

With-profit annuities under a magnifying glass

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2020 has been a year of unprecedented events.

In the financial services industry, it has been an interesting challenge for actuaries to design annuity products that remain attractive whilst factoring in challenges such as extreme market volatility and returns well below the traditional norms stacked up against sharp increases in healthcare costs. In a year characterised by uncertainty, the benefits of a guaranteed life annuity, providing a fixed income with annual increases was highlighted.

What is a with-profit annuity?

A with-profit annuity provides a guaranteed income for life with increases dependent on performance of the underlying investment. The bonus formula depends on market returns, however the application of smoothing significantly reduces volatility. Decisions about the increases are partly subjective, as they allow discretion of how to distribute profits from, for example, mortality experience. Such decisions are however well regulated and made by experts and actuaries in the industry.

What is a purchase rate?

The purchase or discount rate is the net investment return required to provide a level pension. The lower the discount rate, the more it costs to purchase a given initial level of pension but the higher the expected future increases in pension. Once a bonus has been declared, the purchase rate is deducted from the bonus to determine the increase, for example, with a declared bonus of 10% and a 3% purchase rate, the pension increase will be 7%.

What is the philosophy for declaring bonuses?

The aim of bonus declarations is to transparently declare bonuses in line with the stated bonus formula, based on underlying fund performance, subject to adjustments based on the mortality experience of the pool. Subject to these criteria, a bonus as high as is deemed sustainable will be declared.

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Please explain the risks covered by a with-profit annuity?

In a with-profit annuity, the insurer carries the longevity and investment risks of the annuitant. Pensioners receive a guaranteed monthly income as long as they are alive. For joint life pensions, the spouse will receive a pension after the death of the main pensioner until their death. If the underlying portfolio returns are negative, your income will not decrease, however poor returns would limit the increases you receive.

Who should invest in a with-profit annuity?

Investors in a with-profit annuity seek some investment exposure to market returns of a balanced fund. These investors are willing to take a bit of risk to earn some upside potential, but also want the security of a guaranteed pension for life.

Questions to ask your annuity provider

Comparing different with-profit annuities and products from different providers is a difficult and complicated exercise. There is a huge responsibility for funds to do the right thing and offer ethical pricing. It's also a product where there are a limited number of service providers to choose from.

Here are some important questions that you should ask any with-profit annuity (WPA) provider before buying an annuity product:

1. Are my funds being placed with a company I can trust to survive for the rest of my life?

Get information about the company's financial stability, the solvency ratio of the insurer and report by investment analysts.

2. How the increases are calculated?

With-profit annuity products designed in the 90's were often referred to as "black boxes" due to the provider's discretion to determine the increases, despite the fact that such decisions are made by experts (actuaries). Current product providers should be able to give you details about the way increases are calculated and any discretionary adjustments that may apply. Investors should get clarity on how recent low and negative market returns due to COVID-19 and the rating downgrade, will influence their future increases, since bonuses are often calculated using weighted recent returns. This might prompt some further questions such as:

- What is the level of investment participation in market returns?
- Do bonus smoothing reserves or funding levels from recent poor market performance adversely affect new policyholders' initial increases?

3. How will the administration and the service capabilities of the product provider be rated?

Previous experience from clients will be the best barometer for administration efficiency and service excellence

4. What is the long term track record of the provider and what is the expectation of the level and stability of bonuses?

Realistic returns and sustainable and stable increases over the long term should be a feature before opting into a with-profit annuity. Looking at recent increases and the impact of the economic conditions on future increases will give an understanding of the sensitivity to market conditions.

