



The Actuarial Profession

making financial sense of the future

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Vesting Annuities Impact of Regulatory and Market Change

Vesting annuities – Introduction and Focus

Commercial management & impact of new regulatory requirements for vesting annuities. This will cover:

- Overview of the UK market
- Recent and forthcoming regulatory changes
- Market Changes
- Analysis of how With-Profits providers currently manage vesting annuities
- Case Studies of providers who have recently made changes to address With-Profits issues regarding vesting
- Potential actions/considerations for providers

Current UK Market (1)

The current UK market is large and growing:

- In 2011 total UK annuity market £11bn (after lump sums)
- Proportion remaining with pension savings provider when OMO available – 54% in 2011 compared to 65% in 2009
- Significant driver for the ‘low’ OMO rate is guaranteed annuity rates currently ‘in-the-money’
- Average size of pension fund to purchase an annuity £26k and this is positively skewed
- Large growth predicted – PPI/NAPF double within 5 years (a little sceptical of this) but definitely in medium term
- Starting to see the shift from OPS’s DB and trust-based DC to annuity purchase which will increase market

Current UK Market (2)

Fairly segmented market between those competing for OMO 'price' business, Enhanced & reliance on internal

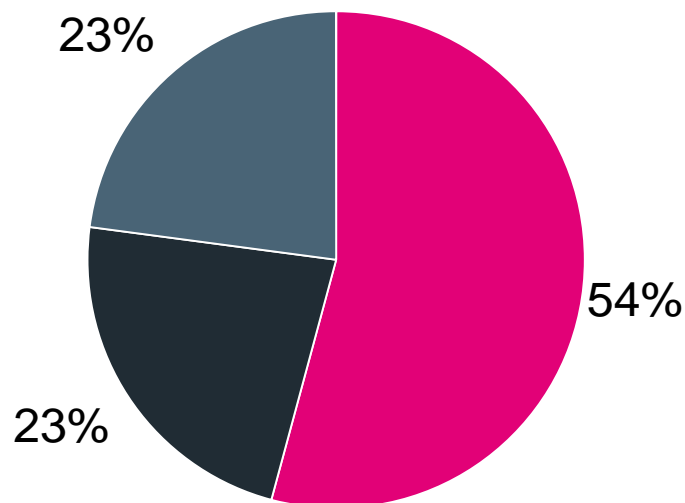
**Internal Vesting Only
(10+ providers)**

Provide annuities only
for existing pension
customers – c£2.5bn

**OMO only
(c.4/5 providers)**

Primarily
enhanced/impaired
specialists now have
c20% of the market
- c£2.6bn

**Total Annuity New Business
2011**



■ Provide both OMO & Internal (with OMO proportion > 10% of total)

■ OMO only

■ Internal Only (any OMO proportion less than 10%)

**Provide both OMO &
large internal books
(c.4/5 providers)**

Mainly price players
but also have 50% of
the internal business
-c£3.8bn OMO
-c£2.4bn Internal

Regulatory Change (1) – OMO Reform

There has been a long journey to the current position:

- | | |
|-------------------|---|
| Sep 2002 | FSA requires OMO to be included in wake-up pack |
| 2007 | Treasury/DWP sets up an OMO Review group to review the market |
| April 2008 | Outcome of the FSA thematic review on OMOs |
| 2009 | ORIGO's Options pensions introduced to speed up the transfer process |
| 2011 | The Government threatens to consider legislative options to improve OMO rates |
| Mar 2012 | The ABI compulsory Code of Conduct is launched with a deadline of 1 st March 2013 for compliance |

Regulatory Change (2) – ABI Code of Conduct

Customers will be better directed to get a higher annuity

- Firms must provide clear, consistent and complete customer communications
- Firms must prominently highlight the benefits of different types of retirement income
- Firms must clearly signpost customers to advice and support
- The outcomes should be a more transparent annuity market
- Firms must provide a shopping around guide
- Application form must be requested

Regulatory Change (3) – EU Gender Directive

Gender specific pricing will become illegal from 21 Dec.

- Insurers will be forced to price on unisex rates
- New concept of gender mix risk when pricing annuities
- Firms may consider alternatives to gender
- Reinsurance arrangements will not necessarily be on unisex rates
- Implications for the industry.
- Guaranteed pensions

Regulatory Change (4) – RDR

The Retail Distribution Review will come into effect from 1st Jan 2013

- Commission will be banned and there will need to be a separate charge for advice
- The cost of advice will increase
- The number of advisers is likely to reduce
- Pensions are complex even those with small pensions pots
- Customers likely to be priced out of the at-retirement advice market
- Alternatives

Regulatory Change (5) – Solvency II

The timing of SII remains uncertain but there could be big implications for annuities.

- Pricing methods will change under SII
- Generally, this will depend on a firms own business mix and strategy
- There is a particular issue for many annuity writers who traditionally backed annuities with corporate bonds.
- The matching adjustment rules are intended to assist annuity writers but these are complex and by no means certain.
- These may only be a transitional measure
- EIOPA Long-term Guarantee Assessment

Regulatory Change (6) – Others

The size of vesting annuity pots could be impacted by:

- NEST & auto-enrolment
 - As employees are auto-enrolled into new schemes existing plans will become paid-up, leaving providers with lots of small, dormant plans and so small pensions
 - If transfers into NEST are allowed in the future then providers also risk losing profitable funds they currently hold
 - When vesting, annuities will be offered from a fixed panel
- Small pensions proposals
 - Ensure savings aren't lost and that consumers aren't penalised when converting small funds
 - Virtual aggregation tools
 - Abolition of short-service refunds

Key Market & Other Changes

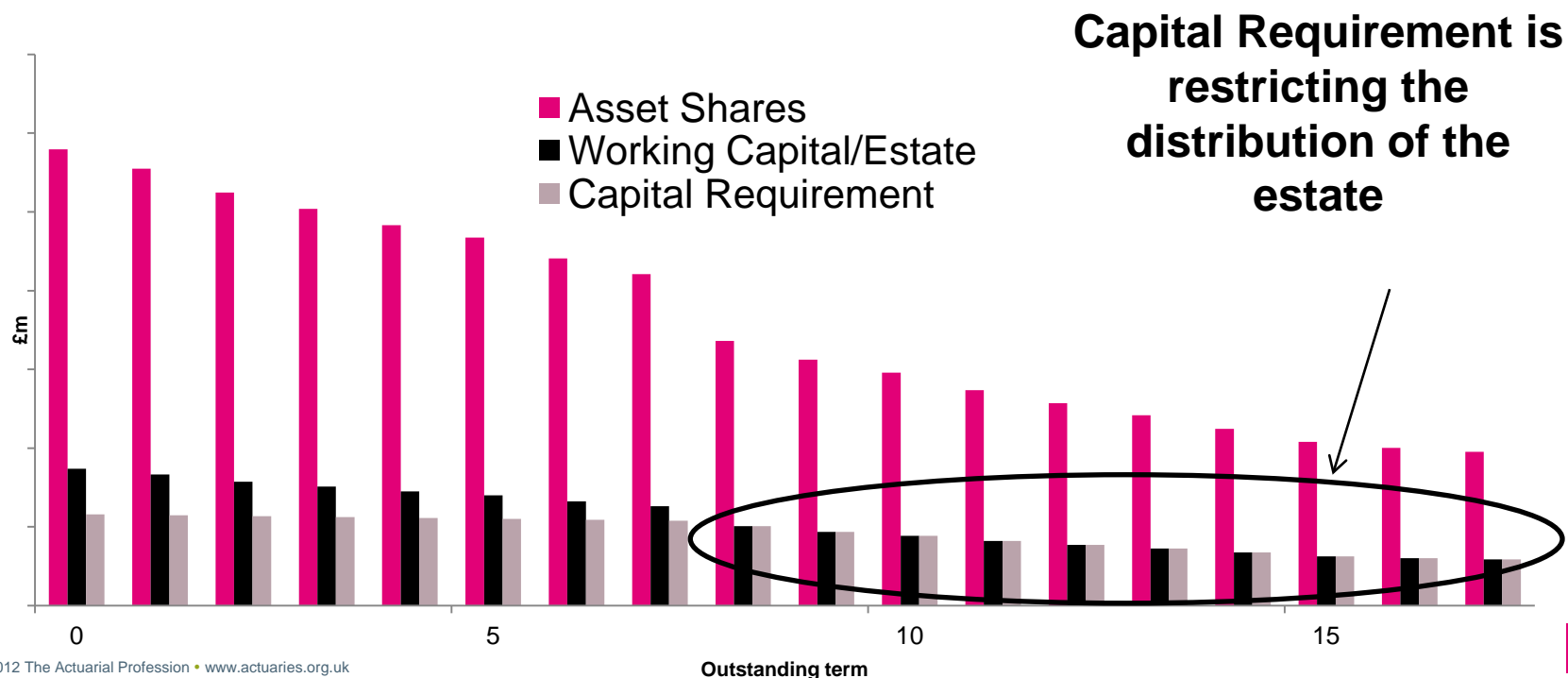
Regulation is not the only driver for change:

- Development and growth of the enhanced/impaired market
- Fixed term annuities & possibly new drawdown / variable annuity solutions
- Low interest rate environment
- Demographics and phased retirement
- Growth of direct offerings
- Reduction in the number of price players

Vesting Annuities from With-Profits Business (1)

There are three specific issues regarding annuities that vest from with-profits policies:

1. With-Profits (WP) Run-Off - If annuities remain in the WP fund the regulatory capital requirement can act as major constraint on estate distribution



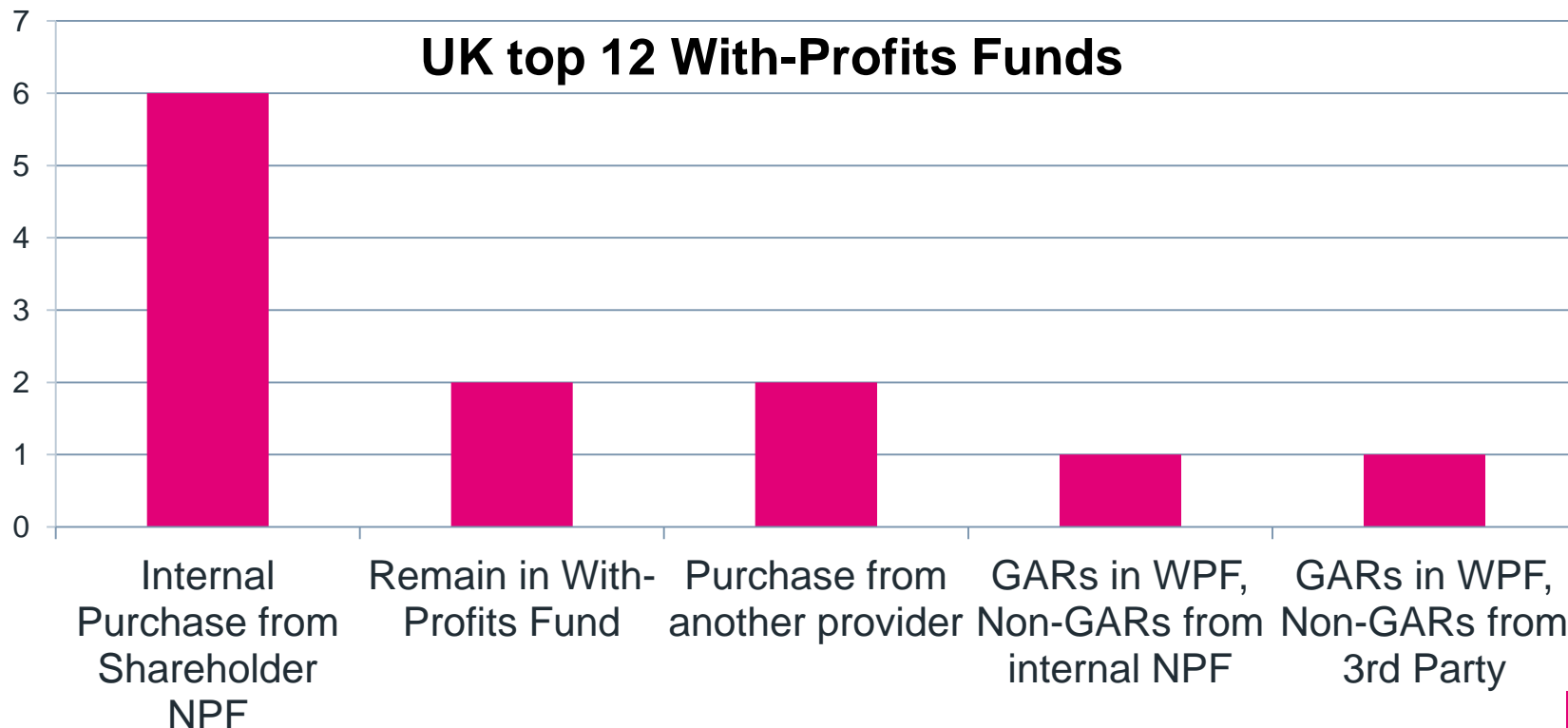
Vesting Annuities from With-Profits Business (2)

2. WP policyholders are essentially investing in longevity risk and have a geared exposure to credit through the annuities. This investment may not be consistent with their original expectations.
3. Guaranteed Annuity Rates (GARs) – whilst not unique to WP business this can become a key factor in the management of the estate and WPF aim will be to minimise the cost (as estate has to fund excess over asset share)

Also can be in shareholders interest for annuities to transfer to a shareholder owned fund if sufficient ROC can be achieved whilst demonstrating fairness

Vesting Annuities from With-Profits Business (3)

Most large UK firms have implemented a solution where WP vesting annuities are effectively purchased from an internal non-profit (shareholder owned) fund or a 3rd party. Many small WP funds (often mutuals) still writing in WPFs



Vesting Annuities from With-Profits Business (4)

The following change in PS 12/04 was largely viewed as codifying the FSA pressure applied to a number of firms to ensure that with-profits funds were not paying excessively for guaranteed annuities transferred to a shareholder owned NPF or 3rd party

COBS 20.2.1

“A firm must take reasonable care to ensure that all aspects of its operating practice are fair to the interests of its with-profits policyholders and do not lead to undisclosed or otherwise unfair benefit to shareholders or to other persons with an interest in the with-profits fund (COBS 20.2.1 A R)”

“For the purposes of COBS 20.2.1 AR the FSA expects a firm to be able to demonstrate that it has taken reasonable care to ensure its operating practices are fair, including being able to produce appropriate evidence to show that it has followed the relevant governance procedures (COBS 20.2.1 D G)”

Many commercial agreements for transfer of GARs often tied to OMO rates. If these move to Gender neutral the male dominance of GAR annuities likely to result in higher cost to WPFs but as B2B could still remain gender specific (GARs only). Existing agreements need review.

Vesting Annuities from With-Profits Business

Case Study 1

Pressure from WPC led to benchmarking of GAR purchase terms

- Existing agreement for GARs to transfer from WPF to shareholder NPF at provider's OMO rate
- OMO competitiveness significantly reduced and differential between the agreement cost and best available price was a significant direct hit to the estate
- Scheme & policy T&Cs effectively restricted 3rd party solution and available reinsurance deals not that attractive
- Benchmarking solution introduced but not that simple (e.g. limited number of competitors, postcode, adequate ROC for the shareholder, enhanced the real comparison?)

Vesting Annuities from With-Profits Business

Case Study 2

Large mutual wants to avoid WPF becoming dominated by annuities & provide improved rates for customers

- Run off projections showed continuing to write annuities would constrain estate distribution
- Also desire to improve customer rates (non-GARs) and scale/investment risk appetite meant poor ROC for WPF
- Bureau introduced for non-GAR vesting including enhanced option (very much aligned to ABI OMO code of practice) but legacy system constraints meant very difficult to implement for GARs
- New risk that if GAR rates get close to enhanced rates the longevity experience of the remaining GARs will improve resulting in higher cost to the WPF

Potential Options for Vesting Providers

Vesting-only firms will need to think about new strategies to maximise/defend value and meet the new compliance requirements.

- Maximise value by pricing to keep the business you want to keep
Examples: Bureau model – in which you participate;
Encourage/incentivise loss-making small pots to take lump sum
- Improve pricing approach - Use rating factors such as postcode or other data from the pre-vesting stage
- Defensive actions such as partnering with an enhanced/impaired provider
- Segment the book – eg by with-profits fund, fund size
- Exchange annuity manufacturing margin for commission (3rd party or platform) for vesting

Summary

The changes affecting the management of vesting annuities will bring significant change but the specific impacts will depend on each insurer's individual goals, structure and vesting customer base

- The vesting annuity market will grow and we will probably see an increase in the pace of business moving from the vesting only players to the OMO market
- However, whilst most of the regulatory change is pushing this shift, the impact of RDR could actually increase the fund size required for independent advice
- Difficult to see how a vesting only model will survive in the long term given regulatory and competitive pressures
- GARs are likely to remain a structural restraint on OMO growth but as with-profits funds decline further actions will be required

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 presenter.

