



FEATURE ARTICLE

Date: 5th July 2010

Issued by: **Andrew Gadd, Head of Research - Lighthouse Group**

(The Following Article was written by my colleague Tim Collyer and originally appeared in an internal Lighthouse publication in June 2010)

Solvency II – The Future of Annuities

The financial papers are currently carrying a number of articles on the subject of Solvency II and if you have been attending the Business Development Days you may have seen the L&G presentation on the matter. Either way the key concern for most advisers is the potentially devastating news that annuity rates will fall by up to 30%. This is an area of concern and some advisers have been emailing in that annuity rates have already started to drop and are concerned for their clients. While we don't have all the answers, it is important we explore the issue to give us the best chance of dealing with it.

What is it ?

In the words of the FSA "Solvency II is a fundamental review of the capital all insurance and reinsurance firms with adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current Solvency requirements." The basis of it is an EU Directive which applies to gross premium income exceeding €5 million or gross technical provisions in excess of €25 million, due to take effect in November 2012 (as if there was not enough going on). Full details can be found here: <http://www.fsa.gov.uk/Pages/About/What/International/solvency/index.shtml>

For most people an in depth understanding will not be necessary, so here is the very basic explanation. The new legislation applies new rules designed to lower the risk of insurance policies, part of this is administrative, but part of it will be the requirement for appropriate capital adequacy to support outstanding risks and liabilities. While the Directive will have wider reaching effects the immediate and concerning issue is that of annuities, because currently the supporting investments backing annuities have been higher risk and higher yielding bonds, but the new rules will require a



significantly larger proportion of lower risk Sovereign Debt (e.g. Gilts). The price for this lower risk is a lower yield and hence a lower annuity rate.

To get this in perspective, the return on an annuity is based on 3 elements:

1. The yield of the underlying investments
2. The mortality rate of the population – which determines the mortality premium (returns cash to the pot for distribution)
3. Costs

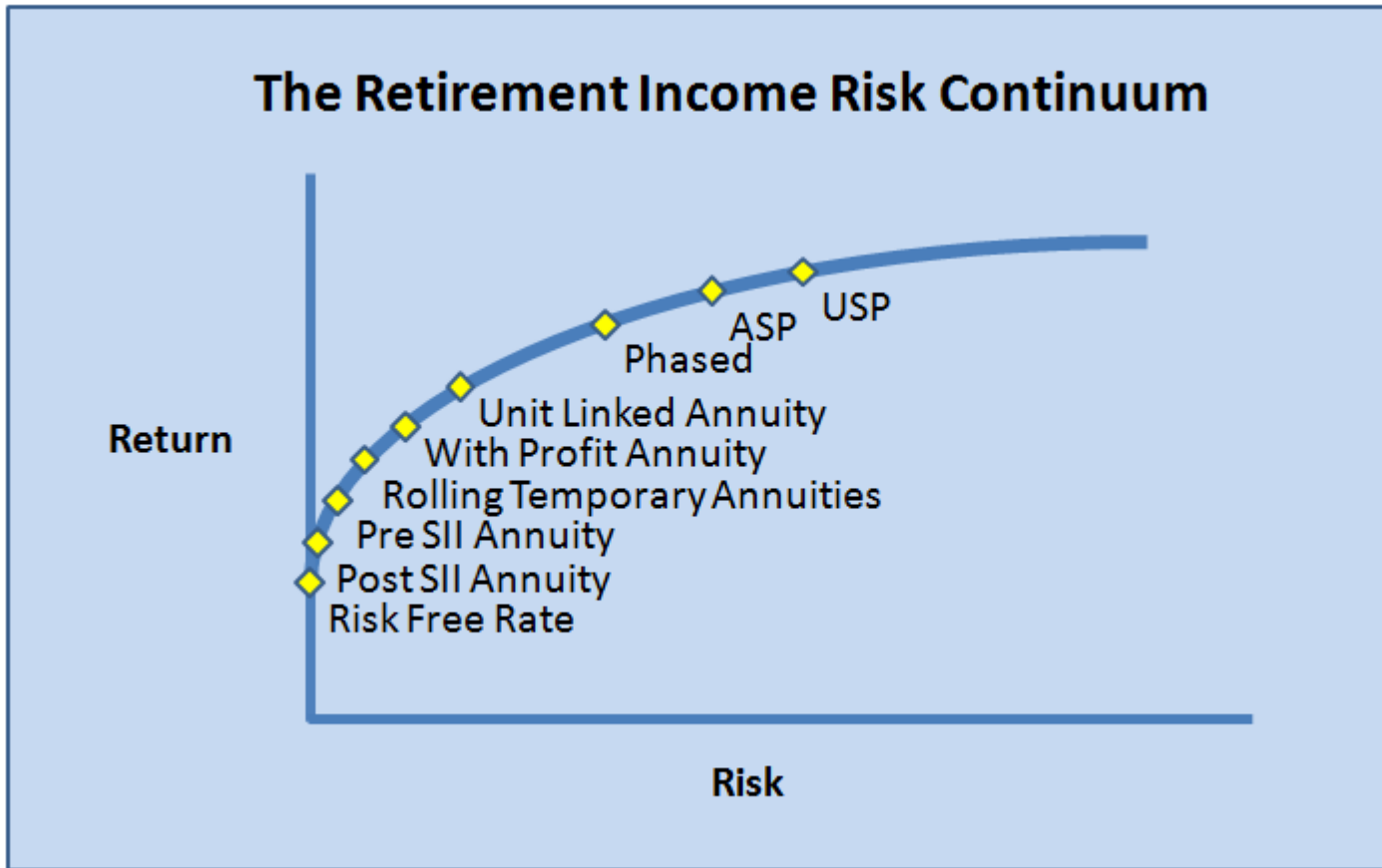
Solvency 2 will:

1. Lower the yield of the underlying investments as lower risk Sovereign Debt replaces the current bonds
2. Not affect the mortality rate - but which is generally lowering, reducing the mortality premium
3. Increase costs due to additional administration requirements

It is clear then that Annuity rate must fall. Opinions are divided by how much, but the figure of 30% is being used and that would seem reasonable to me.

From the financial planning perspective, it is more important than ever for us to do our job properly. There is a continuum of risk and reward and our job is to place clients at the right place to get returns that suit their retirement plans without adding too much risk for them to be able to physically or psychologically deal with.

Apologies for the lack of definitive data on the following graph, but it is designed to generally demonstrate the issue – solving the issue will require specific analysis of the client situation and the products you are considering using:



While not completely accurate, I have tried to illustrate some points that I believe are key:

1. The change from pre SII to Post SII represents a large drop in return for the risk removed
2. The Post SII rate is very close to the “risk free rate”, so the benefits of mortality when offset by costs is now very small, favouring invested solutions

(The risk free rate is a theoretical return that can be generated without experiencing any risk. It is theoretical as it does not exist, but the closest we can get are short term government bonds.)

With all this in mind it will be more important than ever to correctly determine the risk profile of the client for retirement as it will have a direct financial impact on their standard of living. Equally important is to explain the consequences of the risk, too much (without adequate explanation and positioning) could easily lead to complaints. Too little will result in too little income and bearing in mind the life stage of the client could cause irreparable damages to their finances and of course, complaints.

For the moment I would expect Solvency II to gradually erode annuity rates until it reaches full effect at about mid 2012, when annuity rates are expected to be at their lowest rate ever, some 20-30% lower than at the moment. In reality it changes nothing, but it does underline the requirement to provide a full



analysis of all retirement options to the client, which needs to be sufficient for them to be able to make the right decision for their circumstances.

Whilst LighthouseXpress Ltd has taken every effort to ensure that the above research is accurate, we cannot accept liability for any errors or omissions. In addition, it should be noted that the research does not constitute advice to invest, or not invest, in any product referred to above. This research is provided in order to assist you to provide your clients with sufficient information on which to make an informed investment decision. The past performance of an investment provides no guarantee as to the future performance of the new funds. The value of unit prices can fall as well as rise and the return of your capital is not guarantee.

LighthouseXpress Ltd is a wholly owned subsidiary of Lighthouse Group Plc, the AIM listed largest autonomous IFA and wealth management group in the UK. Full details of the group, including regulatory authorisations, can be found at <http://www.lighthousegroup.plc.uk>, or by contacting:

General enquiries phone number: 08000 85 85 90

General enquiries email address: enquiries@lighthousegroup.plc.uk