Are Living Annuities Really So Great?

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Living annuities are one of the most popular pension products used by retired persons to provide for their income needs during retirement.

A living annuity is a financial product that is offered by many insurance companies and linked product providers. In exchange for investing a cash lump sum (usually a pay-out from a pension fund, a provident fund or a retirement annuity), the investor receives a monthly pension for the remainder of his or her lifetime. These products contain a number of attractive features:

- Flexible Drawings: The investor can select the annual rate of drawings from the living annuity subject to a minimum annual drawing of 5% of remaining capital and a maximum of 20% of remaining capital. This facility can greatly assist in minimising tax paid on the pension.
- Investment Flexibility: The investor has a high degree of choice as to how the investments are managed. Many products offer the option of choosing between virtually any South African unit trust. The investor can switch investments on an ongoing basis in order to try to obtain improved investment returns. The investor can also invest a portion of the funds in asset classes such as equities, thus improving the probability of beating inflation over the medium to long term.
- Capital Protection: The remaining capital is not lost in the event of death after retirement, and can be paid out in income form to nominated beneficiaries. This is a particularly attractive feature for retirees suffering from poor health.

The above attractive features have made it very easy to sell living annuities compared to other forms of pensions such as conventional annuities. Conventional annuities seem less attractive as they offer a predetermined pension, no investment choice and the possibility of the loss of capital upon death.

So why should any retiree not choose a living annuity given all these advantages?

The truth is that living annuities hold a host of dangers for very many retirees, and are probably not suitable investments for the average man (or woman) in the street. Some of these dangers include the following:

- Longevity Risk: People who live longer than average are highly exposed to the risk of depletion of their capital in real terms. Living too long is perhaps the greatest risk for retired persons, and living annuities offer little protection.
- Investment Risk: While it is attractive to enjoy the facility of managing one's own investments post-retirement, this does place a great burden of responsibility on the pensioner. There is also a great risk that pensioners will shift investments at the wrong time, thus incurring unnecessary transaction costs, and very possibly not improving investment performance.
- Drawing Risk: The pensioner assumes the responsibility for choosing the amount of drawings each year. The temptation may exist to draw close to the maximum of 20% of capital each year. Drawings of this magnitude will very quickly erode the pensioner's capital base, especially once inflation is taken into account, and will result in an inadequate pension within the space of a few years. As a rough rule of thumb an annual drawing rate of above 8% will probably result in great hardship in later years.

Conventional annuities are often criticised because the capital is usually forfeited in the event of the early death of the pensioner. One often hears claims such as "the insurance company steals the remaining capital" or "no wonder the insurance companies are so profitable". These claims are incorrect. What actually happens is that any capital that is forfeited on death is used to pay the pensions for those pensioners who live longer than actuarially anticipated. This reflects a normal principle of insurance - i.e. pay the most to those who bear the greatest cost. People who buy conventional annuities are effectively insuring against the risk of living too long.

The potential loss of capital on early death allows all pensioners to receive a higher pension than would otherwise be the case. Actuarial calculations demonstrate that the differences can be quite staggering. For example, consider a 65-year-old single male who wants to buy a level pension of R1 000 per month without annual increases at a time when long-term interest rates are 13.5% per annum. Initial capital of R94 096 is required if the product is structured so as to pay dependants the remaining capital on early death. If instead the capital is retained for surviving pensioners, the initial annuity purchase price drops to only R70 411! This means that the initial capital of R94 096 buys a starting monthly pension of R1 336 - an increase of 33.6% in the initial pension merely as a result of the mortality insurance feature! For escalating annuities the differences are far greater, and being prepared to risk one’s capital in the event of early death can more than double the initial pension!

No such mortality insurance is provided by living annuities. Living annuities may seem attractive in the early years following retirement, but there is a very high probability that these annuities will not be delivering an adequate pension as early as 10 years after retirement. Pensioners who live 20 or 30 years after retirement may well find themselves facing a continually dropping standard of living because living annuities are designed so as to pay out all that remaining capital to the dependants of pensioners who die in the early years following retirement rather than retaining the remaining capital for those pensioners who live longer than anticipated by the actuaries!

In summary, living annuities are very flexible products and offer many attractions to the sophisticated investor. They do, however, have some significant disadvantages, and as such are probably not suitable for the vast majority of South African retired persons.

At present it is not possible for South Africans to purchase a conventional annuity with increases guaranteed to match inflation. Investors must therefore carefully consider an appropriate annual increase rate. Any fixed increase rate below 5% per annum is highly unlikely to prove sufficient to maintain a pensioner’s real standards of living. A problem is that even if one secures a higher guaranteed rate of increase, one still bears the risk of a steep rise in the inflation rate. Some insurance companies offer with-profit annuities whereby annual increases are dependent upon the bonus declarations of these insurance companies, which are in turn dependent upon investment performance. In the absence of guaranteed inflation-linked increases, such with-profit conventional annuities on balance offer better protection to pensioners than non-profit conventional annuities with predetermined annual increase rates.

The Government has very recently issued South Africa's first ever tranche of inflation-linked bonds. This facilitates the introduction of an improved form of the conventional annuity - viz. annuities with annual increases guaranteed to match the official inflation rate. It can be expected that some product offerings will emerge in the market over the next few years, although these may be limited owing to the small bond issue amount. Such products will better satisfy many of the real needs of retired persons such as payment security, lifetime income and full inflation protection. These products will better serve the vast majority of South African pensioners than do living annuities.

This article has been prepared by the Actuarial Society of South Africa as a service to the public.