What next for annuities

A local and offshore perspective? What does the future hold for annuity buyers?

Presented at Botswana Pensions Society Conference by Frank Dalo

Agenda

- Why annuities?

Why annuity

- Annuity is a form of pension or post retirement income.
- Normally offered by employers through pension scheme provision where the pension amount is guarantees at the outset.
- Or where the retirement lump sum is given to a retired employee to seek their on pension from the insurance market.
- Due to the risk that the annuity provision pauses, some employers opt for de-risking their balance sheet by insuring the annuity risk through bulk annuity insurance.

Insurer perspective

- In return of a premium, they guarantee a fixed payment of a pension until the unlikely death of the pensioner.

- This introduces three main risks,
  - Ability to match the liabilities with appropriate assets(long dated bonds).
  - High interest rates on the bonds available
  - Pensioners living longer that assumed in pricing

Pensioners perspective

- The guaranteed payments may be lower due to low interest rates on the market and the view from insurers regarding life expectancy.

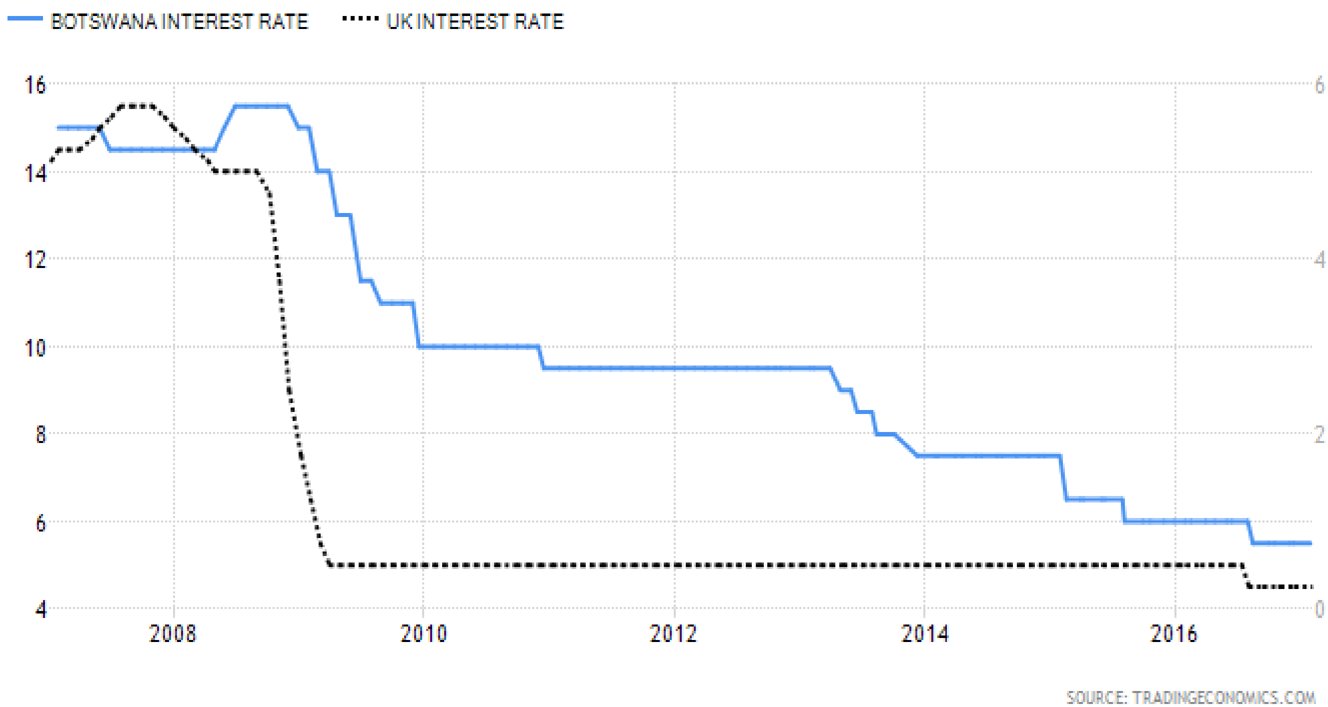
- This potentially leaves the pensioners with lower pension in the midst of rising cost of living

What has happened – Interest rate

- Interest rates have been relatively high which enabled pension schemes and insurance companies to offer higher annuity amounts.

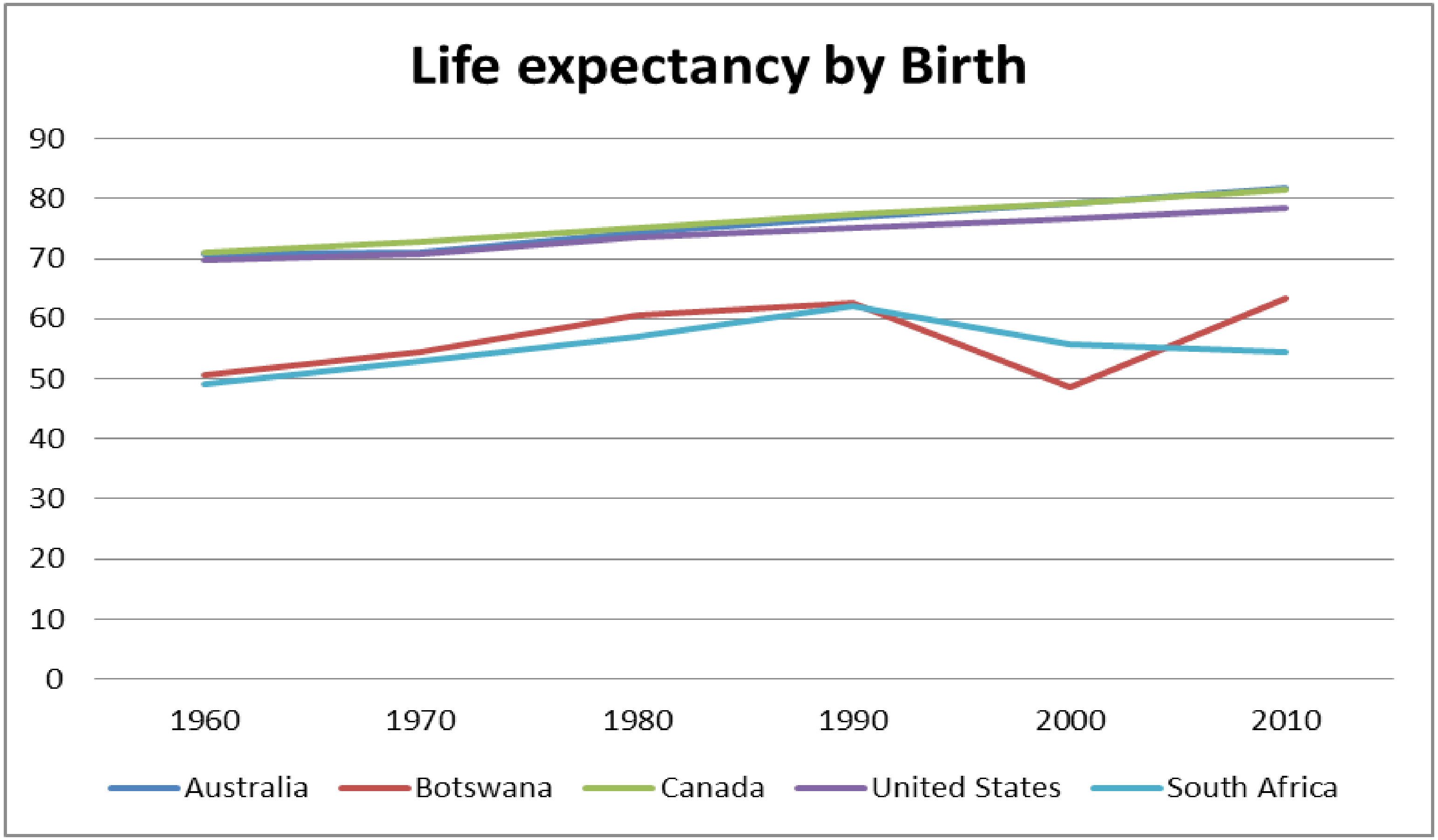
- Yield on BW 007 bond was 8% p.a and now it is at 4.6% p.a

What has happened – Interest rate

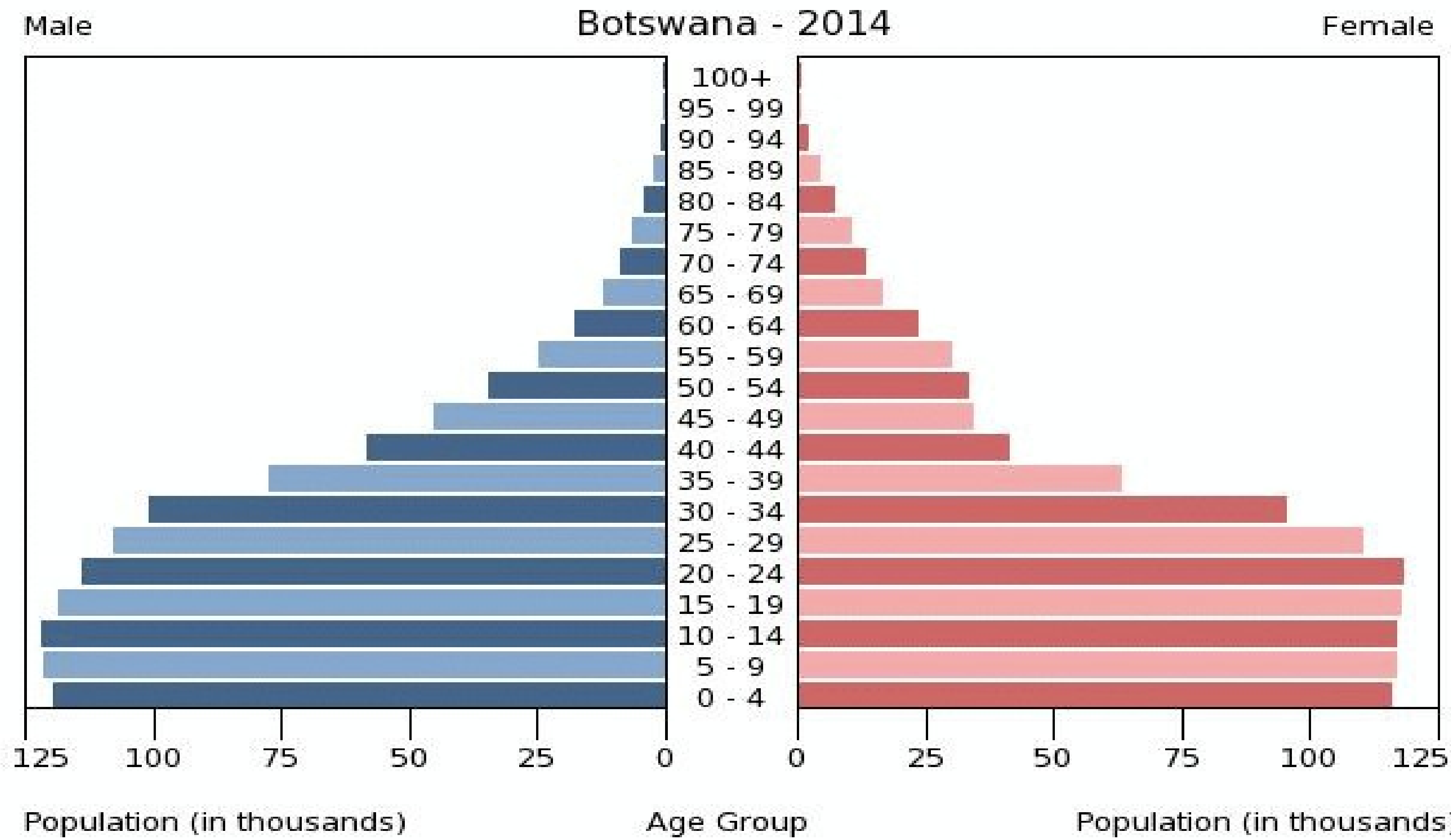


- Interest rates have dropped since the financial meltdown in 2008
- This resulted in significantly low annuity guarantees

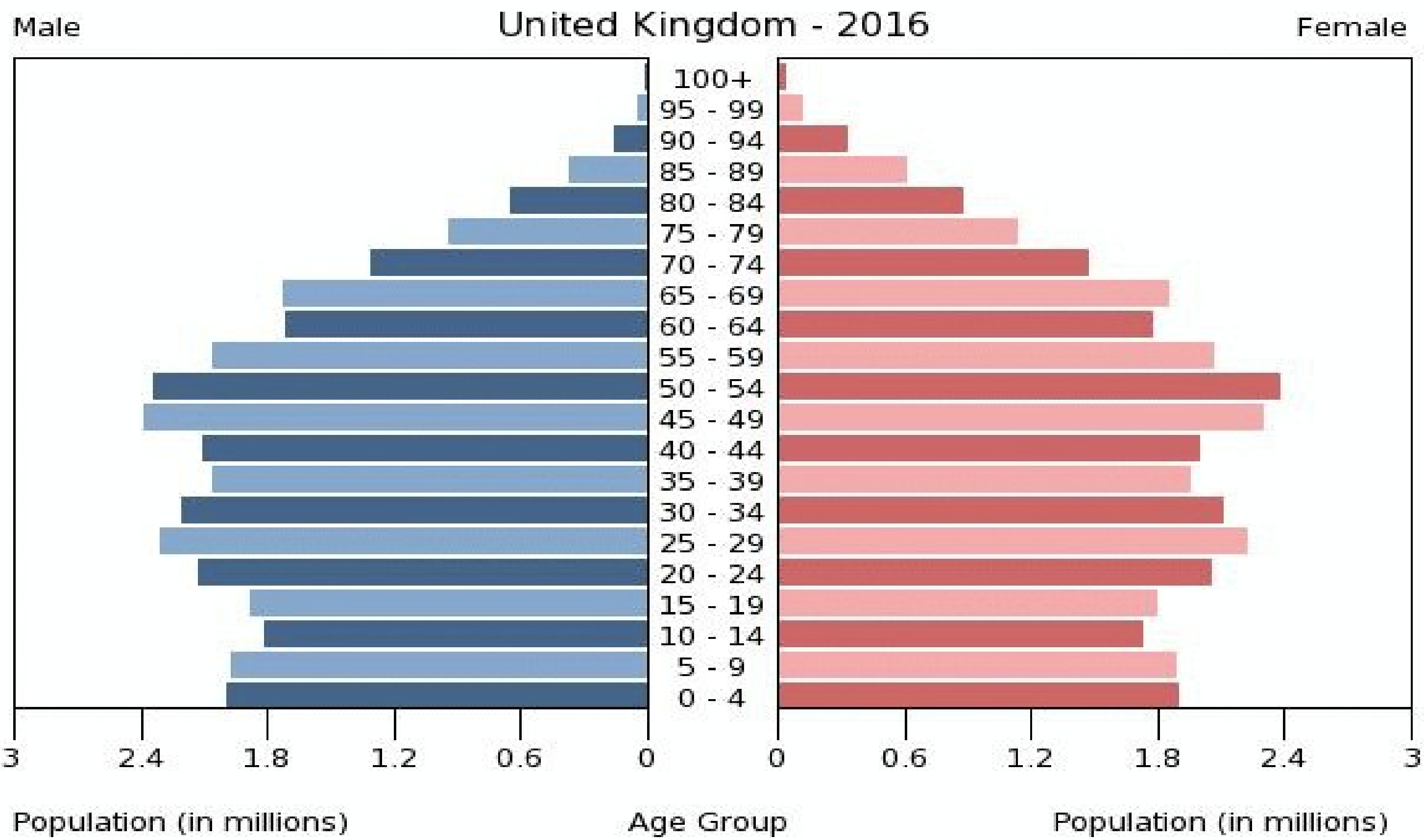
What has happened – Life expectancy



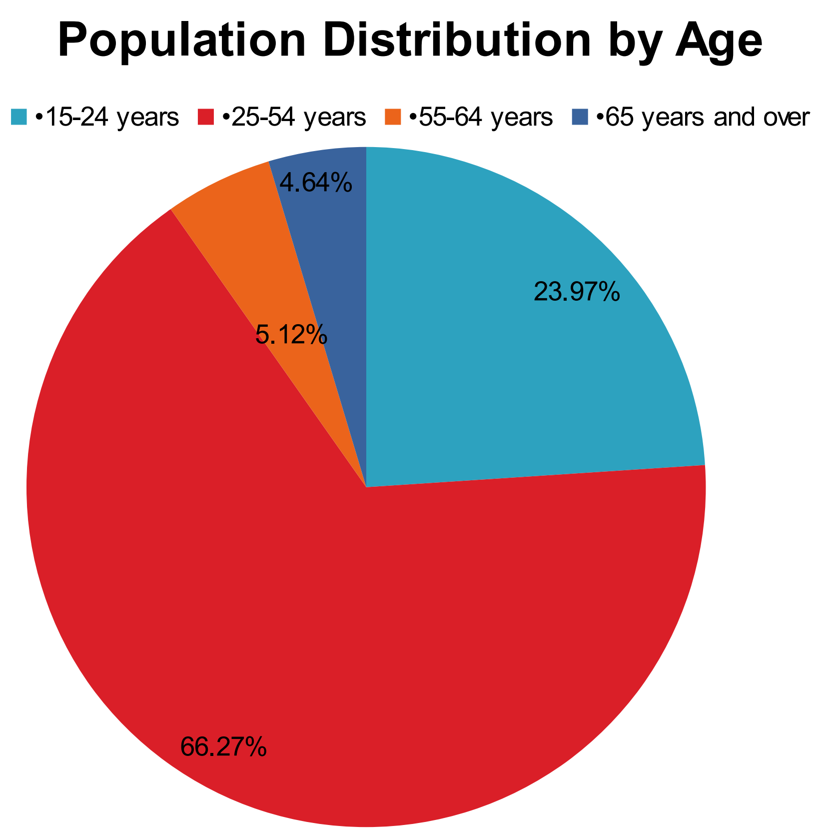
Need for Annuities - Botswana



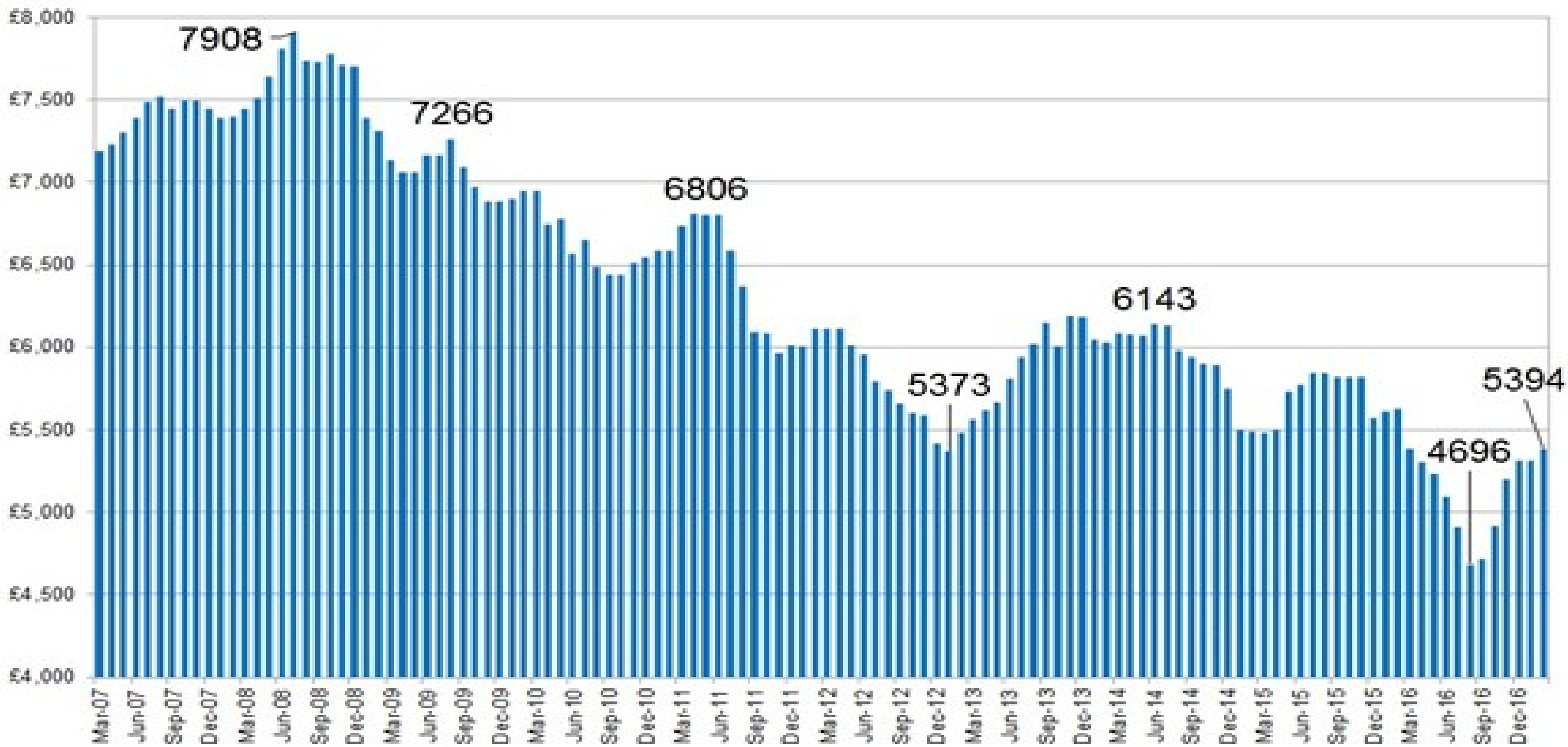
Need for Annuities - UK



Need for annuities



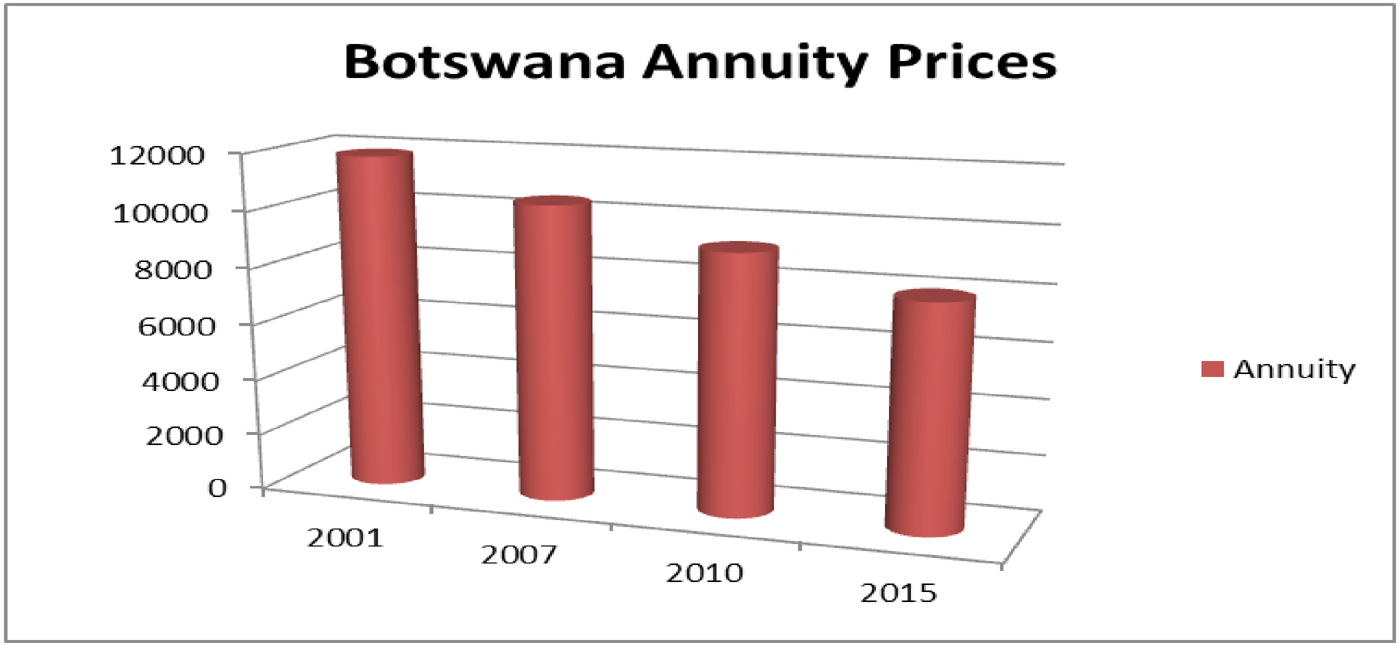
Annuity rates



Annuity rates chart for £100,000 fund, aged 65, level and single life

Annuity amounts almost halved since 2008. While cost of living is still rising

Annuity rates



- Prices for a 60 year Old
- Drop in interest rates has pushed down the prices for annuities

Alternatives

- No pension – pensioner runs a risk of out living their savings

- **Living/** Variable **Annuity**

Living Annuities

- Introduced in the 1950s as an alternative to fixed annuities.
- Allow investors to invest in a dozen or more professionally managed subaccounts consisting of various asset classes.
- Gives investors the opportunity to earn higher rates of return, which can increase the amount of capital they can accumulate
- Provide a variable income stream to potentially outpace inflation.

Living Annuities -Problems

- Investors assume the risk of their investments not outperforming the guaranteed return of a fixed annuity, which can result in less capital accumulation and a smaller income stream.

- A living annuity is an investment from which the retiree can draw an income ranging from 2.5% to 17.5% of the capital each year.

- Retirees could run out of funds if they either draw down too high an income or if the market does not perform.

Living Annuities Biting Point

Alternatives

- If the retiree lives until age 90 he requires a risk free return on his living annuity of 10.5% p.a. to break even with the monthly annuity received from the guaranteed annuity.

- If he only lives until age 80 the corresponding rate drops to 3.5% p.a.

- If the retiree dies before age 77 the return on a guaranteed annuity is actually negative so any positive return on a living annuity would result in a better outcome.

- This is because the value of the monthly annuity payments received from age 65 to 77 is less than the initial contribution.

Summary

- Key challenges are low interest rates, improved mortality and lack of long dated bonds.
- Alternatives are there but there are riskier compare to traditional annuities.

Questions