of relevant factors for decades ahead. These factors include future mortality experience, future expenses and future investment returns as well as the costs of the capital needed as reserves. In the absence of a crystal ball these assumptions have to be quite prudent if the income guarantee is to be meaningful. Some of the insurers' costs are not immediately obvious. Just to take one example of regulatory costs, the forthcoming introduction of the Solvency 2 regime across the EU that is anticipated in 2016 has already cost the major insurers millions of pounds just in reviews of their businesses and preparations for the new reporting requirements. All in all, the costs of providing absolute guarantees really are very substantial – and inevitable.

Surely the most important thing is to consider the value to the individual of a guaranteed income for life alongside the assessed risks inherent in other at-retirement solutions. In making this assessment it will be important to consider not only the higher initial income likely to be available but also the subsequent opportunities that are often overlooked - including switching in the future to other products or to guaranteed annuities as markets and the circumstances of the individual change.

Apart from traditional annuities, other "at retirement" solutions allow for a change in strategy to focus on, for example, guarantees of investment return rather than just an ultimate guarantee of income. This implies an assessment of risks similar to those that insurers have to guard against, how significant these are for particular individuals and whether the cost of protecting against all of these risks is really worthwhile.

But this is not the whole story by any means. It could be said that traditional guaranteed annuities also carry a risk – the risk that an individual's circumstances may change and the annuitant could not adapt the annuity to match these changes because they have locked in for life. In contrast the new breed of reviewable annuities usually includes options that could be used very beneficially.

One simple example is that of an annuitant whose health takes a turn for the worse. An annuitant with a traditional annuity would be likely to become one of those in the insurer's pool who dies "early" and therefore contributes to the income for those who live longer than average. However, an individual receiving income from an alternative at-retirement solution could purchase a traditional impaired life annuity at that point to secure significantly higher future income for life. Other changes in personal circumstances – e.g. death of a partner – may raise somewhat similar considerations.

Another example is that of investment opportunities. Potential may be seen in delaying a traditional annuity purchase – because of the prospect of a higher rate at a later age or because of an anticipation of higher interest rates leading to generally improved annuity rates. This course will have to address the matter of income in the meantime and hence will require careful consideration of the most appropriate investments.

Investment in corporate bonds is one approach that may have attractions – bearing in mind of course that any company could run into problems and its bonds fail to be redeemed. This risk will need to be considered in the context of each client and a view taken of an appropriate bond selection.

Currently coupons in the region of 6% are readily available from 5 year bonds issued by the likes of Tullet Preborn (5.25%) and Thames Water (7.75%), with yields to redemption of around 5% (Tullet Preborn 4.6% and Thames Water 5.8%). These yields may well be attractive to some given that they come with the prospect of applying the redemption money at an annuity rate in, say, 5 years time for someone 5 years older.

For example a 65 year old male with £100,000 could currently lock into an annuity rate of around 6% for life (giving gross annual income of £6,000). One alternative could be to take a reasonably conservative five year bond coupon at say £6,500 (to give a similar annual income and cover costs) and then apply the redemption money (approximately £90,000 given that the bond will currently stand at a premium) to an annuity rate for a 70 year old. At around 6.8% in current day terms that rate would then provide annual income from an annuity of about £6,181 representing a modest 3% increase over the annuity income from 65 if market conditions remain unchanged.

However, taking a longer view – say 10 years also with bond coupons available around 6% (Severn Trent at 6.25% and Citigroup at 5.875%) - similar initial income could be taken and the subsequent guaranteed income from an annuity for a 75 year old male on a similar basis might work out at around £7,200 i.e. a 20% uplift on the annuity income from 65.

These figures are to an extent reflective of the effects of "reverse mortality drag" and even ignore the possibilities for the eventual annuity purchase being on an impaired life basis. When added to the opportunities afforded by reviewable annuities (e.g. wide range of available investments, nil cost 10 year guarantee period, income related initially to one life under a first single life annuity possibly followed by a second annuity to a survivor rather than a lower income throughout based on a joint life rate and also the very important option to transfer to another annuity – possibly with a guarantee) it is clear that careful selections from all of these options could be the best fit for a whole variety of different circumstances.

The costs of the alternatives to traditional annuities will tend to make it more difficult for them to compete at very low fund values but at all levels the best solution will depend upon both fund size and the circumstances of the individual – e.g. dependants, health, financial commitments and other resources.

The real challenge is to understand and to be aware of all the alternatives to traditional annuities. In a recent poll of 2,000 advisers 77% of responses supported development of a lifetime annuity that is reviewable on an annual basis – but such a product already exists of course.

Despite the assurance of a guaranteed income that they give, the lock-in nature of traditional annuities is a major factor underlying much of their unpopularity – as is the thought that the annuitant could be one of the unfortunate ones that dies "early" so that the perceived residual fund is lost to survivors and effectively applied to fund others.

On the other hand, reviewable annuities offer valuable flexibility and the facility for lump sum death benefits to be paid to the annuitant's dependants, or alternatively to a charity, has a clear attraction.

There can be no "right" answers but the vast majority of individuals will need expert professional advice to weigh up the pros and cons of locking into a traditional annuity versus the flexibility of reviewable annuities and drawdown if they are to make the most of the pension fund that they have accumulated.

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Financial Adviser – December 2013

-ENDS-

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Notes to Editors

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