Society of Actuaries in Ireland

The Big Debate
Annuity vs ARF

9th June 2014

Retirement Actuary of the Future Working Party – Scope

"Form a considered view of the likely nature and timing of the change in the pensions market and how actuaries can maintain their relevance and continue to contribute to the development and maintenance of an effective system of private pension provision."

"Consider the roles that actuaries can play in retirement planning in the future – identify the skills and competencies that will be needed and the support that the society can give members in developing these."

Conclusions and Recommendations

Recommendation 5

Pension Actuaries need to consider up-skilling in Life Insurance techniques that impact on post-retirement product design.

Recommendation 6

The SAI has a role to play in bringing Pension and Life Actuaries together in discussions on post-retirement issues.

Recommendation 7

The SAI should consider holding CPD events that introduce Pensions Actuaries to "relevant" technical insurance issues that impact the retirement market.

Conclusions and Recommendations

<u>Recommendation 8</u>

The SAI has a role to play in promoting the value that actuaries can add in providing financial wealth planning to individuals.

<u>Recommendation 11</u>

The SAI should consider the creation of a committee or group with responsibility for addressing the issues identified in this paper in general and the recommendations in particular.

Focus for Tonight

- Demonstrate (at least to ourselves) that we are well placed to advise individuals about key retirement decisions
- Identify why this is the case
- Begin to form basis for future paper and press release

Ground Rules for Debate

- No right answer
- Aim is for debate to bring out all the pros and cons of each side using simplified examples
- Shouldn’t be Pensions Actuaries vs Life Actuaries
- Focus on DC pot
- Plenty of time for audience contributions

Format

- Shane O’Farrell FSAI – case for annuities
- Munro O’Dwyer FSAI – case for ARF
- Follow up questions
- Michael Sheehy (Railway Procurement Agency) will give some reflections
- Further questions / reflections from attendees

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Case for Annuities

Shane O’Farrell

Retirement Actuary of the Future

- Perfect question for the ideal Retirement Actuary of the Future as requires:

1. Technical understanding of the issues involved (investment, risk, longevity, tax and legislation)

2. Communication skills to explain these to a lay person

3. Ability to understand what is right for one person is not right for another and the decision is human, not robotic

Arguments in Favour of Annuity

peace of mind

- What price peace of mind?
- Should be a basic objective for anybody to have certainty around a comfortable baseline level of income in retirement
- The retiree can spend and enjoy this income without concern and enjoy their retirement with good mental health
- Don’t need to worry about the latest crisis hitting investment markets or feel the next generation tut-tut as they eat into “their” inheritance

Get Real About Investment Returns

- "Risk free" interest rates are the starting point of any expected investment return
- These *are* low by historical standards-but people said that 5 years ago-Central Banks have successfully killed inflation expectations
- You can expect *all* prospective investments returns (even ARFs) to be lower as a result-any excess is a reward for risk: should you take that in retirement?
- Annuity and Endowment Mortgages as similar to Annuity and ARFs: but despite the even longer term and being younger and working more people chose the annuity: why?

Valuable pooling of longevity risk

Certainty of outcome

- Actuaries have consistently got future aggregate longevity improvements wrong (too low): should the future be different?
- Whatever about the profession under-estimating *average* longevity, an individual can never know their own *specific* longevity: the longevity insurance an annuity offers is a classical insurance pooling and a socially optimal outcome in face of uncertainty
- Approx. 0.6% of annuity lives die in the first year (and guarantee periods smooth out some of the impact)
- Risk is not just that an ARFs runs out but the retiree spends too warily for fear of the uncertainty and has a sub-optimal retirement

Implicit costs of ARFs

Simple and honest

- Annuity is an transparent product: it tells you what you will get under a searing light. It's not designed around flashy investment models
- ARFs are advisor intensive products with the high commission levels that are required to support this, the high AMC (say 1.25%) eats significantly into the funds over time (especially with low interest rates)
- The client needs to set aside time and money each year for financial reviews (with risk of inaction and inappropriate investment mix if inertia sets in)
- Annuity is a simple, "does what it says on the tin" low maintenance, low stress product: touch once and then enjoy retirement

The poor health argument

- In the past, if you were in poor health, an annuity *was* poor value for money
- With enhanced annuities now available this is no longer the case: lives in poor health can get certainty of income in retirement at better value as the annuity rate reflects their medical/lifestyle conditions
- These lives most need the certainty of some basic income and are least capable of exposure to investment volatility but could live for some time into the future
- One of the classic arguments against annuities has been defeated

Why ARFs often appeal to some

- An ARF is an easy sell to the client ego: “you are a clever chap and I’m a great advisor, together we can outperform the market and enjoy great riches”
- But most clients (and brokers) are not Warren Buffet and will perform middling (or worse) on a risk-adjusted basis after fees and costs
- It’s human nature for some personality types to be attracted to this proposition as both an advisor/seller and client/buyer- clients who want feelings of control, active management and ability to direct will often select this option (these are often clients with the larger funds)
- For many others, the stress and hassle involved ultimately brings a negative reward

Real situations and advice

- Any portfolio needs diversification: in reality it's a question of what value of X and Y with X the annuity % and Y the ARF %
- Assuming full freedom of choice, how clients invests TFLS also matters-if this is invested longer term already, then less need for an ARF
- The lower the income in absolute and replacement ratio terms the greater X needs to be and vice-versa

Real situations and advice

- Also depends upon:
  - Level of financial experience & risk tolerance of person-their attitude is critical
  - Degree to which tax efficient inheritance planning is an issue-what is purpose of the investment?
  - Level of current debt and interest rates thereon-is there a need for more cash now?
  - Age of the client-younger age make ARF more appealing?

Essential question

- Crux of the issue: what is the purpose of the decision?
- If it’s to provide certainty of income in retirement & is the primary source of retirement funding, an annuity has to be the dominant part of the portfolio for longevity hedging and investment guarantees reasons
- If it’s an additional investment to some other income, designed to provide for the next generation in a tax efficient way or to be tool for playing markets for an experienced investor, the ARF wins. But if a (say) 50% drop in ARF can not be tolerated or impinges living standards, then too much is in the ARF

Essential question

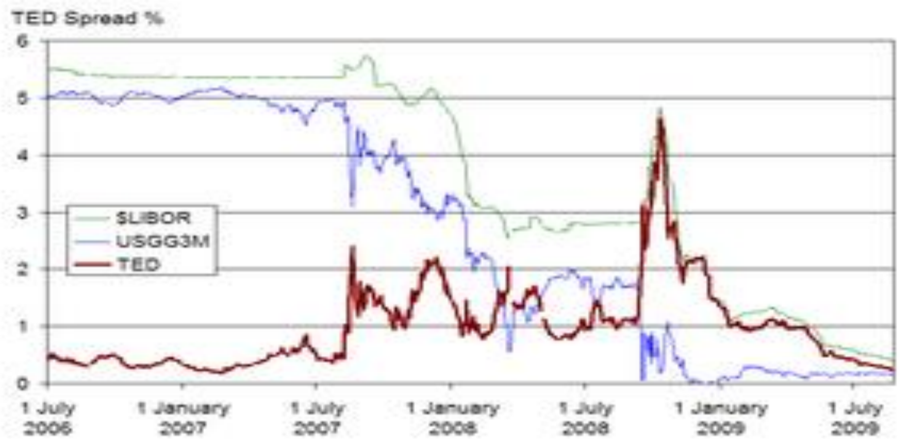
- Evidence suggests majority of ordinary DC members fall into the first box; a smaller number (but with higher funds) into the second
- Actuaries are specially capable of highlighting the risks and issues involved

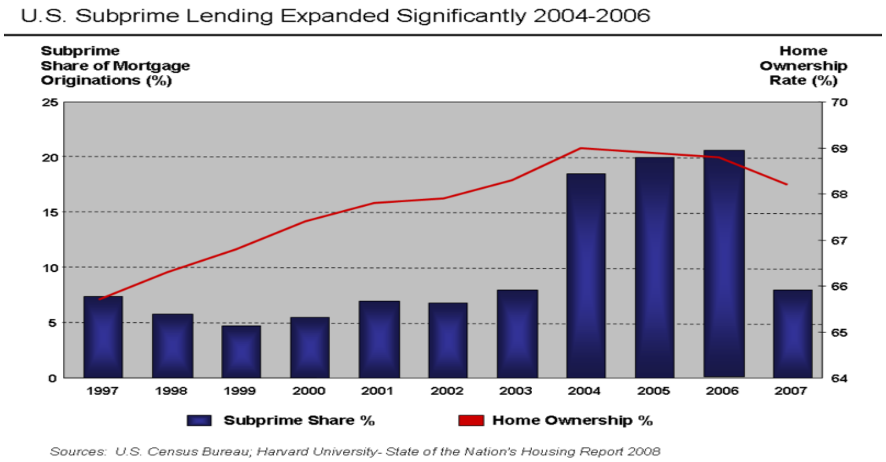
In conclusion

- An annuity should be the core building block of any post retirement fund: provides necessary ballast to the portfolio

- ARF should be the extra topping that is additional to this: akin to the bonus earnings that upgrade a holiday during working life.
- Primary reason for this is actually mental health in retirement: for most typical DC retirees the annuity is the best choice for that core part of the portfolio to enjoy a retirement with sound sleep

ARFs offer uncertainty and stress





Annuity offers good mental health

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Case for Approved Retirement Fund (ARF)

Munro O’Dwyer

Selecting an Approved Retirement Fund (ARF)

- I want to get value for the pension fund I have accumulated
- I don't want to invest for 25 – 30 years into a product that offers such a low level of investment return
- I might not be as healthy as the annuity provider is assuming *(or I'm male!)*
- I would like to have flexibility on when I draw the fund – including the flexibility to draw it all should I wish
- I would like to pay less tax
- I already have a (more) significant benefit contingent on my life

Case study

- **€250,000 fund, Male 60, Female 55**
- €62,500 tax free – likely higher than where the annuity route is chosen
- €187,500 balance
- As at 2 June, offers €7,126 per annum + 50% dependant pension from age 60
- €11,975 pa + dependant entitlement will apply from age 66

Looking at future scenarios

Longevity	10 years	20 years	30 years	40 years
Annuity	€67,858	€129,289	€184,901	€235,247
ARF	€178,333	€169,614	€161,322	€153,435
State Pension	€114,033	€217,266	€310,721	€395,325
Annuity + State Pension	€181,891	€346,555	€495,622	€630,572
ARF + State Pension	€292,366	€386,880	€472,043	€548,760

ARF investment strategy

- €63,500 into an AMRF / €124,000 into an ARF
- Minimum income is €6,200
- €62,000 will be drawn down over the first 10 years
- €125,500 will be invested for a 10 year + time period

ARF myths

- The fund may not provide an income for the rest of their lifetime and may be depleted before death
  - Any income drawn from the fund becomes an asset of the individual
- The individual is taking on investment risks
  - Alternative is a 30 year investment in a low risk investment product
- AMRF requirement is restrictive
  - Only reflects how the fund would be drawn down in any event

Tax – 3 considerations

- 25% of the fund may be greater than 1.5X final remuneration (given the fund value is €250,000 – salary of €50,000 or lower) *[NEUTRAL]*

- 5% of the ARF (of €187,500 - €63,500) = €6,200 *[NEUTRAL]*

- Any balance left in the ARF on death – no PAYE tax is payable *[NEUTRAL]*