The Future of Retirement Income – Beyond Annuities
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No-one can have failed to notice the changes affecting pensions that occurred in 2014. Before that year's budget, almost everyone with a defined contribution pension bought an annuity at retirement. Even those that chose drawdown were obliged to buy an annuity at age 75 unless they had significant alternative guaranteed income. But no more – the 2014 pension freedoms mean that no-one has to buy an annuity.

There is a danger that some people will expect pension freedoms to allow them to have a much higher standard of living in retirement than would have been provided by an annuity. However, if annuities appeared expensive, this was in no small part to the rise in longevity (both actual and expected) and the fall in interest rates. These have not just increased the cost of annuities. They also mean that investments are likely to offer lower returns than in the past, as well as having to last longer.

But might the death of annuities be exaggerated? Some people in the UK are still buying them. It is also helpful to look overseas.

In the United States, where annuities are generally unpopular, they still exist. Advanced life deferred annuities allow people to secure at retirement an income that will only start decades later. Variable annuities, which are essentially income guarantees added to mutual fund investments, are also popular. But the cultural aversion to risk pooling means that annuities will always struggle. How similar is the investment culture of the UK to that of the US?

In Switzerland, annuities are not compulsory, but they are popular. This is because for part of the second pillar, annuitisation – at a non-market rate – is the default option. Both the fact that it is the default and the generous interest rate help the popularity of annuities. But another factor is the low level of home ownership, meaning that a regular retirement income is important, making sure that rents get paid.

In New Zealand, however, the annuity market has completely vanished. This is partly due to tax issues, but also perhaps because of NZ Super, which provides a moderate guaranteed level of income. This means that the guaranteed income provided by an annuity is simply not needed.

So what might the future look like for the UK? Given the state of range of factors involved, complicated. It will most likely depend on the investor type. Investor types can be defined by:

- the level of wealth (excluding defined benefit pensions);
- the level of income in addition to that generated by wealth;
- the health of the individual;
- the bequest motive; and
- the risk tolerance.

Using these criteria, it appears that there are three broad types of investment or payment strategy that might be appropriate. The first is a short-term top-up income. This might be to supplement part-time work before the commencement of a defined benefit pension, or because the pot is so small that it is useful only for providing income in the run up to the state pension age. In any case, a secure, short-term income is what is needed.

The second is for a long-term level of income with limited constraints around uncertainty in this income. This might be for someone for whom the defined contribution assets are topping up a significant defined benefit pension, or for whom the defined contribution pot is so large that it can comfortably provide the necessary level of income.

The third category is where the defined contribution pot must provide an income for life, with significant restrictions on volatility. This is likely to be relevant for many people, for whom a smaller-than-anticipated defined contribution pot must provide the majority of their retirement income. For these people, some form of longevity insurance is important. This might be achieved through an advanced-life deferred annuity, or by hypothecating some assets for the purchase of an annuity later in life. The remainder of the assets can they be drawn down in the intervening period.

One complication is that people cannot know how their health will develop in retirement. This has an impact on the period for which income will be needed, and the pattern of that income. It also suggests that an element of flexibility is necessary. Another issue is that there may be other unexpected expenses, particularly in relation to property.

But the key issue is that current rates of saving are so low that too many people are likely to find themselves running out of money and falling back on the state rather than having the opportunity to enjoy most of the strategies described here.