Annuities Market in India: Rationale, Structure and Challenges

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Organization

- Rationale for developing robust annuities market
- Annuity Markets in India: An Overview
- Key Challenges
- Concluding Observations

The Rationale /1

- India is experiencing rapid population ageing. Projections indicate that the proportion of population over 65 years will be 8 per cent (122 million people) in 2031, and over 13 per cent (229 million people) by 2051.

- Life expectancy at 60 years was expected to be 17.5 years in 2001; by 2006, it had reached 19 years. Women in India are living longer by about 3 years, broadly in-line with international trends.

- The combination of declining fertility and higher (but uncertain) life expectancy have lent greater urgency to addressing the longevity risk; and provision of survivor’s risk.

The Rationale /2

- Frequent labour mobility, rural-to-urban migration, and social changes have gradually diminished the role of traditional extended families in providing financial support in old age. Individuals (and nuclear families) need to be more self-reliant in managing retirement needs.

- India has a large and growing informal sector. These workers need instruments and mechanisms for retirement financing in accumulation as well as payout phase which generate reasonable returns net of all expenses and taxes, and in which people have confidence.

The Rationale /3

- There is a global shift from DB to DC schemes in private occupational pensions. This is the outcome of increased longevity as well as changing labour market and economic conditions.

- Government sponsored DB plans are not sustainable as India attempts to control fiscal deficits; and increases pension accessibility and coverage.

Rationale /4

- The shift to DC pension plans in private and public sectors portend a need for instruments that provide a regular payment stream from the accumulated pension savings.

The Rationale /5

- The New Pension Scheme (NPS) launched in 2004 is a DC system of individual pension accounts for civil servants.
- NPS requires mandatory annuitisation of at least 40% of the accumulated balance.
- The reach of NPS is potentially very large. A scheme to extend NPS to any citizen on a voluntary basis is likely to be implemented in late 2009.

Annuity Markets in India: An Overview/1

- There are 22 life insurance companies authorized to provide annuities. Of these, 21 companies are in the private sector. The Life Insurance Corporation of India (LIC)– the sole annuity provider in the public sector– is the market leader.

Annuity Markets in India: An Overview/2

- A dis-aggregation of first year premiums underwritten during 2006-07 shows that annuity products contributed 2.62 % of the total premium underwritten, and life insurance and pension products contributed 67.4% and 29.94 % respectively.

- The rising demand for pension products is expected to translate into higher demand for annuities in the future, as most plans have a provision for purchase of annuities by a life-insurance company of their choice.

Annuity Markets in India: An Overview/2

- Annuity products available in the Indian market has been innovative, and permits a variety of risk-management preferences of the …to be addressed.

- Almost all insurers now offer
  - Joint life annuities, which provide survivors' benefits;
  - Increasing annuities, which are designed to at least partially mitigate the impact of inflation on annuity streams
  - Deferred plans, which allow individuals to choose the age from which they wish to receive annuity streams
  - Annuities that return the initial capital on the death of the purchaser within a specified period.

- The price of an annuity (and implied return) varies with the design features chosen.

Key Challenges/1

- Actuarial Issues
- Marketing of Annuities
- Phased Withdrawals
- Inflation Risk
- Market Risk
- Annuitisation Age
- Financial Education and Literacy

Key Challenges /2

<u>Actuarial Issues</u>

- Standardized Mortality Tables used for longevity prediction are outdated, and have not been revised to incorporate the improvements in health and nutritional levels, and life expectancy.

- The tables do not adjust for variations in mortality across different ethnic and occupational population groups; or among men and women; urban and rural dwellers.

- Thus longevity tends to be underestimated; and annuity providers compensate by pricing annuities conservatively. Accurate Price Discovery is significantly hampered.

Key Challenges /3

Marketing of Annuities

- Present incentive structure for insurance agents is skewed in favour of non-annuity insurance products.
- Establishment of alternate innovative distribution channels such as multi-level marketing processes or internet based sales will enhance annuity penetration, improve awareness of retirement financing instruments and facilitate competition.
- A nation wide electronic system for comparing standardized annuity rate quotations from different providers may be considered for improving transparency and reducing costs.

Key Challenges /4

Phased Withdrawals

- Phased withdrawal products- in which accumulated sums remain invested in an individual's retirement account until withdrawn in phases- may need to be offered to those with relatively small balances (in the Indian context, less than Rs.5 lakh capital sum in 2007 prices); and for those who do not anticipate a long post-retirement life.

- Phased Withdrawals require careful design to ensure that consumer does not outlive his pension savings. India should strengthen its social pensions and social assistance schemes to address this issue.

Key Challenges /5

Inflation Risk

- Current annuity options in India only partially address inflation risks.

- Insurers can provide inflation linked annuities to a great extent if inflation-indexed bonds are issued by the government. But such bonds do not increase social utility. They merely transfer the inflation risk to the rest of the society; and may result in pro-high income redistribution.

Key Challenges /6

Market Risk

- The most challenging issue for annuity underwriters is to match annuity-related liabilities with an appropriate pool of long term investments.
- The supply of long-term debt is limited in India.
- The market for long-term debt is dominated by government securities; and only 36% of government debt has a maturity of over 10 years.
- Since annuity providers are exposed to re-investment risk, there is an incentive to safeguard their position by assigning a higher pricing to annuities.

Key Challenges /7

<u>Annuitisation Age</u>

- Mandatory annuitisation at retirement results in a forfeit of the option to defer the purchase of annuities until conditions are favourable. Thus those who retire during economic downturns and when interest rates are low may have significantly reduced annuity incomes.

- A possible solution could be to permit retirees to hold the annuity portion in their retirement accounts until market conditions are favorable; and compulsorily annuitise by, say, the age of 70.

Key Challenges /8

Financial Education and Literacy

- The need for financial education and retirement planning information for investors as well as pension advisors, distributors and employers is critical.
- The Pension Fund Regulatory and Development Authority (PFRDA) and Insurance Regulatory and Development Authority (IRDA) must ensure that annuity purchasers have access to information about the benefits and costs of different schemes and providers.

Concluding Observations

- The present global economic crisis has increased the market risk of annuities. The resulting steep decline in market capitalization in India (from USD 1,473 billion in Jan 2008 to USD 647 billion in Dec. 2008– a decline of 64%) has emphasized the need for insurance companies to find alternate investment avenues that can provide sustained returns along the lines of equity.
- Annuity options and alternate retirement solutions such as phased withdrawals need to be designed carefully.
- The creation of robust annuities markets has to be accompanied by strengthening of India's social pensions and social assistance schemes.