Institute and Faculty of Actuaries

# Call for Evidence: Creating a secondary annuity market

IFoA response to HM Treasury and the Department for Work and Pensions

18 June 2015

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute
and Faculty
of Actuaries

Annuity Consultation
Insurance and UK Regulatory Authorities Team
HM Treasury
Horse Guards Road
London
SW1A 2HQ

18 June 2015

Dear Sirs

**IFoA response to HMT and DWP's call for evidence on creating a secondary annuity market**

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMT and DWP's call for evidence for creating a secondary annuity market.

2. Developing a secondary annuity market that allows existing pensioners to exchange their annuity income for a lump sum / revised pension benefits will not necessarily be straightforward for pensioners, insurers or regulators. It is therefore critical that the wide-ranging implications of a secondary annuity market are fully understood.

3. This response has been written by members of the IFoA who work in either the pensions or life insurance industries, including for insurers active in the annuity and wider post-retirement markets.

4. The actuarial profession has extensive experience in the valuation of pensions and annuities, and analysing the risks attached to this process. Accordingly, we believe the profession has an important role to play in the process, and we would welcome the opportunity to discuss our response and further research with HM Treasury or the Department of Work and Pensions.

**General comments**

5. The 'freedom and choice' initiative in pensions provides a clear opportunity to help individuals manage their retirement income in a way that reflects their specific circumstances. The proposals to create a secondary annuity market build on the pension freedoms announced in 2014. However, widening the choices available to pensioners is not without risk, potentially to some or all of the pensioners, investors and pension providers involved. It is important that these risks are understood and that appropriate measures are in place to mitigate them.

6. Although the freedom to decide how and when to use their pension assets might be attractive to some pensioners, giving up a guaranteed income could increase the risk of inadequate income in later retirement. This could cause both individual financial hardship and an increased burden on the State benefit system; both of these outcomes could have a detrimental impact on the long-term sustainability of the pensions framework.

7. The IFoA believes that products which offer a guaranteed income for life will continue to play an important role for many pensioners. We therefore welcome that this call for evidence

recognises that for many people keeping their annuity will be the right decision. We would encourage HMT and DWP to ensure this is widely communicated ahead of creating a secondary annuity market.

8. Annuities are a form of insurance, guaranteeing an income for the rest of the policyholder's life. Like any insurance policy, the primary feature of an annuity is the pooling of risk across the relevant policyholders. If an annuitant decides to exchange their guaranteed income for a lump sum, then they forego any subsequent pooling of longevity, investment and wider risk experience, which the annuity policy had provided.

9. Access to adequate financial advice will be key to annuitants in understanding the pros and cons of, and the inherent risks relating to, the choices they face. It is important that appropriate advice / guidance infrastructure is put in place before any secondary annuity market is opened.

10. A robust consumer protection regime is also essential to avoid the potential, but real risk, of secondary annuity mis-selling. Many annuitants will likely be amongst the most vulnerable in society, particularly in older age; for example, where they are open to undue influence from relatives or others (such as carers in a nursing home). Robust consumer safeguards both in terms of advice and regulation of annuity purchasers' sales processes will therefore be necessary, although such measures are unlikely to eliminate secondary annuity mis-selling entirely.

11. The call for evidence paper mentions that the Government will seek to have measures in place by April 2016 to support a secondary annuity market. We suggest the Government considers initial evidence emerging from the reforms implemented on 6 April 2015 to ensure there are sufficient protections in place for consumers against both mis-selling and the likelihood of poor decisions being made owing to a lack of information or advice.

12. We agree that whether the terms offered by third party annuity purchasers offer good value to pensioners is likely to be a concern:

    a. as noted in the call for evidence, some individuals may underestimate their future life expectancy. It is also worth observing that life expectancy is only an average measure: 50% of people are expected to survive for longer and so are likely to be (substantially) underestimating how long they will live;

    b. similarly, annuitants may make inappropriate allowance for changes in economic conditions since they bought their annuity, impacting the current expected present value of the annuity;

    c. the potential cost of financial advice – if borne by the annuitant – could be significant, particularly if high in absolute terms relative to a smaller annuity income;

    d. appropriate medical underwriting would need to be designed, as it can be expected that those in ill health will be more likely to exchange their annuity income than those in good health. This may also give rise to a view, for those whose health has deteriorated, that the value of the annuity is underestimated. If the cost of such underwriting were passed to annuitants, this would also reduce the terms offered; and

e. perceived value for money could also be an issue during the early stages of a secondary annuity market, if a relatively small number of third party participants are offering to buy annuities.

13. As well as adequate consumer protection, to be successful a secondary annuity market would require a range of willing buyers of secondary annuities. We understand that the proposals for a secondary annuity market have generated some initial interest from existing pension providers. However, it remains to be seen how much demand there will be in practice for buying secondary annuities once third parties develop their understanding of how the market would operate.

14. IFoA research has found that existing and future pension products could have a role in helping individuals meet the cost of care.[1] In theory, the greater flexibility offered by a secondary annuity market could help facilitate this, although this will depend on the terms available. In practice, people's retirement saving is not expected to be adequate to provide for retirement, so there are still challenges to be overcome before care costs can be assumed to be covered by this source of saving.

**Question 1: In what circumstances do you think it would be appropriate to assign one's rights to their annuity income?**

15. Individuals' circumstances do change and annuities may be paid for a significant number of years. Although we see the theoretical merit in allowing people to realign the benefits they are receiving to their current needs, in practice, the associated costs may outweigh the theoretical gains. However there are a number of circumstances where this flexibility could benefit the annuitant. Such circumstances could include where:

    a. the annuitant has sufficient other pension income to provide a secure income for the remainder of their retirement. They may then wish to diversify their retirement assets (such as invest in property), or provide a lump sum for their spouse or dependants.

    b. the value of the annuity is sufficiently small that the money can be taken without any adverse tax implications and used to pay off existing debts.

    c. an open market option was not taken when buying the original annuity, and where the market is now able to offer better returns. However, we do not think this would be commonplace in practice.

    We also believe that there are important considerations for pensioners to take into account, which may lead them to conclude that retaining the annuity may be the better option:

    a. the annuitant remains in good health and the pension is their main income, so the value of insuring against long life is important.

    b. the annuitant's health has deteriorated, but there is significant uncertainty over length of life. In these circumstances it is likely that investors would assume life expectancy at the shorter end and so the annuitant may not get good value from taking a cash lump sum.

[1] IFoA (2015) How pensions can help meet consumer needs under the new social care regime, updated January 2015

c. the annuitant is relatively old or a vulnerable customer, for whom having a regular income is an important consideration.

d. the lump sum offered on the secondary market is not attractive to the annuitant, such that they then opt to continue with their annuity policy. Consider the following simplified example (these figures are purely for illustration):

   i. An individual retires with a pension fund of £30,000 and buys an annuity. The annuity provider charges £500 to set up and administer and prices the policy with an allowance for margin of £2,000.

   ii. The individual subsequently decides to sell the annuity on the secondary market. Assuming that the allowance for margin is still £2,000, but administration costs are lower (say £200), this then implies a re-sale price of £25,300 if market conditions and underwriting were unchanged. On this basis, the individual is £4,700 worse off.

   iii. If the underwriting assessment deteriorated, the re-sale price would fall further.

**Question 2: Do you agree with the government's proposed approach of allowing a wide range of corporate entities to purchase annuity income in order to allow a wide market to develop, whilst restricting retail investment due to the complexity of the product? What entities should be permitted and not permitted to purchase annuity income and why?**

16. We agree that a wide range of corporate entities should be able to enter the secondary annuity market as long as there are appropriate consumer safeguards in place. For example, by permitting only regulated entities to purchase annuities, or for there to be a regulated entity involved in the process. There should not however, be unnecessary barriers to entry to the market and we recognise that obtaining the right to annuity income may prove attractive to a range of investors, including third party insurers and pension funds. Encouraging a range of third party annuity purchasers will be a pre-requisite for a strong and competitive secondary annuity market. We agree that third party insurers could be better-placed than some other institutional investors to manage mortality / longevity underwriting.

17. Although institutional investors may have a preference for buying secondary annuities on a bulk basis, this would require input from intermediaries, as noted in the call for evidence paper. This is likely to add to the costs of administering the secondary annuity market, costs which may be passed to the consumer. Where intermediaries are involved, they would also need to be within the scope of relevant consumer protection safeguards, to protect consumers from misleading or aggressive sales practices.

18. The IFoA agrees that retail investors should not be included in the secondary annuity market, given the likely complexities of this market, and the pronounced impact on smaller investors. As mentioned in the call for evidence, determining an appropriate valuation price would be a particular difficulty.

19. On a separate point, we suggest that legal advice is sought on how potential disputes between the original annuity provider and the relevant third party annuity purchaser would be resolved. It would not be desirable if the annuity policyholder ended up embroiled in any such dispute.

**Question 3: Do you agree that the government should not allow annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their existing annuity provider ('buy back')? If you think 'buy back' should be permitted, how should the risks set out in Chapter 2 be managed?**

20. The IFoA recognises that there could be unintended consequences of a secondary annuity market if insurers were compelled to offer annuity buy back, particularly if take-up of such an option were financially significant.

21. For annuity providers, an annuity contract is a long term guarantee to pay income throughout an individual's life. The regulators rightly require stringent reserving to make sure this guarantee can be honoured. Most providers will be holding matched assets. There was no past need for liquidity so many will be invested in illiquid assets, thus enhancing returns for the benefit of customers. Annuity providers may also have reinsurance contracts to manage the longevity risk associated with annuities.

22. If annuity providers were allowed to buy back these contracts, they would also need to unwind any reinsurance arrangements and the surrender value would depend on the sale price of the actual assets held, to protect remaining policyholders. This means the buy back price from an existing provider could be very different from the value a third party would place on the payments.

23. As noted in the call for evidence, buy back could also adversely impact the provider's annuity investment strategy, with knock-on consequences for their solvency position. We agree that the benefit of the matching adjustment under Solvency II could be reduced.

24. If annuity buy back were possible, we agree that it would be important that annuitants obtained alternative quotes for selling their annuity on the open market, for the reasons outlined in paragraph 2.16 of the call for evidence. Lack of consumer awareness of 'open market options' post annuitisation would clearly not be in the consumer interest.

25. From the customer's perspective, asking your existing provider to surrender your annuity might seem like the 'easy option'. They might approach their own provider first, 'insist' on a surrender value and reject the need to shop around. This is similar to the issue now emerging with some customers aged 55 and above demanding all their money in cash and the consumer detriment risks would also be similar.

26. There may be a case for allowing existing providers to buy back 'smaller' annuities; however, if a secondary annuity market does develop, there is likely to be limited interest in small annuities. It would seem sensible to allow trivial annuity commutation with existing providers, subject to suitable safeguards.

**Question 4: Do you agree that the solution to the death notification issue is best resolved by market participants? Is there more the government should be doing to help address this issue?**

27. Keeping track of whether annuitants are still alive once payments have been re-directed is likely to be one of the key challenges of a secondary annuity market. The issue of identifying dead annuitants has been one that has challenged insurers and annuity providers have established processes for this. However, the original annuitant would no longer have any incentive to notify the insurance company of any change of address, although this could potentially be incentivised through the retention of some part of the annuity. There could

though still be a significantly increased risk that annuity payments continue after the death of the annuitant, which would give rise to losses for insurers. This is particularly true for cases where the annuitant moves abroad, as they would not be covered by the tracing services many annuity providers use; or where the annuitant was unwilling to cooperate with tracing services where there was no incentive for them to do so.

28. It is also plausible that recovering such overpayments could be more difficult and could be less successful. In such circumstances, new third party recipients would be unaware that the annuity payments were not due and may have invested the proceeds accordingly.

29. The writers of the original annuity will need to consider the impact of such uncertainty and additional cost. This may be factored into secondary annuity quotations or in terms offered to new annuities.

30. Alternative survival / death monitoring procedures may also be more expensive and less reliable than direct communication with annuitants / their estates.

31. Although the original provider could retain a portion of the annuity, this would mean splitting an annuity into a retained part (payable to the annuitant) and a separate part payable to the third party purchaser. This would increase complexity and could give rise to significantly higher costs.

**Question 5: Do you agree with the proposed approach of the government working with the FCA regarding the fees and charges imposed by annuity providers?**

32. This seems to be an appropriate area in which the FCA should be involved. The FCA's monitoring should be able to capture instances where the annuitant chooses not to assign their income to a third party, because they consider the costs quoted / wider terms offered unattractive and to establish whether this is due to the annuity provider over-charging.

33. We do not think it is appropriate that the FCA should propose fixed levels of costs as different annuity providers will have different expense bases.

34. A more challenging (and in our view more important) issue will be how Government or the FCA might assess whether general (as opposed to individual) resale prices offered by third parties are reasonable. The price will be based on (at least) two variables – investment yields and longevity – both of which involve significant subjectivity. It would therefore be very difficult to impose any form of 'charge cap'.

**Question 6: Do you agree that the scope of this measure should be annuities in the name of the annuity holder and held outside an occupational pension scheme?**

35. Where an annuity is held by the trustees of an occupational pension scheme there are two payment streams that could be surrendered:

    a. the payments from the annuity provider to the pension scheme.

    b the payments from the pension scheme to the pensioner.

    Whether or not bulk annuity contracts contain rights for trustees to surrender (or the trustees and annuity provider negotiate a surrender not covered by the policy terms), bulk annuity surrender should remain possible but optional, as it is currently. The pensioner is not a party to such a contract.

36. There is a separate question as to whether a pensioner should have the option to surrender their payments from the pension scheme. This question arises irrespective of whether the scheme trustees have secured the pension benefits via an annuity contract. The pensioner should not have the right to surrender. However, legislation could be amended to extend the circumstances in which the pension scheme is permitted to offer the option to surrender, if it wished to do so and the option was permitted by the scheme rules (as is currently the case with 'trivial' commutation). If pension scheme trustees were to offer full surrender, they should determine the terms offered as appropriate for the financial position of the scheme as a whole. We cannot, however, see a good reason to extend the ability of a pensioner to surrender or transfer a pension in payment from an occupational pension scheme.

**Question 7: Are there any other types of products to which it would it be appropriate for the government to extend these reforms?**

37. Although most existing annuity policies are pension annuities, bought at the time on a compulsory basis, some annuitants have instead purchased life annuities (PLAs). PLA policies are not subject to compulsory purchase and also differ from pension annuities in having an alternative tax treatment. It is not clear from the call for evidence whether PLA policies are within scope of the secondary annuity market proposals and clarity on this point would be useful. If PLA policies are within scope, additional clarity on the specific implications for these policies would also be helpful.

**Question 8: Do you agree that the design of the system outlined in Chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the Government would need to apply to individuals who had assigned their annuity income?**

38. The IFoA supports changes to the pensions tax framework where necessary to encourage innovation and reduce barriers to flexible retirement income options. We note that proposals to tax revised retirement income / lump sum payments at the individual's marginal rate of income tax is consistent with the equivalent framework for new annuitants (announced as part of the 2014 proposals for Freedom and Choice in Pensions).

39. The call for evidence explains that the exact tax treatment of an annuity purchase will depend on the specific circumstances of the buyer. Where this third party is a pension fund, then it is appropriate that the asset proceeds be treated as being exempt from tax, as noted.

**Question 9: How should the government strike an appropriate balance between countering tax avoidance and allowing a market to develop?**

40. The IFoA does not have any comments on this question.

**Question 10: What consumer safeguards are appropriate – is guidance sufficient or is a requirement to seek advice necessary? Should the safeguards vary depending on the value of the annuity?**

41. We would draw parallels between these proposals and those for Defined Benefit (DB) arrangements - where individuals wish to transfer their rights to benefit under the scheme into 'flexible benefits'. With transfers to Defined Contribution (DC) pension schemes pensioners

are also exchanging a secure income in retirement for an option with more flexibility but less certainty. There are similar benefits and challenges facing consumers who make this decision as those who will be deciding whether or not to assign their annuity to a third party.

42. Individuals with DB wealth in excess of £30,000 are required to have independent financial advice before making this transfer. We suggest that it would also be sensible to apply this safeguard to the secondary annuity market. In both markets it is vital that steps are taken to help the individual understand that whilst greater flexibility could mean they are better able to match their current financial needs it will be harder to manage their longevity risk. This could leave them exposed in the later stages of retirement when they may be at their most vulnerable. For many annuitants it will be a difficult decision to know whether or not it is appropriate to accept the offer to assign the annuity, particularly if their health has deteriorated.

43. For individuals with annuity values of £30,000 or less, access to tailored financial advice is also important. We acknowledge that the cost of tailored advice could be significant in relation to the overall value of the annuity, but annuitants with smaller pensions may have a greater need for robust financial advice, particularly if they have limited alternative retirement benefits. We suggest the proposals in the call for evidence for simplified but tailored online / telephone advice should be developed, particularly in the absence of full tailored financial advice.

44. There is an argument for only allowing any assignment of annuities to apply to annuities purchased prior to the introduction of Pension Freedoms on 6 April 2015. From this date, customers have had the choice of whether to buy an annuity or not. Allowing them then to re-sell the annuity gives them opportunities to select against both the annuity provider and those purchasing the annuity as their health changes. It also increases the risk of people purchasing annuities as a default option on the basis they can always cash in if circumstances change. However, an alternative view is that individuals' circumstances can change over time, and although an individual may have wanted an annuity initially, they may not want one subsequently.

45. A further safeguard could be to introduce an upper age limit (e.g. 80 or 90), above which you cannot assign your annuity. The basis of this is that at the older ages underwriting of customers becomes very difficult, lowering the potential value of the cash payments relative to the annuity. Older annuitants are more vulnerable and if they need to go into care it is not clear how converting an annuity into cash would interact with any means-tested benefits. However, the need for robust advice may address this.

**Question 11: What is the best way to implement these safeguards? Should the safeguards include expansion of the remit of Pension Wise?**

46. We suggest that relevant stakeholders including; the Government, the FCA, the insurance industry and providers of guidance consider emerging experiences following the safeguards introduced with the annuity reforms implemented on 6 April 2015. In the light of this, the Government could undertake work to gather an evidence base on consumer understanding of their retirement options, including exposure to longevity and investment risk, tax implications and interaction with means-tested benefits. This evidence base should then be used to influence the advice / wider safeguard framework across the associated stakeholders.

47. We agree that Pension Wise should form a part of the safeguard framework, expanded as necessary, such that its scope deals adequately with benefits and risks relating to existing

annuitants. More generally, we note that appropriate safeguards will be essential for these reforms to be successful, including protecting consumers from fraudulent activity and further pensions mis-selling.

**Question 12: Should the costs of any advice or guidance be borne by the annuity holder (mirroring the arrangements for conversion from a defined benefit scheme)? If not, what arrangements are appropriate?**

48. The IFoA does not have a particular view on this question.

**Question 13: Do you agree that the government should introduce a requirement on individuals to obtain a number of quotes? How else should the government best promote effective competition to ensure consumers obtain a competitive price?**

49. The IFoA suggests that annuitants should achieve a competitive price by choosing an open (secondary annuity) market option supported by suitable financial advice. The suggestion that individuals obtain a number of quotes would need some development to become effective: would the Government prescribe a minimum number of quotes; would a range of quotes be comparable; and how would individuals choose which of these options were most appropriate for their specific circumstances?

50. We suggest a more helpful approach would be to ensure that those buying secondary annuities adhere to high levels of transparency, that appropriate advice services are available and that consumer protections from fraudulent activity or poor advice are in place.

**Question 14: Does the government's approach sufficiently protect the rights of dependants upon assignment? If not, what further steps should the government take?**

- **Should the government or FCA issue guidance to annuity providers about protection for dependants?**
- **Are there particular classes of beneficiary which require special consideration, for example minors or following a divorce or dissolution of a civil partnership?**
- **Are there specific equality impacts that should be considered in this context?**

51. The IFoA recognises the need for the Government / FCA to issue guidance to annuity providers in relation to protection for dependants, particularly if insurers have a degree of discretion over whether to exchange the annuity payments. We also note that a wide range of beneficiaries could be impacted by changes to an existing annuity policy, including joint lives, spouses, civil partners and minors. It is important that annuity providers recognise the rights of these wider beneficiaries when considering re-assignment of annuity benefits.

**Question 15: Should the government permit the principal annuity holder's income to be assigned while dependants retain their own income stream? Should the decision on whether to do so be left to the discretion of the parties to the transaction?**

52. The IFoA believes that it should be possible for an annuitant to assign their income even if there are contingent payments to dependants.

**Question 16. How can the proposed consumer protections for the assignment of annuities ensure that any impact on means-tested entitlement is understood by those deciding whether to assign their annuity income?**

53. This would have to be covered by the provision of advice on the transaction. It will need particular consideration for pensioners with smaller annuities who may be given simplified advice.

**Question 17: Should those on means-tested benefits be able to assign their annuity income?**

54. The IFoA believes this should be allowed, provided appropriate advice is given on the consequences of the transaction.

**Question 18: What are the likely impacts of the government's proposals on groups with protected characteristics? Please provide any examples, case studies, research or other types of evidence to support your views.**

55. A subset of the nine protected interests will be relevant to the determination of terms offered by third party purchasers of annuities. In particular, the first three characteristics below typically feature in current annuity pricing and valuation:

    a. Marriage / civil partnership – as noted above, some existing annuity policies will include current / contingent benefits to existing or former spouses / partners. These benefits should be allowed for in calculating a lump sum where the associated benefits are also being re-assigned

    b. Gender – although most existing annuities (if sold prior to 2012) will have been priced based on gender, gender neutral terms would now need to be offered on annuities sold subsequently. Clarification on whether the terms offered in a secondary annuity market now have to be on a gender neutral basis in all cases would be helpful. There is a risk of price arbitrage, for example, it might prove advantageous for a woman who bought an annuity on a gender neutral basis to take a lump sum if this were not on a gender neutral basis (and offered terms favourable to female lives).

    c. Age – this would be a direct rating factor, influencing the expected future longevity of the relevant pensioner

    d. Disability – we would not expect this to be a rating factor in its own right. However, we would expect the terms offered on annuity income assignment to reflect the current state of health of the pensioner; this may be underpinned by relevant detailed underwriting to guard against health anti-selection.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely,

Nick Salter,
**President, Institute and Faculty of Actuaries**