Sanlam

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Factors affecting annuity pricing

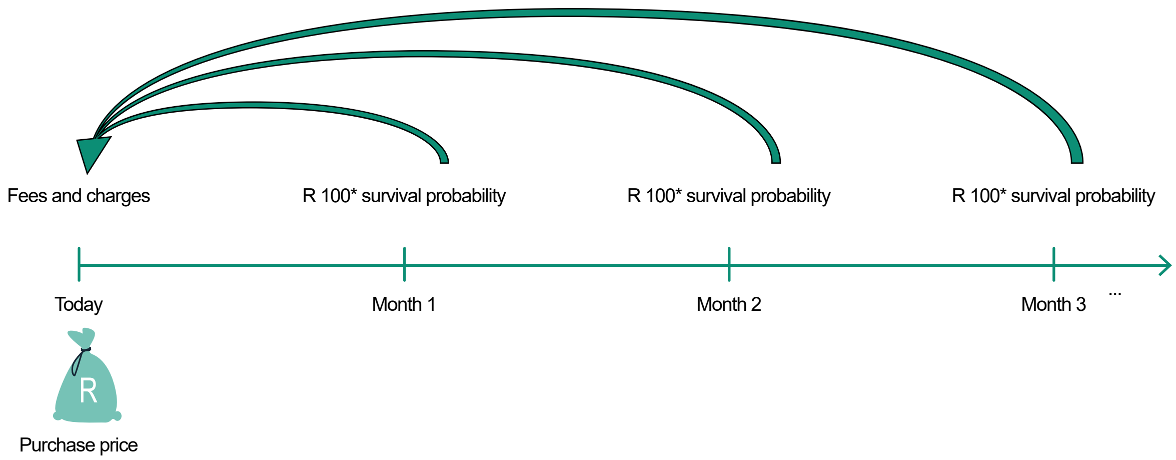
A life annuity is an insurance policy contract that offers the policyholder a pre-determined guaranteed income for the rest of their lives. Sanlam offers a range of life annuities, which mainly differ based on how annual increases are calculated (i.e. no increases, a pre-agreed fixed increase each year, increases linked to inflation or increases linked to the performance of an underlying portfolio or index).

The level of income an annuitant can receive from a life annuity depends on several factors. As one may expect, the type of annuity, initial investment, fees and charges, annuitant's age, gender and income level all affect the price of annuities i.e. the level of income the annuitant would receive. Another important input used in calculating the cost of an annuity is the discount rate, which is the rate used to discount expected future annuity payments.

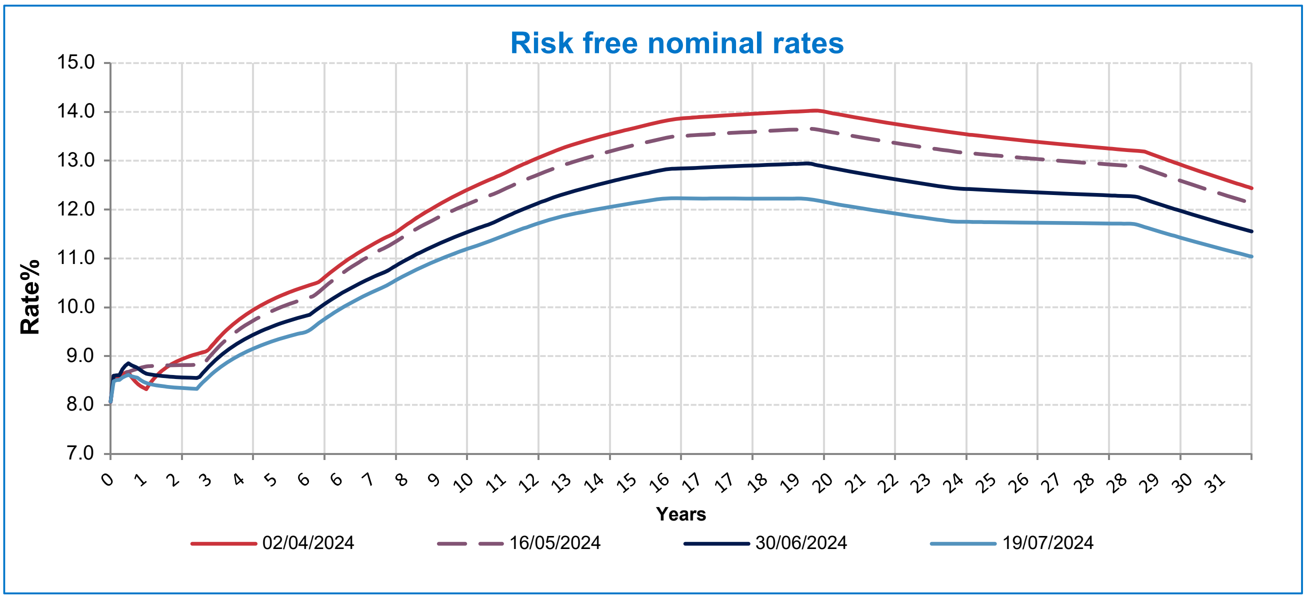
We have received several questions on the impact of market volatility of annuity rates. Daily changes in market yields used (i.e. the discount rate), with all else kept constant, will result in changes in the price of annuities. To better understand how yields affect annuity rates, let us consider an example:

If an annuitant wants to buy an annuity that provides an income of R100 each month for life, the insurer will first estimate the probability that the member remains alive each month to receive the income. The insurer then uses the corresponding point on the yield curve as an interest rate to discount the expected annuity payments. The sum of all the discounted expected annuity payments, with all the charges and expenses loaded, is then the purchase price. When an annuitant has a sum of money to use to buy an annuity, the insurer estimates the level of annuity which when discounted will equal the purchase amount.

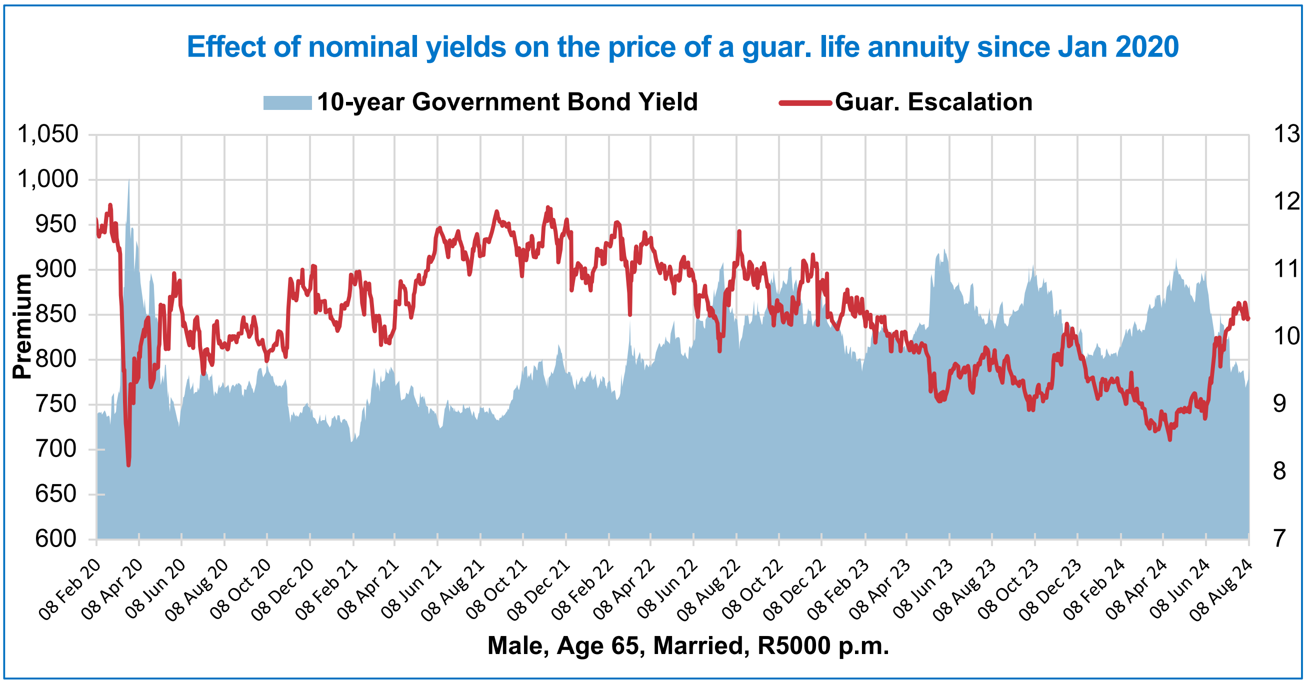
Expected annuity payments discounted using corresponding point on the yield curve



Market yields move daily, and timing of life annuity purchases is essential. Quotations done on different days will result in different annuity rates due to the changes in the prevailing market yields:



We have seen a steady drop in market yields over the past few months. This means that the expected annuity payments will be discounted using a lower interest rate, resulting in a higher expected present value (or purchase price). The graph below shows how the purchase price of a life annuity with a R5000 starting price, for a married male aged 65 has changed since 2020:



From April 2024, the 10-year Government Bond Yield (which is used as a good proxy for discount rates) has been on a steady decline, resulting in an increase in the premium required for a starting pension of R5000 per month. The inverse applies, for a fixed purchase price, the starting income for an annuitant would have dropped significantly. As a result, retiring individuals would have seen significant changes in their quotations for life annuities.

To summarise, factors that influence the purchase price of an annuity are:

- **The annuitant's personal profile (age, gender, annuity type, guaranteed period, etc.)**
- **The survival probability of the annuitant (mortality basis)**
- **The prevailing level of market yields (discount rate basis)**
- **The fees and charges (fee basis)**

Considering these factors, life annuity rates remain favourable for members looking to buy a guaranteed income for life, as members can lock-in the current high rates for, ensuring they retire with confidence!

For any assistance or further questions, please contact us on annuity.support@sanlam.co.za