

Newsletter – The rising cost of annuities

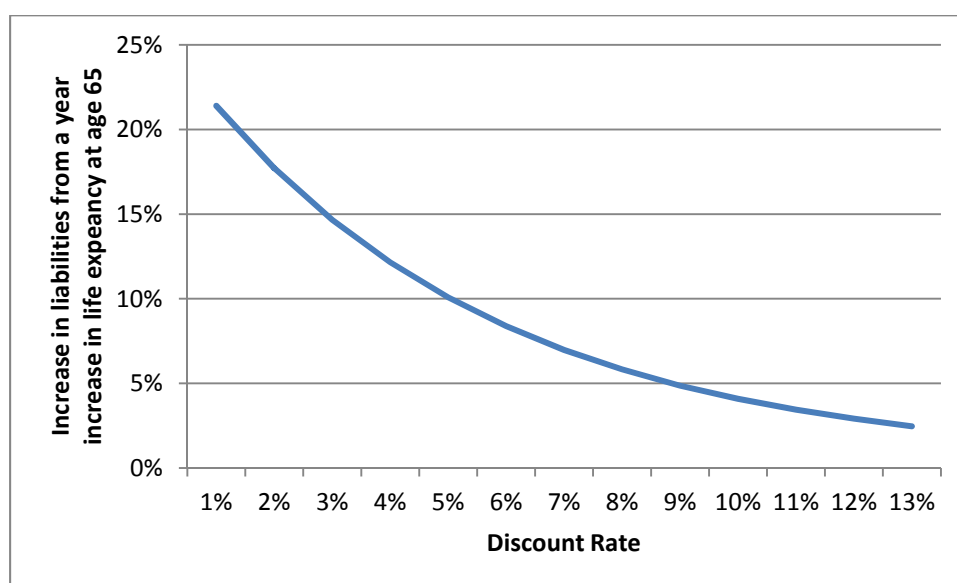


The valuation of pension liabilities for any life company or the pension amount offered to a retiree depends fundamentally on two factors:

1. How long the pension will be paid for; and
2. The return on investments achieved during the period the pension is paid.

When discount rates are high, the decrease in annuitant mortality is less important to the cost of pensions. As the table below shows, if the discounts rates are 10%, the increase in life expectancy only makes 5% difference to pension liabilities. However, when discount rates are low, any decrease in pension mortality can make a big difference to the liabilities.

Figure 1 – Impact on pension liabilities of a 5 year increase in life expectancy aged 65



The above two factors has implication not only for life insurance companies' pension valuations but also for many people approaching retirement and looking to purchase annuities, many are facing reduced income in their retirements.

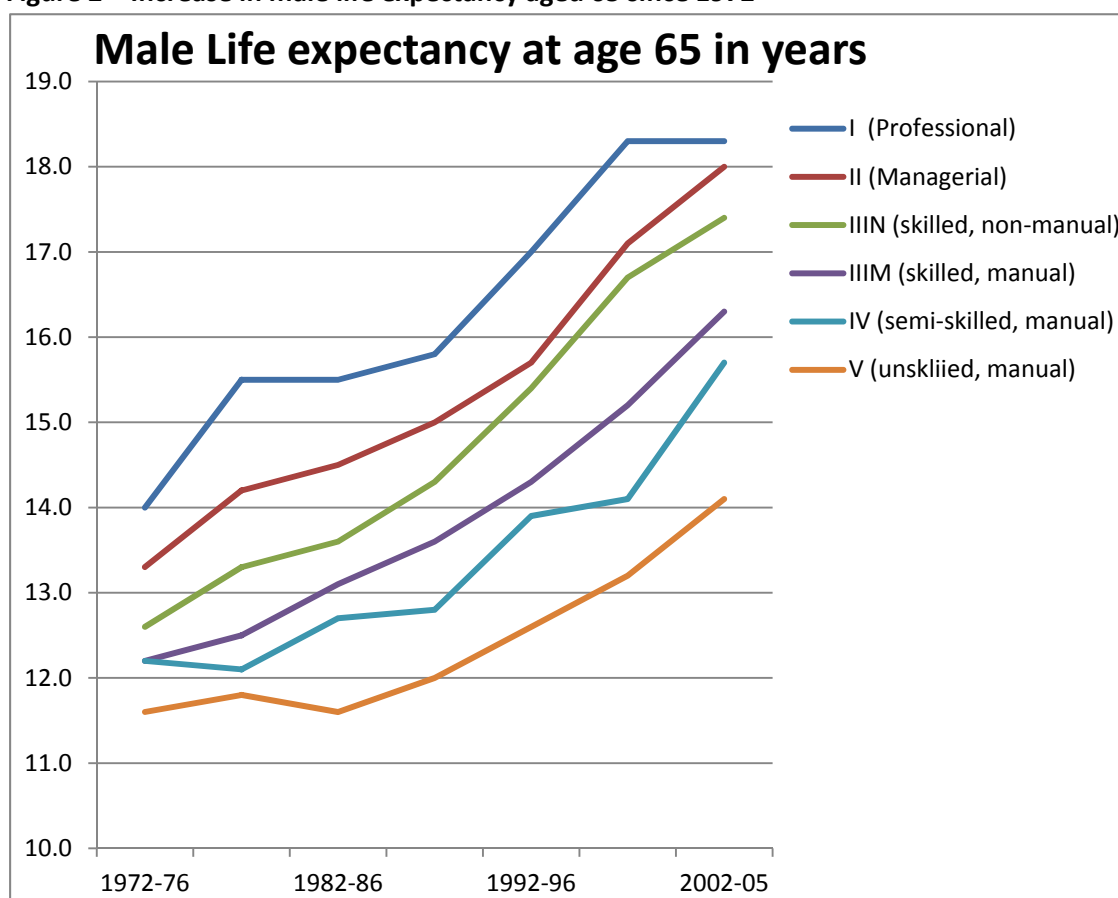
So, what has happened to discount rates and annuitant mortality over the last few years?

Changes in Life Expectancy

As can be seen in the graph below, life expectancy in the United Kingdom has increased steadily over the past thirty years. Every socio-economic group has benefited by about 5 years on average.

The differences between the various groups still remain. This is because, as socio-economic groups have recorded large improvements in life expectancy, groups IV and V have not improved as fast as the others. The other groups predominate in annuity portfolios and defined-benefit pension schemes, however, and they have recorded increases of between 30% and 40% in life expectancy since 1972.

Figure 2 – Increase in male life expectancy aged 65 since 1972



Source: Longitudinal Study, Office for National Statistics

Changes in Investment Returns

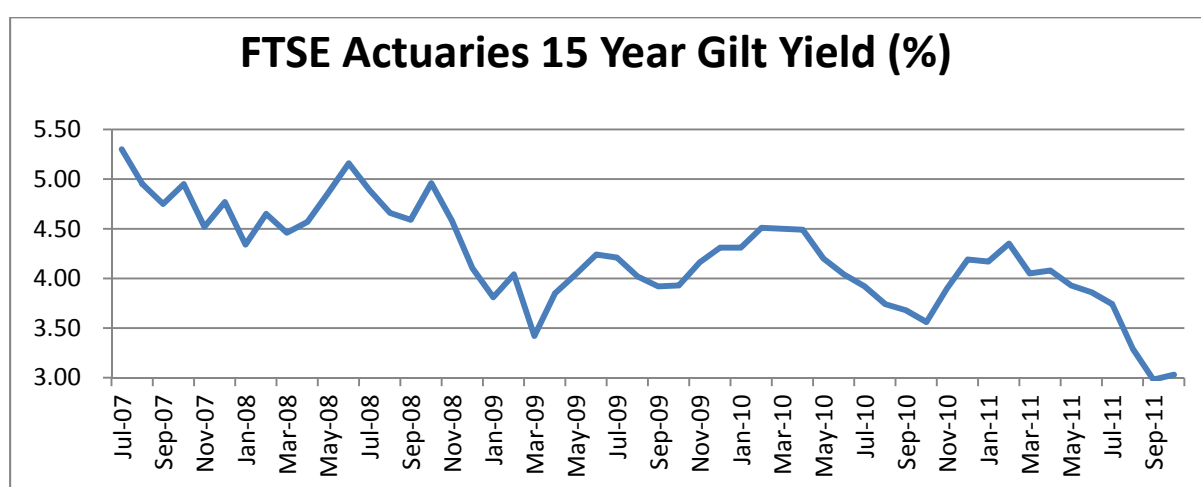
The assets invested by Life companies for the matching of annuity liabilities are usually gilts (or corporate bonds). If the yields on these assets decrease, then pension liabilities increase or the annuity rates offered by life companies decreases.

The graph below shows the decrease in gilt yields faced by life companies over the last few years.

The main reason for the sudden reduction in yields is the flight to quality resulting from the European and US debt problems.

At times when investors are worried about global equities there is a strong demand for gilts, and as the price of gilts rises, the yields fall.

Figure 3 – FT Actuaries 15 Year Gilt Yield since 2007



Implications for Annuities

The table below shows the decrease in annuities over the last few months with the average fall in annuity rates being 8.65%.

	Canada Life	Aviv	L&G	Benchmark Gilt yield
10/07/2011	5,729	5,857	5,903	3.99%
10/08/2011	5,486	5,653	5,584	3.52%
10/09/2011	5,350	5,487	5,475	3.25%
10/10/2011	5,215	5,487	5,274	2.81%

*Male age 65, Female 60, £100,000 purchase, joint life 2/3rds, guaranteed 5 years and level payments.

Outlook for Annuities

As the pressure on gilt yields continue and the expectation on even further reduced annuity mortality, annuity rates are set to continue to fall and pension liabilities continue to rise.

The pressure on individuals, pension schemes and on life companies is set to continue.

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