Guaranteed income for life

David Maida | financialalert | 12 December 2013

Come Christmas, there will no longer be any annuity product providers in New Zealand. Fidelity is the proverbial last man standing, and it's pulling out of the market citing lack of demand. But another player is hoping to set up an annuity scheme by mid-2014.

Fidelity has been providing annuity products in New Zealand for 30 years but has not found it to be a profitable part of its business. It is currently the only provider in New Zealand. CEO Milton Jennings said the firm now writes only a very small amount of annuities.

"There is a very low demand for annuities in the New Zealand market. We don't have a lot of defined benefit schemes. Annuities are really not that popular. It's a diminishing market," Jennings told a crowd at a Financial Services Council Conference in October.

In fact, Fidelity has only done one annuity quote a month for the past 12 months. Of those 12 clients, the only one who signed up was a 95-year-old. "I think he was an actuary. But he's betting on the basis that he can live longer than our mortality tables. I think he's actually quite correct and we'll probably lose money on that one as well."

Jennings said that with New Zealand Superannuation, people feel they already have a pension and don't want to buy another one. Plus, the tax disincentives for annuities are even worse than the disincentives for KiwiSaver, he said, and most annuity capital is invested in bonds. "There will be a little bit of equities but predominately it will go into long-dated bonds."

The Financial Markets Authority (FMA) also made it harder for Fidelity to provide an annuity product, Jennings said.

"The new requirements by the FMA to basically change your prospectus and investment statements into plain English means we probably need to spend an external legal cost around $30,000 to $50,000 to bring it up to that standard, plus all the internal costs. It just doesn't make economic sense to continue with annuities," Jennings said. "Directors are also becoming increasingly reluctant to sign a prospectus."

But the problem is not just local. The UK has gone from having 100 annuity providers in 1970 to just 20 today. Australia only has four.

And, Jennings said, there's been a global shift towards placing the risk on the annuitant rather than the product provider. "We're shifting to these programmed withdrawals where now the annuitant is taking the risk of living too long. If they live too long, then they're going to run out of money or if the market crashes they're also going to run out of money. A big shift is happening like that right throughout the world."

Jennings said life insurance companies have been hit hard by two factors. When they were selling annuities in the 1990s, they didn't factor in how much longer people would be living. They also never anticipated that interest rates would go so low for so long.

"The New Zealand public failed to get Buck Shelford back into the All Blacks. I think the chances of getting Fidelity back into the annuity market are going to be quite similar," Jennings said.

But another player is coming into the market.

Former Tower CEO, Ralph Stewart, has been working on a new project over the past eight months involving lifetime annuity products. He has formed New Zealand Income Guarantee (NZIG) and has been doing focus group meetings around the country, speaking with clients who are aged 60 plus. He plans to go to market in early to mid-2014.

Stewart agrees with Jennings that annuities have not been profitable over the past 20 years. "Traditional annuities are not appropriate for the New Zealand market. This is a completely different business model," Stewart told financialalert.

Traditional annuities have relied on insurers taking a client's capital and their longevity or mortality risk and guaranteeing the client a benefit.

Stewart said his plan is entirely different and incorporates people's longer life-expectancies. "The innovation in markets, when you don't have New Zealand replacement rates as we do with NZ Super, has been enormous. Providers, insurance companies, suppliers and asset managers have been forced to innovate to meet some primary demands by retiring investors."

Rather than pooling investor's funds together and paying tax and holding cash reserves for the whole amount, Stewart's firm will keep every investor's funds separate and individual. "We're working with the Reserve Bank to determine what the appropriate level of reserving is for something like this."

Stewart plans to hold a 50/50 mix of bonds and equities which will be set up in PIE funds, allowing most investors to pay tax at around 18% rather than 28%. The assets would be split into an earnings account and a capital account which would be tax free. In their earnings account are the returns they get from investing in the balanced fund less fees and taxes.

Stewart argues that, currently, retirees don't know how much money they're going to get or how long it will last. He suggests that this new product will fix that problem. It is nearly a $2 trillion business in the US, about $600 billion in Japan and there are at least 15 providers operating in Europe.

It's still technically an annuity because it pays a regular income, but Stewart said it's completely different.

"Another key difference is it's something they can have whenever they want it," Stewart said.

"Under the old annuity, they would never ever get their capital back."

Stewart is proposing two different types: "naked" and "dressed".

With a naked drawdown, if someone puts in $100,000 at age 65, they can expect a return of around 3.7% in a PIE fund (after fees and taxes). This would provide them $5,000 in capital every year until around 96 years of age. "That's not a bad solution and it doesn't need a guarantee. That's almost 36 years. There's a lot of uncertainty in 36 years."

If a client wanted the capital payments guaranteed until they died they could use the "dressed" fund. It would be charged at 1.5% for a lifetime guarantee of $5,000 per year. The return on $100,000 invested would fall to 2.2% meaning the funds would technically run out when the client reached 90 rather than 96. But, Stewart said, the guarantee would then kick in and keep paying.

"What I'm proposing is a capital drawdown that issues capital every year, which is naturally tax free. That capital earns interest on the balanced fund that they're invested in and it's completely liquid."

Clients can come and go and take money out as they wish. The funds would be actively invested and hedged.

By combining the "naked" and "dressed" types, Stewart said, clients can be paid more sooner. He gave an example of someone putting $100,000 in a "naked" fund and $100,000 in a "dressed" or guaranteed fund.

"We can probably pay more out of the naked draw down account to enhance their life now because we know the guarantee is coming. So, in this situation, we haven't set the naked drawdown at 5%, we've set it at 6%. It means the capital is depleted by about age 90 – at which point the guarantee kicks in. The income drops from $6,000 to $5,000 and continues forever."

Retirees could also defer their drawdown. A 65-year-old who deferred payments till he reached 67 could be guaranteed a 5.4% per annum return. If they deferred till they were 70, that would go up to 6% per annum.

Stewart said it is a timely offering because of KiwiSaver. In the last several years, people have been accumulating their KiwiSaver but soon people are going to need a way of decumulating it. "In the next 15 years, insuring or graduating KiwiSavers represents $36 billion and 500,000 people."

By this time, the average KiwiSaver account will be $200,000 to $700,000. Once savers hit 65, they can purchase the annuity.

Stewart is visiting Asia and America to meet with product providers to examine what features do and don't work, in order to create a uniquely New Zealand product. He is also working on getting an insurance license and the solvency capital to meet the regulations. He has about half of the $10 million required and is currently looking for more investors. He has set up a website (www.retirementadvising.co.nz) to introduce advisers to this new product.

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Peter Chote, Chairman of Advice First, has seen Stewart's presentations and said he would recommend the products in certain circumstances. He invited some of his retired and pre-retired clients to hear Stewart's plan. "I think it makes perfect sense for someone in their retirement years to have some guaranteed lifetime income."

Chote said it is almost possible for an AFA to achieve a lifetime income for a client, but it's difficult to manage the longevity risk.

Of course, the risks with an annuity scheme are twofold - the quality of the management of the asset and inflation.

"I vouch 100% for Ralph's integrity," Chote said. "I don't believe for one moment that he'll put a product in the market that won't be able to deliver on its promise. But the perception will be that Ralph's got a challenge in proving that to everybody."

With the growth of KiwiSaver and a lengthy low interest rate environment, an annuity might look attractive, he thinks. "If people are really looking for alternatives in terms of where they can put their money and be confident about the income it's going to return, I think KiwiSaver maturities are going to be looking for a home."

Some new advisers will never have dealt with annuities at all. But, Chote noted, annuities are quite popular around the world, particularly in the US. He believes they are good products for clients with an expected long lifespan but shouldn't be used as someone's only source of retirement income.

He said he admires Stewart for "giving this a crack". "Ralph will have a challenge distributing it through the market because he's going to have a challenge to get people to understand it. But I think he knows that."

Bill Dahlberg, Principal of Goldridge Tasman/Nelson, said some of his clients made up part of the original study for Stewart's focus group.

"They liked the concept," Dahlberg told financialalert. "I think from an adviser's point of view, the annuity systems we've had in the past - New Zealand really just wasn't big enough. There wasn't a fair enough return to the client."

Dahlberg said that since Stewart's plan allows clients to take their money out, it will be more appealing. There is no real standard as to what percentage of a portfolio should be in an annuity, but Dahlberg said it certainly would never be 100%.

He said that with more retirees and more intergenerational wealth, people will be looking for a positive place to put their retirement funds. He said Stewart's plan would offer a good structure for older people. "That will be quite an active segment in the investment market. Ralph's probably one of the ones leading the charge into that area."