Institute
and Faculty
of Actuaries

Retirement income market study: terms of reference

Institute and Faculty of Actuaries response to the Financial Conduct Authority

17 March 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

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.

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17 March 2014

Dear Sir / Madam

Retirement income market study

The IFoA welcomes the opportunity to respond to the Financial Conduct Authority's (FCA's) consultation on the terms of reference for the retirement income market study.

Summary

- We support the scope of the study, as outlined in the proposed terms of reference.
- We would highlight three specific areas where further exploration would be of particular value including: the regulation of sales practices to promote best value for consumers; determining appropriate capital levels for insurers providing annuities; the timing of the decision to purchase an annuity.
- The study may wish to consider extending its scope to include long-term care – given the impact these costs can have on retirement income.

The IFoA is well placed to respond to this market study and engage with the FCA on ways to promote effective competition, in the interests of consumers, in the annuity market. The annuity market is an active area of interest to the IFoA and one which is frequently discussed both at member-level and at committee-level by the Public Affairs & Consultation Committee and Life Board of the IFoA. Our members actively discuss both the technical and commercials aspects of annuities. We have detailed, in Appendix 1, papers that our members have produced to demonstrate the deep level of engagement that actuaries have in these issues. We would welcome the opportunity meet with you and provide further evidence that we are in the process of collating on the mechanics of the annuity market.

Within the existing regulatory framework, actuaries help insurers build products to meet the different needs of different customers. Actuaries are experts in risk and financial modelling and play three vital roles in the annuity market:

- Actuaries help develop new ideas into workable products, which benefit purchasers. For example, they have helped companies develop ill-health annuities and drawdown products, both of which address some of the short-comings of the traditional annuity market.
- Actuaries help insurance companies to assess the profitability of annuities, through consideration of the potential returns on investments held, the potential future longevity experience, and the appropriate allowance for the risks associated with writing the business.

- Actuaries help insurance companies to manage their risks and to determine appropriate amounts of capital to allow these companies to continue to meet their obligations, including annuity payments. They use data-driven approaches to achieve this, including the analysis of historic mortality patterns across different segments of the population and financial modelling to support business judgements on future developments. The IFoA, through the Continuous Mortality Investigation, plays an important role in collating industry data which is helpful to these actuaries and others.

The certainty in retirement income (in either real or nominal terms) that an annuity provides the consumer is fundamentally important. This is a unique promise that no other financial product offers. From the consumer perspective, this confidence comes with the trade-off that the decision to purchase an annuity is one-off and irreversible. We see four specific problems for regulators overseeing this market (Appendix 2 describes our view of these problems in more detail):

- Regulating sales practices to allow customers to efficiently execute the purchase of the best value annuity to suit their circumstances, without overburdening them with costs that cannot be supported, nor indeed warranted. This is particularly pertinent for those with a small pot.
- Determining how much capital insurers must hold to support the long-term promises they are making in the annuity market.
- The timing of the decision to purchase the annuity is as important as deciding the structure of the annuity.
- Determining whether the prices charged to consumers are fair given different views on longevity and investment strategy.

A growth in the use of medical and lifestyle underwriting in the market has further increased the potential retirement incomes available to consumers (especially those in poorer health) versus that of a 'standard' annuity. We see this trend as one that is likely to increase in future years. As a result, the cross-subsidy between lives in poor health and those in good health is likely to reduce, and lead to healthy lives paying more for the same level of annuity (as those in poorer health benefit from the increased rates that the underwriting process enables). Prices might arguably be fairer, but there will be winners and losers, when compared to the current system. Policymakers will have a responsibility to police the boundaries to avoid discrimination.

The importance of advice in helping consumers make optimal decisions in this changing market will increase. However, the costs of even minimal advice levels (estimated to be in the range £1,000 - £2,000) have a significant detrimental impact on smaller funds. The average fund size is less than £30,000 and it is expected that auto-enrolment will lead to an increase in the number of smaller funds. As part of this study, we would welcome an exploration of the cost barriers around advice and the extent to which their removal might impact on the efficacy of the open market option.

The scope of the study is focused on the areas we would expect to see as impacting on consumer outcomes. There may be value in the study extending its terms of reference to include additional products, such as long-term care, since the costs of long-term care can have such a significant impact on retirement income. The IFoA is exploring these issues with its members and would welcome the opportunity to discuss in more detail with the FCA.

When assessing the commercial aspects of annuities against other insurance products, the study may wish to be mindful of the unique risk profile of annuities and the extent to which higher risk investments may enable greater returns that can be passed to consumers.

We look forward to providing assistance to the FCA in developing their understanding and thinking on this important matter. In the meantime, should you want to discuss any of the points raised please contact Paul Shelly (paul.shelley@actuaries.org.uk/ 07917604985) in the first instance.

Yours sincerely,

Derek Cribb
Chief Executive, Institute and Faculty of Actuaries

Appendix 1: Useful documents on IFoA website

2013 Current Issues in Life Assurance presentation suggesting there are plenty of shareholder risks that will need to be managed carefully by annuity providers:
http://www.actuaries.org.uk/research-and-resources/documents/annuities-challenging-times

2013 Life conference presentation on predicted growth in underwritten annuities
http://www.actuaries.org.uk/research-and-resources/documents/b08-all-annuities-all-underwritten-all-right

June 2011 briefing note prepared by life board
http://www.actuaries.org.uk/research-and-resources/documents/briefing-note-annuities

Slides from 2005 conference discussing how asset allocation and mortality drag impact on managing income if annuity is not bought
http://www.actuaries.org.uk/research-and-resources/documents/reinventing-annuities-options-distribution-handouts

Appendix 2 – Specific regulatory problems

Problem 1 – Regulating sales practices

Customers entering the annuity market are not homogeneous. Pot sizes vary from only a few thousand pounds to the £1.25m, or more, of the lifetime allowance. An individual's personal circumstances should determine whether the annuity payments should stop when they die, or continue to support a financial dependant. Actuarial innovation has encouraged the use of each annuitant's health in pricing the annuity. Improved data modelling capabilities allows other predictors of life expectancy, such as postcode, to be included as a ratings factor.

For some, the choice of features to include within an annuity at the point of purchase is relatively straightforward. The key regulatory objective should be to provide the best value annuity for such a customer with minimum transaction costs. With the introduction of automatic enrolment, there may in future be a bigger role for using defaults to give better outcomes to people who do not have the time or inclination to engage with this process at the relevant time.

In practice, regulated firms are concerned that within the current regime they would open themselves up to accusations of mis-selling unless a full advice process has been followed. The costs of providing this complete advice (with fact find face to face meetings etc.) make it uneconomic to service customers without a significant fund size. Obtaining even minimum advice, which is likely to be in the range of £1,000 – £2,000 will have a large impact on smaller funds. Given the average fund is less than £30,000 the purchase of advice would have an immediate detrimental impact on the customer outcome.

There is, as a result, a sizable group of customers who are effectively disadvantaged because advisors cannot build an advice process to serve them cost effectively. Providers are unwilling to sell annuities directly to customers who have not received advice in some form. There are, however, internet based non-advised services emerging, but access to these is not, of course, universal.

Problem 2 – How much security should insurers hold to back their promises

Actuaries have developed models based on historical data and assumptions about the future to help predict for how long different groups of people might be expected to live and what rates of return might be available on investments over those periods. However, as with any predictions, there is a substantive amount of judgement involved in helping actuaries develop these models.

Regulators will quite rightly insist insurers hold extra capital so that they will be able to meet their promises as protection against their customers living longer than expected and insufficient investment. The greater the capital they are required to hold the more secure their promises to annuitants will be, but this will have other implications as commercial enterprises will look to earn a return on this additional capital. Greater capital translates into higher costs to insurers and poorer annuity rates for customers.

The most difficult discussions concerning the adoption of Solvency II have often stemmed from different approaches member state regulators have taken to this issue. As the detail within Omnibus II becomes clearer, it will be possible to assess how the Trilogue's balance will impact on annuity rates. Early indications are that the problem is less severe than previously thought, albeit, with some limitations on asset choices.

Whilst actuaries have expertise in these areas, the ultimate decisions about the levels of security consumers should have and the subsequent trade-off on costs are political, rather than technical. The IFoA remains committed to helping policymakers understand the consequences of different approaches.

Problem 3 – Purchase of an annuity is an irreversible decision

As individuals have much better information about their immediate health prospects than insurers, annuitants are not allowed to change, or cash in, their annuities. If this were allowed, individuals who believed they were at higher risk of a more immediate death, (e.g. diagnosis of a terminal illness) may be more likely to surrender their annuities. Consequently, the insurance company affected would be more likely to face cashflow difficulties as they continued paying annuities to its remaining customers. However there is scope for innovation here, particularly to solve the issue of the tight timeframe under which decisions are currently taken.

This information asymmetry about an individual's health would affect other possible changes to an annuity (e.g. adding, or removing, a dependant, or changing the rates of increase) because these would alter the average term of payments.

Actuaries have helped insurers develop drawdown products to help spread the purchase of annuities over time (and potentially across different providers) so that annuitants are not tied into the annuity rates available on a single day. Spreading the ultimate annuity purchase in this way enables future purchases to reflect individuals' changing circumstances (and health), as well as changing economic circumstances. However, the additional administrative expenses and advice requirements mean drawdown policies are only really cost effective for customers with larger fund sizes (c£100,000 and above, although, arguably this amount is too low unless significant other sources of income were to exist).

Developing investment solutions (such as life-styling) can help reduce the impact of purchasing an annuity on a single day for those with smaller pots, though not entirely effective.

Problem 4 – The fair price for annuities

The pricing of annuities is sensitive to key assumptions made on both the level of investment return the insurers can generate and the longevity of the customer. The long term nature of annuities makes the pricing sensitive to even small differences in these key assumptions.

The investment return factored into the price will be based on the investment strategy of the insurer and each will have their own view of a reasonable strategy. The relative mix between government bonds, corporate bonds and alternative asset classes in this strategy will impact on the investment returns as well as the amount of capital the insurer must hold. The level of capital insurers hold will also need to be reflected in the prices to generate a reasonable return on this capital.

Although actuaries and others invest significant time and research into predictions of future longevity there remains a substantial amount of judgement necessary to establish pricing assumptions. There is no single view of this and estimates of longevity evolve in light of additional data and experience that emerges each year. These judgements mean there is a range of reasonable views on longevity which can have a significant impact on the price to the consumer.