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Should Insurers be offering a guaranteed savings product to the DC market?

6 November 2012

Agenda

- The case for a guarantee
- Practical Issues to be addressed
- Possible solutions?
- Conclusions

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The Case for a Guarantee

Key Wants and Needs - Individuals

Wants

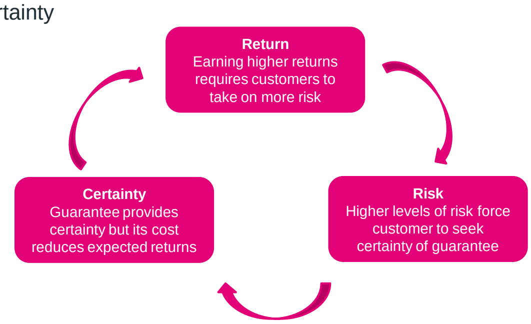
- Maximise annual pension income
- No unexpected sudden losses in pre-retirement phase
- Low, transparent fees
- Simplicity and transparency
- Minimum involvement

Needs

- Annual pension income that provides a certain lifestyle
- Certainty of fund at retirement
- Good value solution
- Effectiveness
- Portability

Assessing maturity guarantees

- From a customer's perspective, guarantees will be a trade-off between returns, risk and certainty



- The following criteria are likely to be important when considering whether guaranteed products meet member's needs and how much a provider could charge for them:
  - Expected returns
  - Likelihood of capital loss
  - Likelihood of exceeding risk-free returns

Other Guaranteed DC regimes

- Guaranteed DC Pillar 2 regimes are common across Northern Europe
- German funds must apply a money-back guarantee at retirement
  - Provided by employers so considered as DB
  - Guarantee is voided if individual transfers provider
- Majority of Danish Pillar 2 funds are DC with minimum return guarantee
  - Compulsory industry-wide funds are common so 80% have a Pillar 2 pension
  - 90% are DC, mostly invested with insurance companies with minimum return guarantees
  - Only 20% on average is invested in equities
- Switzerland runs a mandatory Pillar 2 with a minimum return threshold
  - Minimum return is linked to government bond yields
  - In practice, assets held are government bonds and no out-performance is sought/credited

Why a guaranteed savings product is needed

- Whilst a product that provides a risk-free return may meet some of the needs, it fails to meet the want / hope of seeking outperformance to maximise pension income
- We therefore believe a guaranteed savings product must meet the following criteria:
  - Zero probability of getting less than you put in
  - Expected annual return at least 1% above investing in risk-free assets
  - Probability of beating the risk-free rate greater than 50%
- Used a stochastic model to show that none of the potential strategies considered met these criteria without the need for an explicit guarantee.

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Practical Issues to be Addressed

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Practical issues – Contribution uncertainty

- Need to cope with
  - Different terms to retirement
  - Contribution flexibility

- Can guarantee costs be variable for future contributions?

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Practical issues – Portability

- Portability requirements are important for product design
  - Transfer penalties?
  - “Super” schemes?

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Practical issues – Capital / Risk management

- Insurance companies are required to hold capital against risks retained by offering guarantees
- Investment risk can be passed to investment banks through put options
  - However, option market is limited beyond 20y
  - Need to reduce basis risk
  - Counterparty risk should be collateralised

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Practical issues – Education / Communication

- Number of potential tools and techniques are complex
  - Issues for customers, advisors and consumer bodies
- Communication to members needs to improve
  - Need to refer likely outcomes to goals
  - A money-back guarantee is a simple concept and could help in avoiding disappointment

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Possible Solutions

Possible solutions – "Foundation" or "Consolidation" guarantees

- Foundation Phase concept adopted by NEST
  - Initial period of 5-10y
  - Objective is to encourage ongoing saving
- Consolidation Phase is common in DC
  - Aim is to protect pots built up to date
  - Typical to last 10-20y

Possible solutions - Cost versus benefit

- Levels of uncertainty / flexibility will increase cost
- Cost versus benefit will depend on “value” placed on guarantee by individual
- Our models suggested that a guarantee charge in many cases of up to 1% per annum is possible for various investment pre-defined strategies
  - Meets expected return criteria set out above

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Possible solutions – Re-birth of with-profits??

- Guaranteed minimum with upside potential
- Investments “moving forward” annually
- However, brand and transparency issues
- Cost to provider of smoothing accounts

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Possible solutions – Income guarantees and ambitions

- Offering income rather than retirement pot guarantees
- Does an “ambition” benefit members or providers?

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Conclusions

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Conclusions

- We believe that a guaranteed DC product has a place
  - Has to expect to out-perform risk-free assets
  - Has to offer value versus the cost
- To offer value, product design has to remove risks
  - Possibly not enough risk to justify a guarantee at 40y
  - Flexible contributions and portability need to be addressed
- However, a number of possible solutions exist

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Further reading

- http://www.actuaries.org.uk/research-and-resources/documents/there-place-uk-defined-contribution-pensions-market-guaranteed-sa-0
- To be included in next British Actuarial Journal

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Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenters.