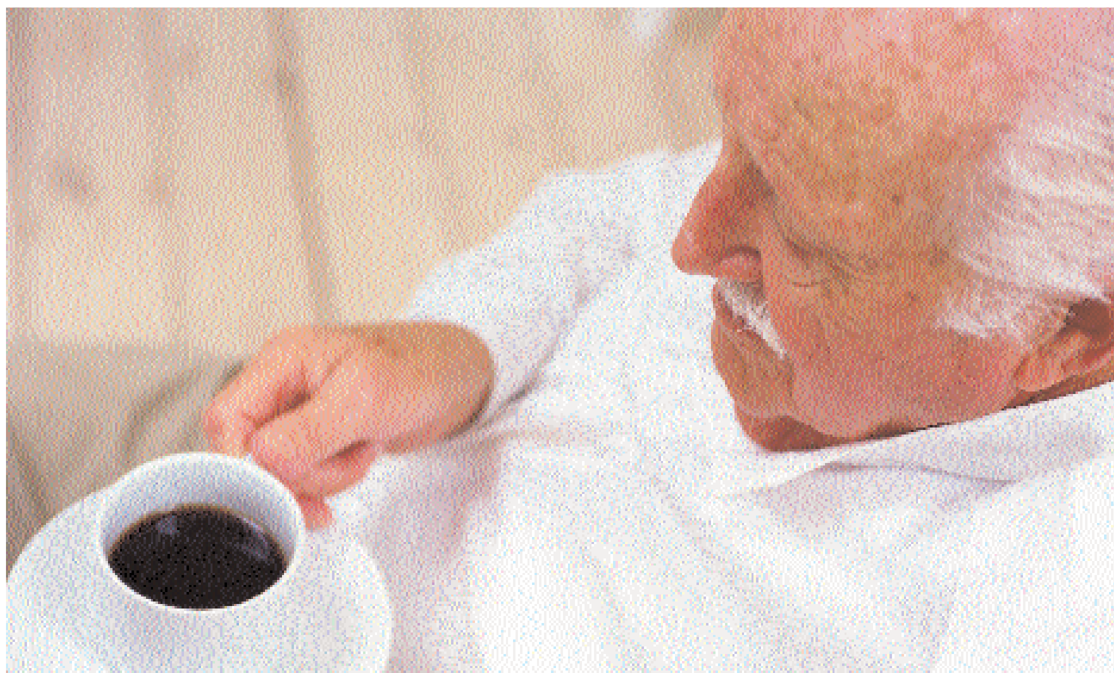
Not many happy returns

Annuity rates have been low recently and the situation is unlikely to improve in the near future. Changing investment conditions and longer life expectancy are having a negative effect, reports Stuart Bayliss



The effect of the change in mortality has come as a significant shock

"Conventional guaranteed annuities are unpopular with both customers and providers"

Guaranteed annuity rates are still at historically low levels and the investments underlying them will continue to have low yields while the government maintains its inflation policy and markets believe it will succeed. The downward pressure on annuity rates caused by improved life expectancy, while not remaining at the very high levels of the recent past (see table), is clearly going to continue above long-term trend.

Those who put off buying an annuity, hoping that long-term interest rates would go up, have been disappointed. Unfortunately, the additional belief that annuity rates go up as you get older, reflecting life expectancy, has also been stood on its head. The life expectancy table shows that, even if we had had increases in interest rates, annuity rates would have fallen and in the real market people who put off taking their annuity at 60 in 1995 find that actual annuity rates at the age of 68 are 16% lower.

The life expectancy assumptions used by insurance companies now reflect that most of those with larger funds and health problems are obtaining impaired or enhanced annuities. Therefore, healthy rates for higher fund sizes have fallen still further, reflecting healthy life assumptions. Conventional guaranteed annuities are unpopular with both customers and providers: customers believe they offer bad value; providers see low margins and potential losses. For the customer, the alternative of self-insurance proves beneficial only if they buck the trend and turn out to be a wealthier person with a shorter life expectancy. Since the norm is greater wealth equals greater life expectancy, for those with larger pension funds self-insurance is normally a poor bet.

Investment-linked annuities – whether unit-linked or with-profits – offer a potentially superior alternative.

The life expectancy assumptions used for investment-linked annuities are lower than for conventional ones, which results in higher income for the same investment return. This is possible as the companies have the right to adjust life expectancy during the policy. To date they have not been altered but if they were, the remaining annuitants will bear heavier costs later in retirement but will have already benefited from higher income. Maximising income early in retirement is often a desire of those with larger funds.

The required growth rate net of charges to match a conventional annuity has over the last year been around 3.2%-4%, varying from company to company. Averaging this level of return over the 20 years retirement lifetime seems to be very attractive, even in today's climate of lower projections.

With-profits are suffering greatly from both real and imagined problems. If your objective is to provide income over a lifetime of 20 years, a

mixed investment base with a mechanism to give smooth returns is close to the ideal answer. In the future we might not call it with-profits but something very similar will provide a route to securing retirement income.

Investment-linked annuities offer an attractive alternative to conventional guaranteed annuities. Not only do they allow the opportunity to take greater investment risk over the retirement lifetime but also they can be cautiously invested and still provide the annuitant with the same initial income as a level guaranteed annuity.

In the past year or so they have too often been rejected as necessarily equating to an increased risk. This is not the case utilising cash; fixed interest and property can all reduce risk.

With major insurers indicating that life expectancy of new annuitants is close to averaging 90 years of age, trying to price a guaranteed annuity likely to pay out income over the next 20-odd years is not an attractive task. The annuity provider can easily lose lots of money. With these lengths of risk, it is equally likely that prudent pricing leads to poor value for the consumer. If we could arrive at a situation where annuities again had an average life of something less than 15 years, then consumer value and the likelihood of profitability for the provider would make for a virtuous result.

Drawdown or deferring retirement altogether are currently the only options for achieving this objective. While it is likely that average retirement age is rising and will continue to do so, the attractiveness of drawdown within the current rules has proved at best debatable since its launch in 1995.

Obviously investment performance has in most cases proved a roller-coaster ride. But while wealthier individuals and their advisers have become more sophisticated at understanding investment risk, the effect of the change in mortality has come as a significant shock. This is partly because the illustrations for drawdown deliberately ignore the potential impact of significantly improving mortality. We must now ensure that either at review, or on initial sale, all purchasers of drawdown are made aware that, despite the assumptions on which illustrations are based, annuity rates can be and have been significantly lower following eight years of drawdown despite the fact that the annuitant is eight years older.

The impact on potential lifetime retirement income of a 15%+ fall in the annuity rate for a 68-year-old, compared with a 60-year-old in 1995, would require investment performance way ahead of that which we are currently allowed to forecast. Even if we believed such changes in annuity rates are unlikely to continue in the future, we need to enable clients to understand what has happened in the recent past.

Table one: **Historic life expectancies (years)**

Year	Male		Female	
	Aged 60	Aged 65	Aged 60	Aged 65
1960	17.9	14.3	21.6	17.6
1990	20.6	16.4	24.8	20.3
2000	23.9	19.1	27.0	22.1
2003	26.4	21.6	29.3	24.5

Notes: The figures given in the table are life expectancies based on standard mortality tables which, including any allowance for future improvements, are likely to have been used for pricing annuities at various points in time.
Source: Willets Consulting

The adjustment in annuity rates over the last 15 months has enabled the remaining annuity providers to feel more relaxed about the profitability of annuities they are currently writing. Other major insurers who have withdrawn from the annuity market in recent years may have been enticed back. However, a reasonable return on capital doesn't compensate for the fact that capital itself is in very short supply. Therefore, the core conventional annuity market may lose one or more players over the next year or two, leaving five or six main players.

This may be countered by new entrants of highly capitalised financial institutions wishing to offer annuity-style products directly for the first time. They will benefit from not having an existing book of business, some possibly written at unprofitable rates. Capital requirements would be high but the cost of reaching the market with a commodity-based product is falling and this will be assisted by increased use of e-trading.

The other provider change will be the continued presence of niche players in enhanced and impaired and the likelihood that all other major players will need to establish such products to run alongside their conventional annuity books. This will be particularly true as trustees realise employer-related schemes should also avail themselves of enhanced annuities.

In addition to improving life expectancy and changing investment conditions, planning at retirement is in a state of flux as a result of annuity modernisation, pensions simplification and the Pensions Bill. Certainty seems a long way off but using the average crystal ball and strained eyes:

- Simplification is coming: April 2005 will need to happen or Gordon Brown's hint that nothing will be done, certainly this side of a general election, will come true.
- Between then and now and for the first three year transition period, we will need to review the circumstances of all those who have or may have pensions around or in excess of the lifetime limit – relatively small funds in retirement are 10 years or more away.
- Modernising annuities will lead to new products. Choices will include capital guarantee annuities and effectively underwriting all annuity purchases in a similar way to term assurance and increasing sophistication around impaired life and enhanced.
- Equally, increased sophistication of investment links, enabling a self-invested annuity to be undertaken with a full range of risk profile.
- The current proposals do not seem to offer a post-75 drawdown opportunity for the majority of people who may wish for this type of planning. The proposals would only be appropriate for very few other than those with a religious or other objection to the purchasing of life insurance. It is not surprising that the rules apply to this group; the pensions simplification paper makes it clear that this is the group they have been designed for.
- Given that consultation is continuing, we may hope for the following: a sensible value for the lifetime limit based on its annuity purchasing power; an extension of the ability to pass pension funds directly to a dependant's pension fund; and an extension of the ability to allocate your assets between pension and non-pension, both during your saving lifetime and during retirement, while accepting that any funds removed from the pension wrapper at retirement would be subject to tax neutralisation (probably 55%) and that a relatively high value of pension fund for the minimum retained in pension would need to be prescribed.

The last of these is, I believe, the most we can hope for from a government and Treasury who are clearly not willing to look at changing current rules in any way that encourages pension saving as a route to capital accumulation.

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