Annuity rates – How low will they go?

"annuities still have a role to play"

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What is an annuity?

An annuity is an insurance company product that provides a guaranteed level of income for life, in return for a single premium.

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The record low annuity rates seen in September hit the headlines in the financial press recently. While annuity rates generally have been falling for many years, the latest sharp fall in government bond yields since the beginning of 2019 has seen annuity rates drop by well over 10% over the last few months.

What this means in practice

At the start of the year a pension pot of £500,000 would have secured an income of £22,670 pa for a 65* year old. By September 2019 the same £500,000 pension pot would have only have been sufficient to purchase an income of £19,832 pa. That's a reduction of 13%, which is almost £55 a week!

Demand for annuities has dropped off in recent years, as they have increasingly been perceived as being expensive. In addition, the annuity market declined further following the introduction of "Pension Freedoms" in the UK from April 2015. However, annuities still have a role to play in the provision of a retirement income; after all, an annuity is the only product available that will turn a defined contribution pension into a guaranteed income for life. The main downside of buying an annuity is that once purchased, an individual is "locked in" to the terms at the date of purchase.

Should you defer purchasing an annuity?

In view of the high cost of annuities at the current time, some have suggested that it may be better for an individual to draw down from their fund, at least in the short term, and consider deferring purchasing an annuity until a later date. However, this is not without risks. If interest rates continue to be very low for an extended period and investment returns are poor, it may never be possible to secure an annuity on better terms.

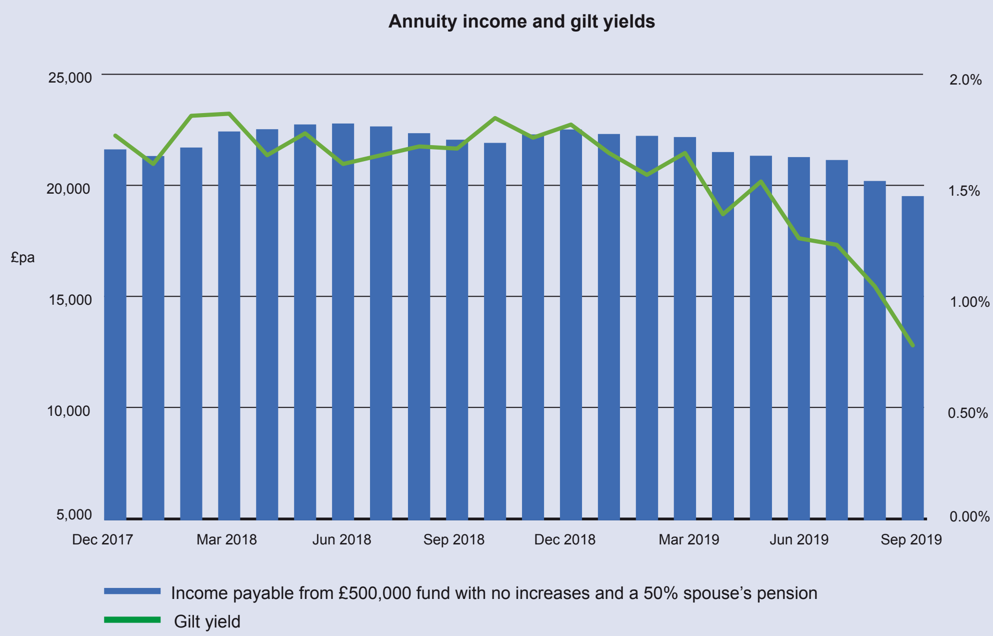
Are annuities still a good option?

With annuity rates at such low levels, to many approaching retirement, purchasing an annuity may not seem like the best option at the current time. However, annuities should not be dismissed without first considering their advantages:

- An annuity can provide a baseline income to cover monthly living costs
- Opting for an annuity that increases either in line with inflation, or at a specified rate, protects against the effects of inflation eroding purchasing power in retirement
- Selecting an annuity with a dependant's pension option provides some financial protection for a partner or dependant after an individual's death
- Including a guarantee period will ensure that the annuity will continue to be paid for a minimum period after retirement, in the event of early death within the guarantee period
- Those with a medical condition or smokers may be able to secure a higher income if they qualify for an "enhanced" or "impaired life" annuity.

Best of both worlds?

For those with more than one sizeable defined contribution pot, they could provide a minimum level of guaranteed income by purchasing an annuity using one of the funds and draw down on the remaining fund(s) to provide extra income when required.



*Non increasing pension with a 50% spouse's pension for a spouse 3 years younger