Institute
and Faculty
of Actuaries

# Guarantees in Retail Products

## Do they have a Future in the UK?

Report by the Institute & Faculty of Actuaries Long-Term Product Guarantees Working Party

**Authors:**

Brandon Horwitz (Chair), Rebecca Macdonald (Deputy Chair), John Manion, Jonathan Kemp, Evrim Köksal Arkut, Nisha Bajaj.

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# 1. Introduction

1.1. Guaranteed products evolved to address genuine customer[1] needs and wants. However, they have fallen from favour in the UK market over time, yet still remain popular in some other countries.

1.2. The Long-Term Product Guarantees Working Party was established by the Life Board in 2019 to investigate long-term guarantees, traditionally available as pension, investment and annuity products in the UK.

1.3. With an ageing population in the UK and increased use of pension drawdown products, including by customers not receiving financial advice, we believe it is a critical time to reassess the role of guarantees in retail products.

1.4. The trend of investment products without guarantees dominating the UK retail market is a clear example of the transfer of risk from institutions to individuals. This has been the focus of the IFoA's Great Risk Transfer project and our Working Party aims to contribute to this important dialogue.

1.5. Our Working Party has aimed to answer these two key questions:

1.5.1. Whether long-term insurance guarantees have a future in the UK, and

1.5.2. What, if anything, could be done to make them more attractive to customers.

1.6. We explored these questions by focusing on the following key areas:

1.6.1. Opportunities to improve customer and adviser understanding of the benefits of guarantees.

1.6.2. The features that deliver value to consumers.

1.6.3. The viability of guaranteed products in a low interest environment and what adaptions may need to be made.

1.6.4. The role of solvency regulation & capital requirements and possible regulatory changes that would allow product innovation to better meet consumer needs.

1.7. This paper presents our findings and importantly aims to put them in the context of the IFoA's Great Risk Transfer initiative and the many other IFoA Working Parties which have covered similar themes in recent years.

1.8. Please note that our research mainly focused on investment guarantees, with some consideration of the interaction with mortality (i.e. longevity guarantees which feature in annuity-style products).

1.9. The aim of this paper is to share our findings and to prompt a discussion of the merits of taking steps to help develop a market in guaranteed products in the UK. We recommend a number of steps in section 3 and these could be progressed by the IFoA, the UK regulator, product providers and by individual actuaries working in these organisations.

1.9.1. Our findings will be discussed at an IFoA webinar on 15 January 2021 after which next steps will be agreed.

[1] Please note that we use the terms 'customer' and 'consumer' interchangeably in this paper and both are intended to refer to the end-user of a financial services product to achieve a particular financial planning goal, such as providing an income in retirement.

# 2. Context & Approach

## *The Great Risk Transfer*

2.1. The IFoA initiated the Great Risk Transfer project in early 2020 to explore the transfer of risk from institutions to individuals[2]. It is described as follows:

*2.1.1. In the 21st century, many financial risks that used to be borne by governments, financial services providers and employers are being transferred to individuals. This change is giving many people the freedom to manage their own finances as they see fit.*

*2.1.2. But making these choices and managing these risks can often be extremely complex. Evidence of this shift exists in a number of areas of public policy and actuarial work and amounts to a profound change in the way that individuals organise their life and finances.*

*2.1.3. Meanwhile, levels of numeracy, financial literacy and understanding of risk are low, meaning large parts of the population are not well equipped to deal with the risks they now face.*

*2.1.4. This transfer of risk poses important questions about the changing priorities and responsibilities of the institutions that once managed those risks. In financial services, it means greater thought about how to ensure consumers are equipped to make decisions that are in their best interest.*

*2.1.5. In public life, it means taking a close look at the relationship between citizens and the welfare state, and questioning whether the current balance of individual and collective responsibility is right.*

2.2. The Great Risk Transfer's interim report reaches tentative conclusions about the role of policy to address the issues identified, including considering key issues such as:

2.2.1. Is responsibility with the right parties?

2.2.2. Is risk sharing preferable to risk transfer?

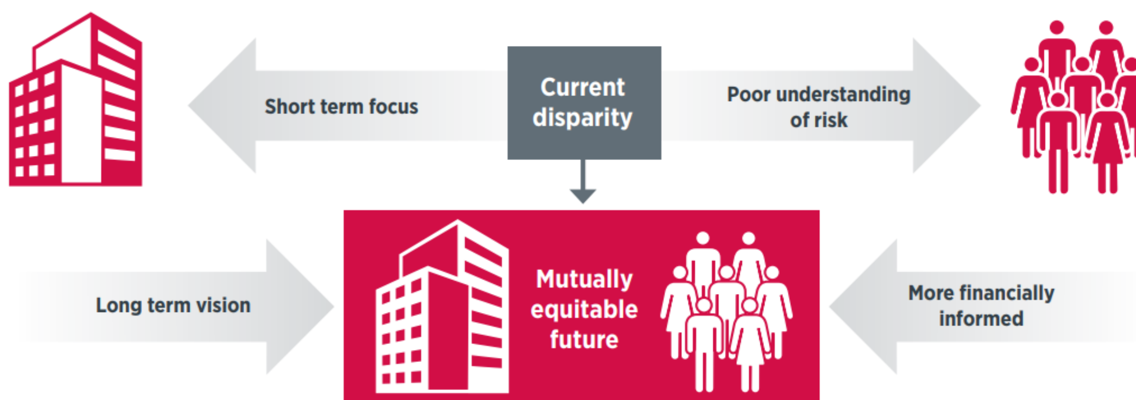
2.2.3. What should the State's role be?

2.2.4. How can we incentivise institutions to innovate?

2.2.5. How can communication and education be improved?

2.3. A vision is painted of a future where the issues identified can be mitigated by successful policy interventions:

[2] https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/great-risk-transfer




2.4. We position our Working Party's research as fitting neatly into this vision, especially in terms of encouraging institutions to innovate and enter the market to offer long-term product guarantees to meet the needs of consumers.

## *Relevant previous working parties*

2.5. Our Working Party's research builds upon work undertaken by many others, and aims to build on their findings and recommendations, which we summarise below:

2.5.1. The **Value of With-Profits to Consumers Working Party**[3]:

2.5.1.1. Which found (amongst other things): a low level of general understanding or appreciation of the key features of with-profits. This provides some cause for concern in the age of pensions transfers and drawdown products being seen as more desirable than potentially valuable guaranteed annuity incomes.

2.5.1.2. And recommended: Some clear, consistent, generic explanations of with-profits products, features and important considerations may be needed. Customers receiving statements, asking for current values or looking to take action should be given clear information and sufficient warnings about the consequences of actions.

2.5.2. The **Consumer Risk Metrics Working Party**[4]:

2.5.2.1. Which found (amongst other things): that the communication of risks faced by consumers is an important matter for insurers and regulators; there are financial consequences when things go wrong.

2.5.2.2. And recommended (amongst other things) that: in order to be of value, risk metrics need to be applied consistently across the products being assessed: this may mean either a prescribed metric by an industry or regulatory body (e.g. in the UK, either bodies such as the ABI, FRC, or FCA), or an independent body carrying out the assessment of products.

[3] https://www.actuaries.org.uk/practice-areas/life/disbanded-research-working-parties/value-profits-consumers

[4] https://www.actuaries.org.uk/practice-areas/life/disbanded-research-working-parties/consumer-risk-metrics

2.5.3. The **Modelling Pre and Post Retirement Savings Products Working Party**[5]:

2.5.3.1. Which is considering the retirement products and/or investment techniques that could help improve the options available to consumers on retirement, as well as developing a framework to assess success at meeting consumer needs and wants.

2.5.3.2. And which has so far concluded that: there are opportunities in the current retirement market and that a combination of products (offering investment and guaranteed features) could offer an attractive solution to consumers (and be of great benefit to consumers and providers).

2.5.4. **Communicating Investment Returns in the Retail Customer Journey[6]:**

2.5.4.1. Which found (amongst other things) that: over half of the population surveyed do not understand the risk and returns of their investments (only 13% understood all risks completely); customers want simpler, more engaging documents, but these documents alone cannot improve understanding.

2.5.4.2. And which recommended: that regulators, providers and all stakeholders in financial services evolve their communication, using digital technology through a variety of preferred customer mediums (tailoring communication to different customer types and segments).

2.5.5. The **Transforming Consumer Information Working Party**[7]

2.5.5.1. Who analysed the current state of consumer information for long-term savings and investments in the UK and proposed a model for the future. Their ideas are founded on a strong belief in the role of advice in helping consumers make the best choices. The best outcome for a consumer is to receive excellent financial advice supported by engaging information they can easily understand. In cases where the consumer doesn't have access to advice it is even more important that they can easily digest the available information.

2.5.5.2. And proposed that information providers: communicate savings progress relative to the consumer's goal; communicate risk and reward by reference to the chances of achieving the consumer's goal; and ensure communications are engaging, easy to digest and free of bias.

## *Research approach*

2.6. We started our research by reviewing a range of guaranteed products currently (or recently) available in the UK and elsewhere in the world. This helped us to identify some common features of these products which we could then explore in more detail with a range of stakeholders.

2.7. We then discussed these product features with stakeholders in the UK including:

2.7.1. Industry bodies, representing the main providers of investment products in the UK, including guaranteed products such as structured products

[5] https://www.actuaries.org.uk/practice-areas/life/research-working-parties/modelling-pre-and-post-retirement-savings-products

[6] https://www.actuaries.org.uk/practice-areas/finance-and-investment/disbanded-research-working-parties/communicating-investment-returns-retail-customer-journey

[7] https://www.actuaries.org.uk/system/files/documents/pdf/bajweb-versionupdatedpdf.pdf

2.7.2. A sample of financial advisers

2.7.3. The Financial Conduct Authority (FCA)

2.7.4. Representatives of other Working Parties (i.e. those noted above)

2.7.5. We did consider undertaking research involving retail consumers but chose to focus our attention on the providers of products. This decision was informed by the observation that there is established research[8] of consumer demand for guaranteed products, but limited research focused on the drivers of the lack of supply of these products in the UK.

2.8. We generally focused our research on products offering long-term product guarantees as a feature, for example in the cases of:

2.8.1. Retirement income products which aim to mitigate 'sequencing' risk as consumers draw down on their Defined Contribution (DC) pensions, or

2.8.2. Where consumers are saving for a particular goal (e.g. children's education).

2.9. We considered two key ways in which providers typically offer long-term guarantees:

2.9.1. Structured products issued by a single provider like a bank, most commonly based on the investment returns of a single type of investment (e.g. linked to the FTSE100 index)

2.9.2. Insurance-linked guarantees, most commonly provided on a diversified portfolio of investments held with the insurer (e.g. in a unit-linked investment held within a pension or life bond).

2.10. We also considered 'smoothed' return products, including With-Profits style investments. Please note, however, that we did not focus specifically on With-Profits and excellent work has been undertaken on this subject in particular by the relevant Working Party (as noted above).

2.11. While a wide range of customers may desire guarantees, we have chosen to focus our attention on those with more modest pension and investment savings who are relatively less sophisticated, more risk averse and who may make limited, if any, use of financial advice.

2.11.1. We believe that this group of people is currently not well served by products currently available in the market and we see insurance-based products as likely to be more suited to their needs (i.e. as they may not appreciate some of the risks and complexities of structured products such as credit risk, liquidity risk, concentration risk, etc).

2.11.2. We provide further detail about this particular customer group in section 7 where we outline what would be needed to help create a viable market for guaranteed products.

[8] Please note that the majority of this research demonstrating customer demand is proprietary and the Working Party members had typically seen it through their professional work for providers of these products in the UK over the past c. 20 years. Public research confirming this includes the following which was commissioned by the FCA as part of their thematic review of structured products in 2014: https://www.fca.org.uk/publication/research/structured-products-consumer-research.pdf

# 3. Summary of findings & recommendations

3.1. We summarise our findings in the table below alongside and key policy recommendations which we think could help to address the issues highlighted.

| Finding | Recommendation |
|---|---|
| **1. Understanding of guaranteed products**<br>There is considerable variety in consumer and adviser knowledge and understanding of guaranteed products.<br>This includes consumers not necessarily understanding the benefits and limitations (including opportunity costs) of these products, especially compared with cash or 'non-guaranteed' investment products.<br>While some advisers are familiar with these products, many have limited experience of them or negative associations with particular historical products (some of which may have offered poor value-for-money).<br>Existing mandatory point-of-sale disclosures for investment products are often based on backward-looking (historical) returns and may not fairly illustrate the benefits (and limitations) of guaranteed products. | **1. Education and balanced promotion**<br>Consumers and advisers could benefit from education about the benefits and limitations of guaranteed products.<br>Especially important is how these products can be used in retirement to help secure a minimum level of retirement income at a time when it is most needed (i.e. including addressing sequencing and longevity risks).<br>Balanced promotion of the features is needed which clearly and transparently highlights how the benefits of guarantees come at explicit and implicit costs. This should include illustrations of how reductions in risk are typically balanced by reductions in potential returns (relative to non-guaranteed products).<br>Forward-looking stochastic projections are well suited to illustrate the value of guarantees to consumers as part of a financial plan and in discussions of value-for-money. |
| **2. Limited manufacturing expertise**<br>Today in the UK, there are relatively few practicing actuaries (and other financial services professionals) who have comprehensive experience in creating and managing guaranteed products.<br>Specialist skills are required to develop and operate these products, especially in an insurance company / economic capital environment, with careful asset-liability management required.<br>With-profit actuaries could be well-suited to do this, but there are relatively few actuaries working (and training) in this area. | **2. Develop skills and transfer experience**<br>Actuaries working in developing and managing retail products would benefit from training to develop the skills to create and manage guaranteed products.<br>This could involve creating opportunities and a structured programme by which experienced actuaries in this area can transfer their knowledge to the 'next generation' of actuaries.<br>Work could also be undertaken to identify if and how historical with-profits techniques and knowledge can be refreshed and promoted to raise awareness of applications to create and manage guaranteed products. |

| 3. Perceived regulatory risks and scrutiny | 3. Fair value and regulatory 'safe harbour' |
|---|---|
| Guaranteed products are often perceived as being 'too risky' to develop due to fear of how the FCA might scrutinise providers offering them.<br><br>This perception is informed by historical examples of mis-selling of guaranteed products and/or failure of providers.<br><br>Some historical products also offered poor value-for-money for consumers and/or involved high commissions for advisers (i.e. presenting significant 'conduct risks').<br><br>The FCA has also introduced much more explicit value-for-money requirements for all products. | Any products developed should have the delivery of fair value to consumers as a core design principle.<br><br>Development of products needs to follow both the letter and spirit of the FCA's product governance regulations. This includes being compliant with 'Retail Distribution Review' requirements (i.e. no commissions payable to advisers).<br><br>Providers could be encouraged to enter the market if the FCA were to consider a 'safe harbour' for products which meet a set of standardised features, including robust product governance, controls against mis-selling risks and independently validated 'fair-value' / 'value-for-money'.<br><br>An actuarial standard for fair value assessment could be developed, with a clear framework to calculate and present this transparently. |
| **4. Solvency treatment of guarantees**<br><br>The capital impact of offering guarantees on insurance companies is seen as a significant impediment.<br><br>While internal model firms can calibrate their 1 year 1-in-200 stress tests to manage capital requirements in line with their risk exposure, for standard formula firms, guarantees tend to generate significant capital penalties. | **4. A different standard formula**<br><br>Regulators could consider a different approach within the standard formula in Solvency II, one which is more reflective of the economics of guarantees.<br><br>Changes could include better allowance for the ability to closely hedge liabilities with widely available and transparent derivative products. |

3.2. Further discussion is required to identify who is best placed to implement these recommendations and we propose to socialise these findings with regulators, industry bodies and providers to help progress them.

3.3. We are also actively contributing to the IFoA's Great Risk Transfer initiative. Our findings and recommendations are being considered by the IFoA policy team as they work on the next report of the GRT, to be published in 2021.

3.4. The rest of this paper summarises our research and thinking which led us to the above findings and covers:

3.4.1. What are long-term product guarantees and how are they delivered?

3.4.2. Why do people want and need long-term product guarantees?

3.4.3. Why have guarantees fallen out of favour in the UK market?

3.4.4. What would be needed to help make these products viable going forward?

3.4.5. What products are currently available in the UK and elsewhere?

# 4. What are long-term product guarantees?

4.1. Long-term product guarantees typically appear either in the form of capital guarantees or income guarantees.

4.2. Capital guarantees typically involve mitigating or eliminating investment risk. Common examples are products which may:

4.2.1. Promise a customer a return of at least their initial investment, or

4.2.2. Promising that any losses will be capped, for example not losing more than 20% of the highest value of a customer's investment.

4.3. Income guarantees typically involve mitigating both investment risk and/or mortality risk. Common examples are products which may promise a customer:

4.3.1. A fixed amount of income paid for a fixed period of time, or

4.3.2. A variable amount of income paid for a fixed period of time (depending on investment performance), but with a fixed level of income paid as a minimum, or

4.3.3. Either of these options paid for life (i.e. a 'traditional' annuity or 'variable' annuity), or

4.3.4. A variation of the above offering a fixed or minimum level of income linked to inflation (i.e. an 'index-linked' annuity).

*Delivering investment guarantees*

4.4. The investment risk mitigation element of guarantees is typically delivered through investment strategies which incorporate options or dynamic asset allocation strategies which seek to replicate the behaviour of options.

4.5. Options are a type of investment instrument called a derivative which make payments derived from (i.e. depending upon) the performance of an underlying investment (e.g. an index such as the FTSE100 or S&P500 or a specific portfolio of investments).

4.5.1. Put options typically pay out when the underlying investment falls (providing 'down-side' protection).

4.5.2. Call options typically pay out when the underlying investment rises (providing 'up-side' exposure)

4.5.3. Many variations of options exist, both 'standardised' versions available traded on stock exchanges or 'bespoke' versions only available 'Over the Counter' (OTC) from an investment bank.

4.5.4. Other variations also exist such as 'collar' derivatives which incorporate both put and call options (which are typically used to help offset the cost of down-side protection by giving up some up-side exposure).

4.6. Two common types of investment guarantees offered are 'spot' (or term guarantees) vs. 'rolling' (or 'ratcheting') guarantees:

4.6.1. Spot guarantees are provided at a single point in time (e.g. the 5th or 10th anniversary of taking out a policy / making an investment)

4.6.2. Rolling guarantees are provided on an ongoing basis (e.g. guaranteeing the value of an investment will never fall to less than, say, 80% of the highest value it has achieved since launch)

4.7. Typical option-based investment strategies to deliver guarantees are:

4.7.1. Investing in long-term investments and holding put options to provide down-side protection.

4.7.2. Holding shorter-term investments (like cash or short-dated high-quality bond investments) and holding call options to provide up-side exposure.

4.7.3. Investing in long-term investments and putting a collar in place to obtain down-side protection at a reduced cost vs. just using a put (but giving up some up-side exposure in the process, i.e. this involves capping the potential returns to customers).

4.8. Dynamic asset allocation approaches are an alternative to options-based strategies to deliver guarantees.

4.8.1. These approaches typically involve allocating between lower risk assets (cash or short-dated high-quality bond investments) and risky assets.

4.8.2. The allocation approach is usually based on an algorithm and may involve some or no discretion for the asset manager to deviate from the algorithm. The algorithms are typically built to replicate the outcome of having invested in risky assets + using put options.

4.8.3. A common approach to offer a capped down-side guarantee (e.g. an investment not falling below 80% of its highest value) is to use a particular algorithmic approach called Constant Proportion Portfolio Insurance (CPPI). Many variations of CPPI exist, both applied at the level of an investment fund or, more recently, to individual customer accounts (iCPPI).

4.9. There is no single optimal approach to deliver guarantees and the one selected by a provider will depend upon:

4.9.1. The nature of the provider – i.e. insurance companies arguably have a wider range of approaches available to them compared with non-insurers. This is because insurers can use their balance sheet to facilitate a degree of risk transfer or pooling (which requires an appropriate level of risk capital).

4.9.2. The features of the guarantee offered (e.g. spot vs. rolling guarantees).

4.9.3. The skills and expertise of the firm and people providing the guarantee (i.e. being willing and able to dynamically manage the 'hedge' required themselves, or wishing to 'outsource' this by using bespoke OTC derivatives from an investment bank).

4.9.4. The prevailing market conditions – i.e. the level and shape of the yield curve (i.e. short-term vs. long-term interest rates), levels and shape of implied future asset volatility and the nature of the underlying asset classes whose investment risk is to be hedged.

4.10. Guarantees are typically packaged up within an investment product and two common types of product typically available in the UK are: structured products and insurance-based investment products:

4.10.1. Structured products are typically offered by an investment or retail bank and involve the customer purchasing a product offering a return of capital plus exposure to an investment (e.g. the performance of the FTSE100 index). There are many variations of these products with different 'underlying' investments and some offer 'enhanced' exposure to investments (potentially by putting some capital at risk or by only receiving the 'price' return rather than 'total' return including dividends from an underlying investment).

4.10.2. Insurance-based investment products typically involve customers purchasing units in an underlying investment fund which holds a diversified range of assets. The guarantee may be offered on a 'standalone' basis (i.e. purchasing a 'spot' guarantee to return capital at a point in time, e.g. on a policy's 10-year anniversary) or on a rolling basis. With-profits policies are arguably the most well-known and long-established example of this type of product and they have been joined by 'smoothed' investment products in recent years (which share many characteristics).

4.10.3. We explore both of these types of product further in Section 6 when we consider why guarantees have fallen out of favour in the UK in recent years.

### *Delivering longevity-related guarantees*

4.11. The longevity-related elements of guarantees are typically delivered by pooling of insurance risk (e.g. in the form of traditional annuity style products), reinsurance or the use of derivatives (such as mortality / longevity swaps).

4.12. Please note that our work has been focused on investment guarantees, but we have considered mortality-related guarantees where relevant.

4.13. We see life annuities as an important product to meet the need of those customers who desire and are able to afford to mitigate mortality risk (given the relatively high costs of these products, i.e. the relatively low annuity rates being offered today). We explore the role of annuities in section 7, including the benefits of 'third-way' products which offer some features of annuities but also the flexibility of a non-guaranteed investment.

# 5. Why do people want and need guarantees?

5.1. We started our research with the key question of why people may *want* and *need* guarantees. One simple answer quickly emerges, i.e. people typically do not want to lose money. However, we identified nuanced answers depending on the nature of the guarantee and when further considering the differences between a *want* and a *need* in this context.

### *Types of guarantees*

5.2. We observed two common types of guarantees embedded in life insurance products:

5.2.1. Demographic related guarantees, e.g. a payment contingent on whether the policyholder is alive, dead or meetings certain definitions of ill-health.

5.2.2. Investment related guarantees, e.g. a promise that the value of an investment policy will be protected in some way and therefore not just directly related to the performance of the underlying investments.

5.3. We could characterise these two guarantees as:

5.3.1. Demographic insurance, i.e. insuring against the risk of some demographic related event, and

5.3.2. Investment insurance, insuring against the risk of investment related events.

5.4. We noted that the propensity for consumers to take out insurance is related to:

5.4.1. An individual's access to capital (sometimes referred to as their 'capacity for loss')

5.4.2. The cost of capital relative to the individual's perception of the likelihood and impact of the insured event.

5.5. We also noted that these two types of guarantees act to reduce different types of uncertainty for consumers:

5.5.1. Demographic insurance protects against the uncertainty in some health related factors and the costs associated with these factors, e.g. whether you meet a certain definition of ill-health (and the costs of living with this), or how long you might live (and the costs of doing so), or death (and the costs for those who survive you).

5.5.2. Investment insurance protects against the uncertainty in future investment returns, which impact the effectiveness of achieving the purpose for which a consumer invested in the first place, e.g. funding a future payment (e.g. paying for children's education) or funding day-to-day living costs (e.g. an income in retirement).

5.6. A common feature of guarantees and insurance is that they naturally come at a cost – i.e. different levels of guarantee remove more or less uncertainty with higher or lower costs respectively, such as:

5.6.1. High levels of demographic insurance can attract high premiums and opportunity costs from tying up capital today to protect from future risks

5.6.2. High levels of investment protection typically involve a high opportunity cost such as lower expected levels of returns (compared with lower or non-guaranteed investments).

## *Needing vs. wanting a guarantee*

5.7. 'Loss aversion' is a key concept defined in cognitive psychology and decision theory as: *a person's tendency to prefer to avoid losses compared to acquiring equivalent gains.*

5.8. It is closely related to the 'endowment effect' which describes how *people place a higher value on goods they own as compared to acquiring the same good*.

5.9. These concepts are commonly observed in people investing whereby they appear to value 'not losing money' to a much greater extent than 'acquiring more money'. This is illustrated in numerous retail investor risk profiling exercises and numerous research papers[9].

5.10. It is often assumed that consumers have specific goals in mind when saving for the future, and most financial planning activities allocate these into categories such as:

5.10.1. Aiming to generate an income in retirement – both through accumulation of assets pre-retirement and taking an income from these assets post retirement

- Asset accumulation – pre-retirement, and
- Income generation – post-retirement.

5.10.2. Aiming to fund a specific future 'life event', such as paying for children's education.

[9] For example, see 'Investor Risk Profiling: An Overview' published by the CFA Institute: https://www.cfainstitute.org/-/media/documents/article/rf-brief/rfbr-v1-n1-1-pdf.ashx

5.11. However, while these constructs may be useful when financial advisers undertake formal planning exercises, evidence suggests that in many cases consumers have indeterminate goals and may only be saving because they have excess funds[10].

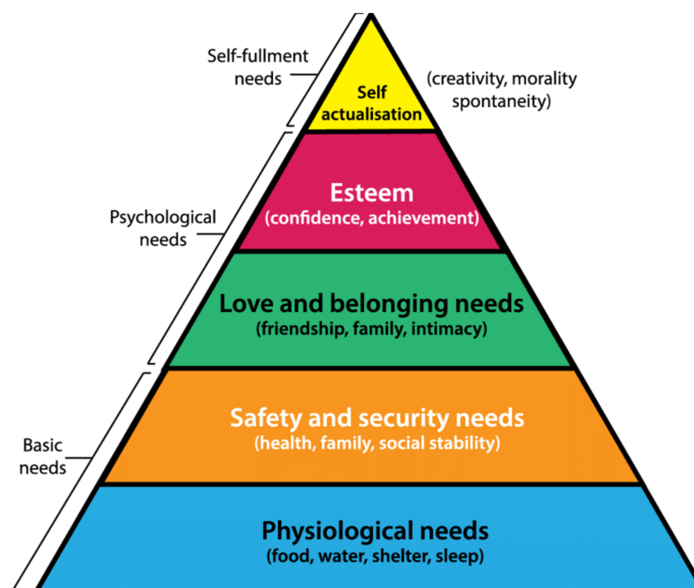
5.12. At the same time, levels of numeracy, financial literacy and understanding of risk are low in the UK population[11], meaning large parts of the population are not well equipped to deal with the risks they now face.

5.13. In this context, it is not surprising that many financial planning conversations may centre upon the emotional aspects of investment selection more than on technical considerations of asset-liability matching.

## *Hierarchy of needs and capacity for loss*

5.14. We observe that whether a consumer considers the funds they allocate towards a goal as a need or want will depend on a perception of the priority of this goal. One model for prioritising goals is the hierarchy of needs proposed by Maslow[12] and illustrated in the diagram below.

5.15. Where the dividing line between a 'priority' need vs. a want will depend on an individual's preferences for their money. For example, some may classify everything above 'basic needs' as a *want* vs. others who may classify everything below 'self-actualisation' as a *need*.




[10] This is based on anecdotal feedback from Working Party discussions with financial advisers over the past two decades which generally illustrate the role advisers play in helping client to formulate goals through the financial planning process and how clients rarely, if ever, have clearly defined goals when they start this process.

[11] This has been illustrated in numerous studies in recent years, including the 2019 Autumn Report from National Numeracy: https://www.nationalnumeracy.org.uk/sites/default/files/building_a_numerate_nation_report.pdf and the FCA's Financial Lives Survey 2017: https://www.fca.org.uk/publication/research/financial-lives-survey-2017.pdf

[12] Numerous references to such a hierarchy exist in Maslow's work and this recent article has a useful summary with references to Maslow's underlying academic papers: McLeod, S. A. (2020, March 20). Maslow's hierarchy of needs. Simply Psychology. https://www.simplypsychology.org/maslow.html

5.16. The question of whether a consumer will desire a guarantee on an investment of their money is closely related to this need vs. want classification, as well as their 'capacity for loss' and 'risk profile'.

5.17. The FCA define capacity for loss in the context of how they expect financial advisers to assess a customer's risk profile as: *'… the customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take'*[13].

5.18. We can generalise this definition by considering it to be a measure of how 'able' a customer is to bear the impact of a financial loss on their circumstances.

5.19. The FCA highlight the notion of capacity for loss in their guidance to advisers because they found evidence that some advisers were only focusing on a customer's risk profile, or willingness to take risk when selecting products for customers.

5.20. There are many established tools used to measure risk profile which generally relate to a customer's attitude to investing, often with a focus on the volatility of an investment and/or the likelihood of loss.

5.21. We now provide examples to illustrate how these concepts of needs vs. wants and ability (i.e. capacity for loss) vs. willingness to take risk (i.e. risk profile) influence whether a guarantee may be appropriate.

**Example 1:**
Consider two people who each require a nominal level of income in retirement of £25,000 a year for life:

- John, a 65-year-old with £500,000
- Fred, a 65-year-old with £2,500,000

5.22. John clearly[14] has fewer financial resources than Fred to withstand the risks to his goal of achieving £25k a year in income posed by volatility in investment returns and potentially living past his 80s (i.e. longevity risk).

5.22.1. i.e. John has a lower ability to take risk (i.e. capacity for loss) than Fred, and it may be appropriate for him to consider investment guarantees and/or demographic guarantees (such as purchasing an annuity) to help him achieve his goal.

5.22.2. However, this does not take into account John's willingness to take investment risk (i.e. his risk profile) and he could, arguably, choose not to adopt an investment approach with guarantees if he has a high tolerance for risk – i.e. he could choose to live with the consequences.

5.22.3. Even if John expressed a high willingness to take risk, it is unlikely that a financial adviser would advise him to take significant investment risk without further consideration of his capacity for loss (e.g. establishing that he has additional funds to call upon if the £500k pot was unexpected depleted).

[13] Finalised Guidance 11/15: Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection - https://www.fca.org.uk/publication/finalised-guidance/fsa-fg11-05.pdf
[14] Assuming all other things being equal.

5.23. Fred clearly[13] has more financial resources than John to withstand these same risks and would have a higher probability of achieving his goal.

5.23.1. Fred therefore has a higher ability to take risk and there is less of a clear case for him to consider guarantees.

5.23.2. However, Fred may have a very low willingness to take risk, i.e. a risk profile such that he would not tolerate volatility in the value of his investments or a loss in value, so he might choose to purchase a product offering investment and/or demographic guarantees (or an annuity).

5.23.3. It may be appropriate for a financial adviser to advise Fred to take out guaranteed products, but they would need to clearly explain the pros and cons of doing so, especially making the case for Fred understanding any opportunity costs (and charges) involved. This is especially important because of the fact that there is probably a high probability that Fred could achieve his goal without using a guaranteed product.

5.24. In practice, guaranteed products are likely to be of most objective value to consumers similar to John who:

5.24.1. Have limited financial resources and would benefit from guarantees which materially improve the likelihood of achieving their goal, and/or

5.24.2. Protect them from the negative impacts of failing to achieve their goal.

5.25. The ability of any guaranteed product to deliver this value depends on the trade-off between the guarantee features and the costs of these guarantees (both implicit and explicitly, for example in terms of opportunity costs). We consider these questions further in the sections below.

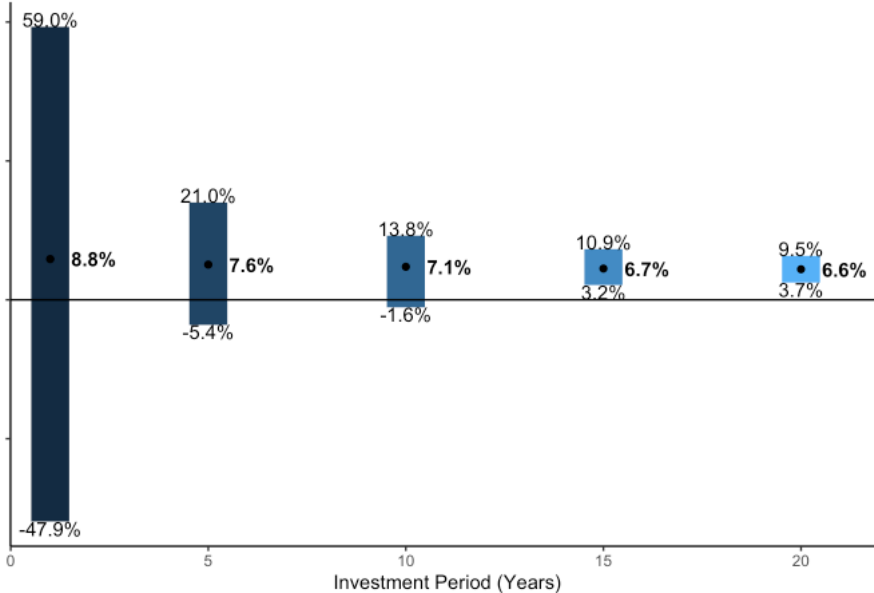
5.26. It is worth noting that timeframe is an important feature in considering whether an investment guarantee is a need vs. a want. The charts below illustrate how investment risk significantly reduces depending on the period for which the investments are held.

**Chart 1 and 2: Spread of returns from investing in global equities [15]:**

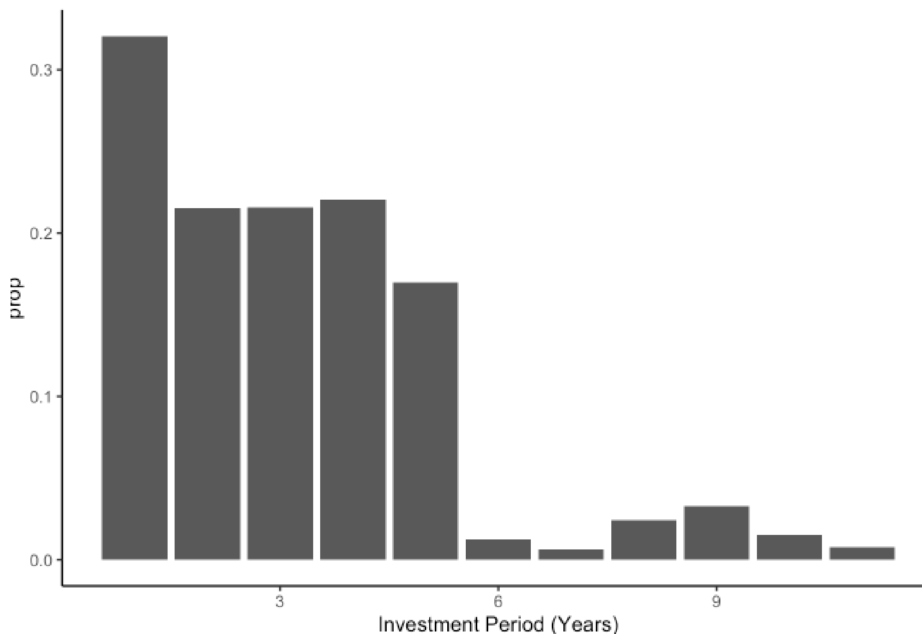
## Selected Periods

This helps focus on the minimum and maximum returns. The minimum may be the focus for retail investors. The dots near the centre indicate the average results.

Dispersion of ACWI annual returns for selected periods




Proportion of observations resulting in an annual return less than zero

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[15] The MSCI ACWI Index, is a global equity index, is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 26 emerging markets. As of December 2019, it covers more than 3,000 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is built using MSCI's Global Investable Market Index (GIMI) methodology, which is designed to take into account variations reflecting conditions across regions, market cap sizes, sectors, style segments and combinations.

The data used comprises of month end index values ranging from 1987-12-31 to 2020-06-30. Returns have been calculated for all overlapping month-end to month-end periods for investments periods ranging from 1 to 20 years.

5.27. The risks of investing may appear very high when viewed over a one-year time horizon with the magnitude of falls experienced in a single year of up to -48% (based on the past c. 30 years). However, this quickly falls to a maximum fall of -5% over 5 years and -2% over 10 years. Investors with a time horizon above 15 years would not have seen a fall in their initial investment over this period[16].

5.28. It is clear that as the holding period increases then the volatility of outcomes narrows. So, while for 1 Year periods there is a variation of c. 107% between the best and worst return, for 20 year periods there is only a c. 6% pa. variation.

5.29. While the above data suggests that guarantees are likely to be of most value for lump-sum investments for 10 - 15 years or less, they do indicate the impact of short-term returns on consumers drawing an income from their investments.

5.30. This concept of 'pound-cost-ravaging' (or sequencing risk) is well understood in the UK retirement savings industry with numerous tools and techniques available to professional advisers and consumers taking their advice to dynamically manage their investments in retirement[17].

5.31. Where a gap remains in the market today, is in providing products for less affluent customers who may not be regularly benefiting from regulated financial advice. The next section explores why products offering guarantees to these types of clients have disappeared from the UK market.

# 6. Why have guarantees fallen out of favour in the UK market?

## *Changes to the UK intermediary market*

6.1. The Retail Distribution Review (RDR), implemented in 2013, significantly reformed how products were sold in the retail investment market[18]. Pre-RDR, the cost of advice was paid for via commission from product providers and appeared 'free' to many customers using financial advisors.

6.2. A key aspect of the reforms was the banning of commission payments from providers on new business, replaced by a requirement for advisors to charge an explicit fee to their customers for advice.

[16] Of course past performance is not a guide to future performance and this backwards looking analysis is only provided for illustrative purposes. This also only consider nominal, rather than real (i.e. inflation-adjusted) returns. Many forward-looking models are available which consider a wider range of outcomes and naturally individual examples of worse outcomes could be identified.

[17] For example, see this paper for a helpful explanation of the concept of sequencing risk with illustrations of the impact on customer savings and sustainability of income: https://finalytiq.co.uk/wp-content/uploads/2015/02/Pound-Cost-Ravaging.Final-copy.pdf

[18] See here for the background to the RDR and a more recent related initiative called the Financial Advice Market Review (FAMR): https://www.fca.org.uk/publications/calls-input/evaluation-rdr-famr

6.3. Another key change was the classification of advisors into independent ('considering products from all firms across the market, and... giving unbiased and unrestricted advice') or restricted (can only recommend certain products, product providers, or both)[19].

6.4. These changes have impacted the sale of products with long-term guarantees in a number of ways:

6.4.1. Arguably the removal of commission has made it less attractive for advisors to sell products with guarantees. Such products are inherently more complex and difficult for customers to understand, and advisors may not be able to attract higher fees than for more straightforward products, whereas pre-RDR commission was likely to have been higher.

6.4.2. The division of advisors into independent/restricted has also reduced the number of advisors able to offer advice across a full range of products, with more complex offerings like structured products and with-profits business less likely to be included in a 'restricted' offering.

6.4.3. Post-RDR it is harder for investors with smaller investment pots to access advice, with a widening 'advice gap' observed in the retail investment market. A 2012 report by Allianz Global Investors found of 166 financial advisers surveyed, 66% claimed it would not be profitable to service clients with less than £50,000 in liquid assets post-RDR. Further research from Schroders in 2017, 4 years post implementation found that half of 250 advisors surveyed had an exclusion point of £50,000[20].

6.5. While guarantees may be more attractive to investors with smaller pots, accessing complex products is much less likely without professional advice. The Phase 3 report of the IFoA Value of with-profits to consumers Working Party[21] found that the most common reason customers included in their survey chose a with-profits policy was influence from a professional adviser and we might expect the advice gap to lead fewer sales of such complex products, despite the provision of valuable guarantees.

6.6. The RDR reforms also led to major reductions in tied-salesforces of banks and insurance companies, in anticipation of customers not being prepared to pay for this advice at a sustainable level. For example, in 2011 HSBC scrapped its tied advice service, while Standard Life, Aegon and Friends Life said they would either reduce their direct salesforces or launch online and telephone services as alternatives. Again. this has created a barrier for customers with smaller investment pots, who would value guarantees and may be more likely to purchase such products from their existing bank/insurance provider than independently.

6.7. Pensions Freedom, which came into effect from 6 April 2015, brought a further shift in the UK market, with customers able to access up to 100% of their pension savings from age 55 and removing the requirement to turn savings into an income by age 75. Customers can now choose cash or flexible drawdown alongside or instead of traditional annuity options which provide a guaranteed income for life. An FT Advisor article from 12 April 2018 noted that before pension freedom, annuity sales were running at about 350,000 a year, whereas

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[19] For more see here: https://www.fca.org.uk/consumers/types-investment-adviser

[20] References: https://www.moneymarketing.co.uk/news/advisers-asking-low-value-clients-leave-firm/ and https://www.moneymarketing.co.uk/news/advisers-asking-low-value-clients-leave-firm/

[21] See https://www.actuaries.org.uk/system/files/field/document/VOWP%20-%20Phase%203%20summary%20FINAL.PDF (question 7)

by 2019 they stood at around 80,000 a year[22]. Interestingly, the FCA's interim report from their Retirement Outcomes Review found that the proportion of drawdown bought without advice has risen to 30%, from 5% pre-pensions freedoms to 30% now, despite being an inherently risky product for customers[23].

### *Declining sales of with-profits business*

6.8. The key features of with-profits products – an opportunity to participate in a pooled investment portfolio with smoothed returns and a guaranteed underpin – address many of the customer demands for long-term guarantees identified in Section 5. In the early 1990's with-profits business accounted for around a third of all new business premiums in the UK life insurance market, but sales have fallen considerably since the turn of the century, with noticeably lower new premiums from the early 2000's[24].

6.9. The falling sales in the 21st century coincide with a string of high-profile scandals which tarnished the reputation of with-profits business. Key examples include the well documented closure to new business of Equitable Life in December 2000, following an unsuccessful legal battle over cuts to Guaranteed Annuity Rates which were no longer affordable, and heavy criticism of the advice provided at the time of sale for mortgage endowments.

6.10. A 2008 report by David Severn notes that as at July 2007 over 1.8 million endowment complaints had been made to the Financial Ombudsman Service, with compensation in excess of £2.7 billion paid out to customers[25]. As noted in the Phase 1 report of the IFoA Value of with-profits to consumers Working Party[26], with-profits business has also suffered from criticism in the press in more recent years (Section 2.3) 'with practices and performance scrutinised for fairness and value for money'.

6.11. The weakened financial position of many with-profits providers, resulting from onerous guarantees written under radically different economic circumstances to those experienced since the dot com crash of the early 2000's, has pushed many funds to hold a much lower proportion of equities than was the case when products were initially written. While this reduces capital requirements, it also reduces customer exposure to up-side returns and has contributed to the reputation of with-profits funds as failing to achieve the returns which were suggested at the time policies were first written.

6.12. However, the Phase 1 report of the IFoA Value of with-profits to consumers Working Party[24] found that the performance of with-profits has been comparable to Unit Linked products and the FTSE All Share, with additional security offered by guarantees. However, the report also acknowledges that performance in terms of payouts is very variable and highly dependent upon the with-profits fund chosen.

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[22] https://www.ftadviser.com/pension-freedom/2018/04/12/state-of-the-annuity-market-3-years-after-armageddon/?page=1

[23] https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf

[24] https://www.nottingham.ac.uk/business/businesscentres/gcbfi/documents/cris-reports/cris-paper-2009-3a.pdf

[25] https://www.financial-ombudsman.org.uk/files/17744/DavidSevernReport.pdf

[26] https://www.actuaries.org.uk/system/files/field/document/Phase%201%20Report%20-%20peer%20reviewed%20-%20final%20update1.pdf

6.13. A key challenge in selling with-profits business is the lack of transparency, with complex product designs and charging structures leaving the products difficult to understand without professional advice. In recent years sales of products like PruFund[27], which invests in the Prudential With-Profits Fund and provides smoothed returns but without a guaranteed underpin, have overtaken traditional with-profits sales.

6.14. So-called 'smoothed' funds have been very popular in recent years. These funds aim to dampen some of the volatility of investing (especially in equity markets) through techniques ranging from with-profits style strategies to 'volatility-control' strategies (which use dynamic asset allocation approaches as described in Section 4 above). A number of providers have entered the UK market in recent years aiming to meet customer demand for this type of product and to challenge the dominance of the PruFund (notably Aviva and LV=)[25].

6.15. These products are typically only available through financial advisers and some also offer 'spot' guarantees as an optional extra (see Section 4 for a definition of spot vs. 'rolling' guarantees). Anecdotal feedback from providers and industry experts suggests these guarantees are rarely taken up nowadays, which could be explained by a number of factors including:

6.15.1. Relatively high costs of the guarantees – for example: a spot guarantee of a return of capital after 10 years can be 1.0 to 1.5% p.a. over and above the annual charges for the underlying investment fund and product 'wrapper', which could be 1.0-1.2% p.a. without these guarantee charges[28] (i.e. total charges could be above 2.0% p.a. with guarantees, which arguably limits the potential for net of charges growth given current and expected asset growth rates, especially for lower risk investments),

6.15.2. Relatively limited availability of guarantees – they are typically only offered as spot guarantees for longer periods of time (8 – 10 years) and may not be useful for customer wanting to protect against shorter-term volatility (such as 1-year volatility as illustrated in Chart 1 above in Section 5) or wanting ongoing protection (for example if drawing-down a pension and wanting to protect against sequencing risk as also explored in Section 5),

6.15.3. Customers who may want and need guarantees not taking financial advice (due to the impact of the RDR, as explained above).

### *Structured products impacted by bankruptcies, mis-selling and value-for-money*

6.16. Structured products were a very common product available through banks (and some insurance companies) in the UK from the early 1990s and by 2009 were estimated to have attracted £10bn of investor money[29]. A key attraction to customers was the perceived simplicity of these products typically offering at least a return of capital and the chance to

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[27] References: https://www.pruadviser.co.uk/funds/prufund/, https://connect.avivab2b.co.uk/adviser/aviva-platform-and-investments/smooth-managed-fund/ and https://www.lv.com/adviser/smoothed-investments

[28] Illustrative charges taken from LV= Smoothed Managed Fund range literature, accessed Dec 2020, https://www.lv.com/lifeassets/assets/documents/smoothed-managed-fund-range-details-of-charges.pdf

[29] http://ig-legacy.ft.com/content/da923670-abfc-11e2-a063-00144feabdc0#axzz6EEFcKkgo

participate in the 'up-side' of investment markets (often offering more than 100% of the return of the price return of the FTSE100 index, say).

6.17. The nature of these products is that they effectively comprise a bond issued by a bank + a 'call' option on the underlying investment (e.g. the FTSE100 index). In the early years of their development, the credit risk of the bond issuer was rarely made clear to customers (i.e. the risk of the bond issuer failing to pay some or all of the capital back). Even when regulation required more clear disclosure of credit risk, it is debatable whether consumers ever paid much attention to it.

6.18. Market confidence in structured products was damaged by the collapse of Lehman Brothers in 2008, which had acted as the underlying bond issuer to a large number of structure product sold in the UK. 5,500 investors were believed to have lost almost £110m in products that were sold as guaranteed not to lose their initial investment following the collapse[30].

6.19. Several firms that sold structured products backed by Lehman's subsequently failed, most notably Arc Capital and Income, who had 250 customers with £5.75m invested in the one of the firm's three Lehman-backed products[31]. Customer confidence was further damaged by the FSA's closure of Keydata in 2009, initially over failure to pay a tax bill but with the subsequent discovery that policies invested with a Luxembourg firm called SLS had their underlying investments sold and proceeds stolen.

6.20. In parallel with these credit risk-related issues, the design of structured products evolved over the 2000s and 2010s to include more complex structures with a range of 'pay-off' profiles and underlying investments. Some of these offered higher potential returns by not only buying call options, but also selling 'put' options, by which customers' funds were at risk if the market fell below 60% say, of its current value.

6.21. These Structured Capital At Risk Products (or SCARPs) presented a significant risk of mis-selling, especially as they were often sold through the same channels as the '100% capital protected' products to the same types of (risk averse and relatively inexperienced) customers by the same sales people in banks. Prior to the RDR, there were also high commissions paid on some of these products, further creating potential incentives for mis-selling.

6.22. Prompted by these mis-selling issues and the Lehman issues, the FCA undertook a thematic review of structured products product development and governance in 2012 and 2015[32]. Their work concluded that firms' senior management must do more to put customers at the forefront of their approach to product governance. This included requiring that firms:

6.22.1. Identifying a clear target market to inform product development and distribution strategy.

6.22.2. Ensuring that structured products have a reasonable prospect of delivering economic value to customers in the target market (using robust stress testing as part

[30] https://www.thisismoney.co.uk/money/investing/article-1682164/FSA-warns-on-mis-sold-structured-products.html

[31] https://www.ft.com/content/1e433af4-c27c-11de-be3a-00144feab49a

[32] https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf and https://www.fca.org.uk/publications/thematic-reviews/tr15-2-structured-products-thematic-review-product-development-and

of product approval and not manufacturing or distributing products failing value-for-money assessments).

6.22.3. Providing customers with clear[33] and balanced information on each product and any risks (especially explaining the likelihood of potential investment returns and any risk to the customer's capital).

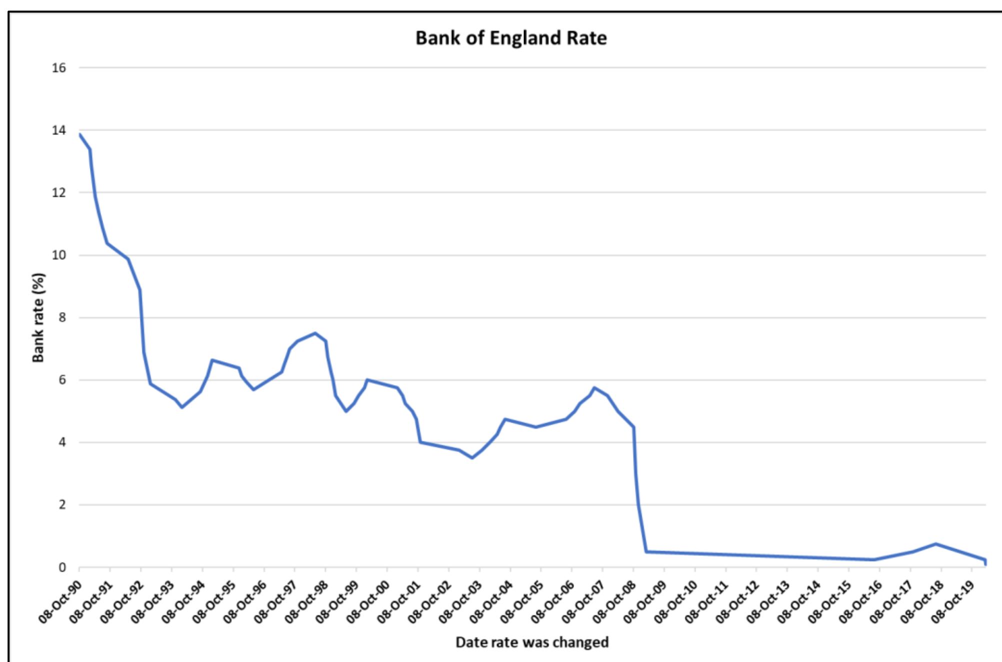
6.22.4. Strengthening the monitoring of their products (including ensuring that distributors have enough information about the product to sell it appropriately and checking that each product is being distributed to its target market).

6.22.5. Applying effective product governance to ensure customers are treated fairly (including best execution where relevant) throughout the lifecycle of a structured product.

6.23. Value-for-money for structured products, and all guarantees, also naturally depends strongly on interest rates prevailing at that time. This is because the bond element is effectively a zero-coupon bond and it is 'cheaper' the higher interest rates are. The difference is stark as illustrated by a guarantee of a return of £100 capital in 5 years 'costing' c. £80 at a 5% discount rate vs. £97.50 at a 0.5% discount rate.

6.24. The difference between the cost of the guarantee and the customer's initial capital (i.e. £100 less the cost) is the amount available to purchase an option to obtain up-side exposure, and to pay the product charges. Clearly a lot more is possible at the 5% vs. 0.5% levels, and this is one key reason why structured products were more popular in the 90s and early 2000's – see Chart 3 and Chart 4 below for context.

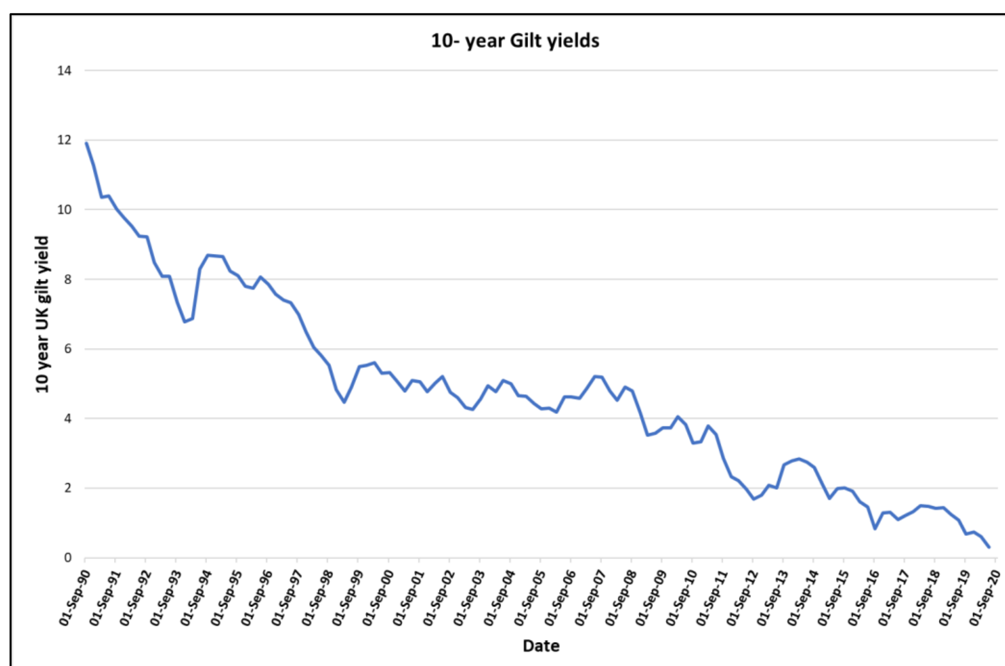
**Chart 3[34]**




[33] This includes clarifying differences between different types of products including structured deposits which may benefit from the Financial Services Compensation Scheme (FSCS) protection, and are therefore 'guaranteed' against credit risk, vs. structured investment products which typically would not be covered by the FSCS. After this point, most products used the term 'protected' with various caveats rather than the blanket term 'guaranteed'.

[34] Source: https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp

**Chart 4**[35]




6.25. Clearly current interest rates in the short and medium term (e.g. 10-year gilt yields) mean guarantees are at the most expensive they have been in decades. Typically providers seek to offset this cost (and to make these products have more attractive 'headline' potential returns) by obtaining the 'bond' element from lower credit-rated issuers (i.e. with higher yields on their bonds, reflecting higher credit risk) or by putting capital at risk (e.g. selling put options while also purchasing call options). They may also use features such as 'auto-calls' which involve paying out early in the event of certain market triggers.

6.25.1. There are few 100% capital protected structured products available in the UK nowadays and where they are available, there tends to be considerable credit risk involved if the product is to provide any material exposure to an underlying investment[36].

6.25.2. Structured products with capital at risk are typically available but are not typically suited to the type of customer we are focused upon (as explained in Section 5). These types of products are more suited to more experienced customers, including some institutional-style wealth management firms who may incorporate them into portfolios for clients.

*Increasing regulation and scrutiny by regulators*

6.26. There has been an increasing amount of regulation and regulatory attention applied to retail investment products in the UK over the past 20 years, and especially to guaranteed products. This regulation covers both the 'conduct' of providers (how guaranteed products

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[35] Source: https://datahub.io/core/bond-yields-uk-10y#data

[36] Please note that we have not considered the various permutations of structured products and the differences between those linked to price indices (e.g. the FTSE100 Price index) and total return indices (e.g. the FTSE100 TR index). There are many subtle differences between structured products and a comprehensive analysis of their features and suitable for a wide range of customers is beyond the scope of the research of our Working Party.

are manufactured, distributed and managed) and providers' solvency (i.e. prudential regulation).

6.27. A key development in conduct regulation was the UK regulator's Treating Customers Fairly (TCF) initiative, first introduced by the Financial Services Authority (FSA) in 2006. This was the first in a series of initiatives highly focused on 'customer outcomes' and judging firms' actions (including the products they created and sold) by these outcomes, rather than just compliance with the letter of regulations. A key example of this was the FSA's 2012 work on retail product development and governance which focused on structured products (see paragraph 6.22 and reference 30 above for more detail).

6.28. This focus on TCF was continued by the Financial Conduct Authority (FCA) which took over the conduct-related activities of the FSA in April 2013, including being incorporated into the thinking behind the Retail Distribution Review (RDR), covered above. This included considering what types of investment products may be suited to distribution without a personal recommendation or with simplified advice (rather than 'full' regulated advice which involves a personal recommendation)[37].

6.29. The FCA also provided further clarity in their work on 'Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development'[38], which included guidance on how the nature of the advice model employed needs to take into account the complexity of the product solutions available to advisers.

6.29.1. While guaranteed products were not explicitly covered in this guidance, it is reasonable to infer that they fall into the category of products which are most suited to advised distribution (rather than 'execution-only' distribution where customers make their own selection). This is due to the complexities involved in the products and the need to ensure that customers understand the benefits and opportunity costs involved.

6.30. The FCA also generalised much of their work on Structured Products in 2012 and 2015 into explicit product governance requirements, some of which also reflect the UK adoption of relevant elements of the EU's Insurance Distribution Directive and MiFID requirements for product governance. The following excerpt from the introduction to the FCA's PROD handbook[39] explain the goals of this regulation clearly:

6.30.1. The purpose of PROD is to improve firms' product oversight and governance processes and to set out the FCA's statement of policy on making temporary product intervention rules.

6.30.2. Product oversight and governance refers to the systems and controls firms have in place to design, approve, market and manage products throughout the products' lifecycle to ensure they meet legal and regulatory requirements.

6.30.3. Good product governance should result in products that: (1) meet the needs of one or more identifiable target markets; (2) are sold to clients in the target markets by appropriate distribution channels; and (3) deliver appropriate client outcomes.

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[37] https://www.fca.org.uk/publication/thematic-reviews/tr14-10.pdf

[38] https://www.fca.org.uk/publications/guidance-consultations/gc14-3-retail-investment-advice-clarifying-boundaries-and

[39] https://www.handbook.fca.org.uk/handbook/PROD.pdf

6.31. Products providing value-for-money (or fair value outcomes for customers) is a common theme to much of this conduct regulation in recent years. It is a concept which we have seen applied to workplace pension schemes since 2015[40] and to authorised investment funds since 2020[41].

6.32. With-profits business has also come under regulatory scrutiny, with the 2010 with-profits regime review leading to changes to the rulebook under PS 12/14 'Protecting with-profit policyholders'[42] followed up by a thematic review over 2018/19 with findings published in April 2019, TR19/03 'Fair treatment of with-profits customers'[43]. While the more recent review did not lead to updates to the Conduct of Business Sourcebook, it expanded the interpretation of the existing requirement, particularly around run-off plans for closed funds.

6.33. As well as mounting UK regulation, under the European Packaged Retail and Insurance-based Investment Products (PRIIPs) requirements, which came into force in January 2018, anyone who advises or sells a PRIIP to a retail investor must provide them with a Key Information Document (KID) before any transaction is concluded. This makes the costs and charges associated with guaranteed products much clearer to customers as well as providing explicit projections of what outcomes (i.e. returns net of these charges) customers may achieve in a range of scenarios.

6.33.1. This increased transparency of charges and potential returns (and opportunity costs) has made the focus on value-for-money much more central to the development and distribution of guaranteed products.

6.34. The most significant change to prudential regulation impacting guarantees was Solvency II (SII) which was implemented in Jan 2016. SII is a European Directive designed to introduce harmonised prudential framework for insurance firms in the EU. It is based on the risk profile of each individual insurance company and aims to promote comparability, transparency and competitiveness. It was designed to address issues in the previous Solvency I framework which arguably did not reflect the risks in each individual firm, did not support intervention by supervisors (when appropriate) nor allocate capital optimally. The SII framework comprises three 'pillars':

6.34.1. Pillar 1 sets out quantitative requirements, including the rules to value assets and liabilities (in particular, technical provisions), to calculate capital requirements and to identify eligible own funds to cover those requirements.

6.34.2. Pillar 2 sets out requirements for risk management, governance, as well as the details of the supervisory process with competent authorities; this will ensure that the regulatory framework is combined with each undertaking's own risk-management system and informs business decisions.

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[40] See here for the latest update from the FCA on this: https://www.fca.org.uk/publications/consultation-papers/cp20-9-driving-value-money-pensions

[41] The relevant regulations are covered in the FCA's 2018 asset management market study policy statement and firms first needed to comply with this in 2020: https://www.fca.org.uk/publications/policy-statements/ps18-8-implementing-asset-management-market-study-remedies

[42] https://www.fca.org.uk/publication/policy/fsa-ps12-04.pdf

[43] https://www.fca.org.uk/publication/thematic-reviews/tr19-03.pdf

6.34.3. Pillar 3 addresses transparency, reporting to supervisory authorities and disclosure to the public, thereby enhancing market discipline and increasing comparability, leading to more competition.

6.35. The biggest impact of SII on guarantees provided by UK insurers is in the Pillar 1 capital requirements. For businesses offering long-term guarantees, the original SII basis produced outcomes that were unacceptable to member states, so a package of measures covering long-term guarantees was introduced in the final regulation.

6.35.1. The contentious issues relate to the requirement to apply market consistency to both assets and liabilities which some argued could create unintended impact upon financial stability and other questions being relevant to long-term guaranteed business.

6.35.2. Solutions to address these issues were put together into the 'Long-Term Guarantees (LTG) package' within SII, with the aim to eliminate 'artificial' volatility from the balance sheet of insurers. The package includes things like the: Ultimate Forward Rate (UFR), Matching Adjustment (MA), Volatility Adjustment (VA) and transitional measures. For more about the efficacy of these measures see: 'A review of Solvency II – has it met its objectives?' (2017) by the IFoA Retrospective on Solvency II Working Party[44].

6.36. While these measures within SII are helpful for some types of guarantees, e.g. the Matching Adjustment is helpful for writing annuity business, they cause issues and relatively high capital requirements for other types of guarantees, including the types described in Section 5 above.

6.37. We also note that the likely high capital requirements of offering guarantees naturally reduces the level of earnings which could be made available as dividends to shareholders in life insurance companies with external shareholders. This issue is exacerbated in the current low interest rate environment and has been illustrated by a number of UK insurers existing the market[45].

6.37.1. We therefore observe that a mutual insurance company may be better placed to offer guarantees due to absence of a return on equity requirement adding to the costs of the guarantee design (and therefore increasing the chance of a product offering value-for-money to a consumer). This is illustrated by a number of smaller friendly societies in the UK continuing to offer guarantees to new customers.[46]

6.38. Having considered all the above factors contributing to the decline of guarantees, we now turn our attention to what could be done to help develop the market for these products in the UK.

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[44] https://www.actuaries.org.uk/sites/default/files/Solvency%20II%20-%20has%20it%20met%20its%20objectives.pdf

[45] For example, Metlife's exit from offering unit-linked guarantees in 2017: https://www.moneymarketing.co.uk/news/metlife-uk-closes-new-wealth-management-business/

[46] For example, Healthy Investments offers an ISA investing in their with profit fund with a capital guarantee (as at Jan 2021): https://www.healthyinvestment.co.uk/products/isa/

# 7. What would be needed to help make these products viable going forward?

7.1. We believe that there should be a viable market for guaranteed products to meet the needs of a particular customer segment not being well served today. We appreciate that meeting demand alone is not sufficient to create such a market, so we also consider what measures would help encourage supply of guaranteed products by providers.

7.2. We think this is an important issue for us as individual actuaries and for the IFoA, given our public interest responsibilities as a royal chartered professional body.

7.3. The customer segments we think would benefit from these products includes those who:

7.3.1. Are near or in retirement with relatively limited amounts to invest over and above what they might hold in ‘emergency cash’ (i.e. readily available cash savings). In particular, we think there is a gap in the market where customers with £20 to £100k in ‘investable assets’ are not well served by financial advisers (who either are not interested in serving these ‘lower value’ clients or where current advice fees are disproportionately high relative to the sums to be invested).

7.3.2. Are relatively inexperienced and who would appreciate a product which delivers simple and clear outcomes (such as guarantees), even if there is complexity involved in how these outcomes are delivered.

7.3.3. Have relatively low tolerance for risk (willingness to take investment risk) and relatively low capacity for loss (ability to bear investment risk or to replace a short-term loss in capital or income).

7.3.4. Need to maintain the purchasing power of their income, i.e. ideally are able to take an income stream from their investments which is linked to inflation. This is related to these customers’ limited capacity for loss, i.e. they would be impacted by increases in inflation more significantly than customers with additional assets (and/or additional income streams) who could draw upon these if their living costs increase.

7.3.5. Are relying on the UK state pension for a significant part of their income in retirement, but for whom this would be insufficient to maintain the standard of living they aspire to in retirement.

### *Annuities, investments or a ‘third-way’?*

7.4. The product which naturally comes to mind for the type of customer described above is an inflation-linked lifetime annuity.

7.5. However, these products have typically proved very unpopular due to the fact that they provide a relatively low initial income compared with a conventional, or level, annuity. This is due to both the current low yield environment and the uncertain long-term inflation environment.

7.6. This results in relatively poor value to customers who choose to use inflation-linked lifetime annuities, driven by the unattractive pricing of these products by insurance companies (which in turn reflects the relatively high capital requirements imposed by Solvency II for this type of business, as well as a lack of competition in the market for these products).

7.7. Therefore, a ‘full transfer’ of the investment, inflation and mortality risk to an insurer for the type of customers outlined above is unlikely to be an optimal decision.

7.8. Guaranteed products can offer a 'third-way' between investments products with no protection and annuity products. They can offer customers a way to maintain some long-term inflation exposures through investing in 'real' assets such as equities, while providing a level of protection against the 'downside' risks. We describe the various types of guarantees in Section 4.

7.9. We have chosen to focus on life insurance-based guaranteed products because of the flexibility which they offer to provide both investment exposure and longevity risk management features for customers. We also believe that a diversified portfolio of underlying investments is most appropriate for the type of customers described above.

7.10. While structured products are attractive to some more experienced customers, we believe that they may not be best suited to the type of customers outlined above. Reasons include customers potentially not appreciating the undiversified credit risk posed by the underlying issuer of the product.

7.10.1. Please note that the techniques involved in created structured products are typically incorporated into the design and management of insurance-based guaranteed products. These include using bond investments to target future cashflows and using options to obtain exposure to or protection from specific investment markets.

7.11. We now expand upon our ideas for what could be done to create a viable market for guaranteed products.

7.12. These proposals are relatively high level at this stage and we suggest that further work could be done on these, either by an IFoA working group, or by the IFoA policy team (if there is support for doing so, perhaps as part of the Great Risk Transfer initiative).

### *Understanding, education and promotion*

7.13. Our research has highlighted that there is considerable variety in consumer and adviser knowledge and understanding of guaranteed products.

7.13.1. This includes consumers not necessarily understanding the benefits and limitations (including opportunity costs) of these products, especially compared with cash or 'non-guaranteed' investment products.

7.13.2. While some advisers are familiar with these products, many have limited experience of them or negative associations with particular historical products (some of which may have offered poor value-for-money).

7.14. We believe a key solution to this is to create more independent and actuarially robust education about the benefits and limitations of guaranteed products.

7.14.1. This includes a focus on how these products can be used in retirement to help secure a minimum level of retirement income at a time when it is most needed (i.e. including addressing sequencing and longevity risks).

7.15. The complexity of guaranteed products is often cited as a reason for the not being suited to retail consumers. We considered this assertion in great depth within our Working Group and concluded that this argument conflates the nature of the product - 'what' it delivers to a consumer – with 'how' it delivers it.

7.15.1. We believe that consumers could understand the nature of a guarantee well enough to make use of it in an investment strategy to achieve their goals, especially if receiving financial advice. This understanding should include enough of an understanding of the pros and cons of the guarantee to make an informed decision but does not necessitate

the consumer understanding the mechanics of the underlying investments or options utilised.

7.15.2. We compare this to consumers using a wide range of things on a daily basis ranging from cars to smartphones. It is unlikely that many consumers understand the detailed 'how' behind these items, but that does not impede their ability to use them to achieve their goals.

7.15.3. We would also assert that other common products ranging from individual equity (i.e. shares in companies) to investment funds (following a wide range of investment strategies) are arguably no less complex than a guaranteed product, but they benefit from being much more ubiquitous and arguably more widely understood (although some would debate this).

7.16. Closely related to this, is our strong believe that there is a need for balanced promotion of the features of guaranteed products.

7.16.1. This involves promotions which clearly and transparently highlight how the benefits of guarantees come at explicit and implicit costs.

7.16.2. This should include illustrations of how reductions in risk are typically balanced by reductions in potential returns (relative to non-guaranteed products).

7.17. We think this is especially important when it comes to the financial planning models used by advisers and/or made available to consumers directly on various websites. Some of these tools guide users to consider how long their pot of investments will last in drawdown with a reference point of an average expected lifetime of, say, 85 years in the UK.

7.17.1. We believe that models which better demonstrate a range of 'what-if' scenarios would be more helpful and effective. For example, even just illustrating the impact of living to age 100 could highlight the benefit of appropriate guaranteed products (especially lifetime or deferred annuities).

7.18. Similarly, there are still many tools in the market which use deterministic assumptions for the returns from individual asset classes or portfolios of investments. While these tools may be useful and easy to understand, they do not demonstrate many key aspects of investment risk, especially the 'path-dependency' which causes 'pound-cost ravaging' or sequencing risk (as explained above in Section 5). They may also fail to capture inflation risk and the link between real asset returns and inflation.

7.18.1. We believe that tools which reflect investment risk more precisely, such as those using an Economic Scenario Generator (or stochastic modelling) are better placed to inform decisions about whether a guaranteed product may be appropriate for a customer's circumstances (and especially taking into account their risk tolerance and capacity for loss).

7.18.2. These tools also lend themselves to a comprehensive 'fair value assessment' of guarantees as they allow for an exploration of the value-for-money of guaranteed products vs. the alternatives of unprotected investments and annuities. There is unlikely to be a right answer for every customer and these tools can facilitate analysis of which may be optimal for an individual.

7.18.3. Another key benefit of these tools is that they can help facilitate improved customer understanding of risk. Recent research by the IFoA's Customer Journey Working Group confirmed this and suggested ideas to improve the situation for consumers[47].

7.18.4. Simply put, these types of stochastic modelling tools allow for quantification of the benefits, explicit costs and implicit opportunity costs of using guaranteed products. This informs a much more nuanced discussion than the often reached conclusion that 'they are expensive'.

7.19. We believe that there is an important role for the IFoA and actuaries to help set standards and best practices when it comes to the type of modelling outlined above. We note that the IFoA's Modelling Innovative Pre and Post Retirement Products Working Party has been focusing on this and plans to publish further output in 2021[48].

7.20. We also note that the PRIIPs (Packaged Retail and Insurance-based Investment Products) regulations[49] have arguably significantly improved transparency in mandatory disclosure documents for guaranteed products. PRIIPs requires the production of a Key Information Document (KID) which sets out information about the nature of a product including an indication of potential future performance and all the costs involved.

7.20.1. The potential future performance must be presented under four 'performance scenarios' representing a stress scenario, an unfavourable scenario, a moderate scenario and a favourable scenario. This is particularly helpful to demonstrate the benefits and opportunity costs of guaranteed products (and does need to take into account credit risk).

7.20.2. The costs section has driven much greater transparency than has ever been seen before in guaranteed products, especially structured products. This is because many product structures use implicit rather than explicit charging structures and historically have evaded disclosure of all charges by hiding some of these out of sight. The PRIIPs methodology uses a 'reduction in yield' approach which makes these much more transparent.

7.20.3. It is worth noting that the design of the PRIIPs disclosures took into account guaranteed products and was informed by empirical consumer research, especially as to what type of presentation of performance scenarios was likely to lead to the greater degree of consumer understanding[50].

7.21. However, one significant shortcoming of the PRIIPS framework is its heavy reliance upon historical investment returns. This can introduce a historical bias into the metrics provided to consumers. One way to mitigate this is for financial planners advising consumers to include forward-looking projections of returns in their analysis and dialogue with clients. This type of analysis, ideally undertaken on a stochastic basis, can help illustrate a wider range of outcomes to provide a balanced discussion about risk (and the potential value of guarantees).

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[47] See here for more and note this working group's innovative use of a video to communicate their findings: https://www.youtube.com/watch?v=80Zlkf1Xon4&feature=youtu.be

[48] See here for more: https://www.actuaries.org.uk/practice-areas/life/research-working-parties/modelling-pre-and-post-retirement-savings-products

[49] https://www.fca.org.uk/firms/priips-disclosure-key-information-documents

[50] See 'Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance based investment products' for more: https://londoneconomics.co.uk/wp-content/uploads/2015/11/Final-report.pdf

### *Developing skills and transferring experience*

7.22. The relatively limited range of guaranteed products currently available in the UK (and the absence of research and development in this space) has resulted in very limited manufacturing expertise in the industry.

7.23. Today there are relatively few practicing actuaries (and other financial services professionals) who have comprehensive experience in creating and managing guaranteed products. Where this expertise exists, it is often found in legacy providers who are managing 'back-books' of products which are 'running-off', rather than developing new products (with all the regulatory requirements as set out in Section 6 above)

7.23.1. Developing and managing guaranteed products requires specialist skills especially in an insurance company / Solvency II environment, with careful asset-liability management required.

7.23.2. With-profit actuaries could be well-suited to do this, but there are relatively few actuaries working (and training) in this area, especially compared to the situation 20+ years ago.

7.24. We propose that actuaries working in developing and managing retail products would benefit from training to develop the skills to create and manage guaranteed products.

7.24.1. This could involve creating opportunities and a structured programme by which experienced actuaries in this area can transfer their knowledge to the 'next generation' of actuaries.

7.24.2. Work could also be undertaken to identify if and how historical with-profits techniques and knowledge can be refreshed and promoted to raise awareness of applications to create and manage guaranteed products.

7.24.3. It may be useful to consider moving towards using more 'modern' terms for the work undertaken in this space, such as 'hedging strategies and applications for actuaries' in place of 'with-profits techniques'.

### *Standards for 'fair value' assessment and a regulatory 'safe harbour'*

7.25. The regulatory risks involved in developing guaranteed products (and accompanying likely scrutiny by regulators) is perceived as a significant obstacle today. This perception is informed by historical examples of mis-selling of guaranteed products and/or failure of providers.

7.25.1. Some historical products also offered poor value-for-money for consumers and/or involved high commissions for advisers (i.e. presenting significant 'conduct risks').

7.25.2. The FCA has also introduced much more explicit value-for-money (or 'fair value assessment') requirements for all products, and these can set a high hurdle for guaranteed products to deliver good outcomes for customers.

7.26. We believe that these issues can be addressed by ensuring that new guaranteed products are developed with the delivery of fair value to consumers as a core design principle.

7.26.1. Product development needs to follow both the letter and spirit of the FCA's product governance regulations. This includes being compliant with 'Retail Distribution Review' requirements (i.e. no commissions payable to advisers).

7.27. Providers could be encouraged to enter the market if the FCA were to consider a 'safe harbour' for products which meet a set of standardised features, including robust product governance, controls against mis-selling risks and independently validated 'value-for-money' or 'fair-value' assessment.

7.27.1. One way of addressing this could be the development of an actuarial standard for fair value assessment, with a clear framework to calculate and present this assessment transparently.

7.27.2. The 'safe harbour' could function in such a way that products meeting the prescribed set of criteria (and independently certified as such) could be confident that they will not attract regulatory enforcement in the event of future issues (e.g. claims of mis-selling etc).

7.27.3. While we appreciate that some might perceive this as a desire to pass on responsibility by the manufacturer of a guaranteed product, it is not our intention or suggestion. We are proposing the development of exacting standards and an assurance framework to demonstrate compliance with these standards.

7.27.4. We believe that it could even be possible to create a 'safe' enough product which could be distributed on a non-advised basis or through simplified advice, i.e. rather than requiring 'full' financial advice (which is more demanding and expensive for both the consumer and adviser).

7.28. We believe there could be a role for the IFoA to help start a dialogue with providers and the regulator to create such a framework, learning lessons from successful initiatives (such as Auto-Enrolment) and less successful initiatives (such as stakeholder pensions).

### *Solvency II – a different standard formula?*

7.29. The capital impact of offering guarantees on insurance companies is seen as a significant impediment. While internal model firms can calibrate their 1 year 1-in-200 stress tests to manage capital requirements in line with their risk exposure, for standard formula firms, guarantees tend to generate significant capital penalties.

7.29.1. We appreciate that there are measures in place to address this issue for some categories of product, including annuities. These include the Matching Adjustment and other elements of the Long-Term Guarantees (LTG) package within SII.

7.29.1.1. For example, during the Q1 2020 economic volatility we observed non-economic aspects of SII, such as the value of the volatility adjustment increasing as spreads widen, led to reduced cost of guaranteed annuity rates.

7.29.2. However, even allowing for these measures, there still remain solvency obstacles to many firms entering the market for guarantees, especially the type we described in Section 5 (e.g. those to mitigate the risks relating to drawing a pension from an investment portfolio over time or targeting a lump sum amount).

7.30. We believe that one solution could be a different standard formula:

7.30.1. Regulators could consider a different standard formula approach under Solvency II, one which is more reflective of the economics of guarantees and the UK may have more freedom to do so post Brexit.

7.30.2. Changes could include better allowance for the ability to closely hedge relatively simple liabilities with widely available and transparent derivative products.

7.31. The reason for our proposal above is that the manufacturing of guaranteed products typically involves the use of options. Options themselves are exposed to residual market risks that cannot be hedged, so it is important that the capital standards properly recognise these risks.

7.31.1. For example, exposures to risks such as equity or interest rate correlation and volatility over different time periods are inherent in many of these products.

7.31.2. Existing regulatory capital frameworks can both lead to inadequate as well as excess capital requirements above those that would be held on an economically prudent basis

7.31.3. The insurer typically needs to manage the risk exposures created by these products using a mixture of capital at risk; market hedging approaches; and, a range of investment strategies.

7.32. Finally, we now summarise some of the research we undertook of guaranteed products available today, both internationally and in the UK. Our analysis and discussion of these products played a significant role in informing our findings and proposals above.

# 8. Examples of guaranteed products available today

8.1. Our Working Party drew on our members' professional experience across Europe, Turkey, the USA, Australia and India to identify examples of guaranteed products available today.

8.2. We looked into how each product works, the key features, target client needs and the outcome. We wanted to understand the background and the context in which these products were introduced and how they later evolved to meet certain client needs, regulatory requirements, economic conditions, or profitability opportunities.

8.3. Our view was not only to find out about these products, but also to understand whether they have any features applicable to the UK market, including if they were potentially compatible with the UK regulatory requirements and distribution models.

8.4. Our investigations prompted detailed discussions and helped us arrive at and refined our thinking which informed our findings and recommendations above.

8.5. We summarise many of the products we considered below and also note how they informed our thinking. We also provide links to the online product literature for those who are interested to find more about each product.

### *Europe and Middle East*

8.6. 'Active 4 Life'[51] from Allianz is a unit-linked whole of life insurance, which requires a minimum level of single premium. The product features a rolling 1-year capital guarantee, designed to reduce market risks for the customers and, at the same time, benefit from growth opportunities offered by the markets. Policyholders can change the fund (and therefore the guarantee level) or deactivate / reactivate the guarantee every year.

[51] For further information https://www.allianzgloballife.com/en_GB/products.html

8.6.1. The premiums are invested in one of the three funds - prudent, balanced, or aggressive - which are designed to meet investment needs of clients with different appetites for risk. Each of these funds has a corresponding guaranteed capital level, which is supported by a certain mix of investments in the European bond and global stock markets.

8.6.2. A version of the 'Active 4 Life' product has been developed for the European market with similar economic conditions to the UK and is an example of the 'rolling guarantees' described in section 4 above.

8.6.3. Considering the wider picture, Allianz's '4 Life' suite of products, including 'Active 4 Life', 'Invest 4 Life' [52] and 'Target 4 Life' [53], is a solution combining asset management and insurance know-how to meet the needs of different client segments.

8.6.4. The products may not be considered a 'suite' as such by the provider, as they have been offered at different countries through different channels and potentially different times. However, the common denominator to all three products is that they are written through the Irish company of the Allianz group. The products technologically (and potentially cost-wise) benefit from being managed centrally as well as tapping into the international competence and know-how of the group.

8.6.5. While 'Active 4 Life' with the rolling 1-year guarantee is interesting from the perspective of Long-Term Guarantees Working Party and 'Invest 4 Life' and 'Target 4 Life' meets the consumer needs covered in section 5 of the paper, specifically the desire for an 'income in retirement' and 'saving for other reasons', including targeting a specific lump sum.

8.6.6. 'Invest 4 Life' is a unit-linked whole of life annuity product with a minimum level of single premium, offering a guaranteed annuity for life, which is guaranteed not to decrease and benefit from potential increases in the income based on the investment trend. As such it targets the 'income in retirement' need.

8.6.7. 'Target 4 Life' on the other hand is a unit-linked product targeting younger audiences with a lower minimum premium requirement. The investment path is tailored for the individual at the start, based on a simple questionnaire on the target amount to reach, duration of the investment, level of risk and method of payment. Policyholders have the option of making additional payments depending on the different needs and financial availability of the moment.

8.6.8. In this way, the product suite could be utilised to contact the "mass market" consumers at an earlier stage of their life cycle, ready to introduce wealth management services through the mid-life period (perhaps when they are in the higher net worth group), and later stages in life to meet their retirement needs.

8.7. "Child Savings Product"[54] from Anadolu Hayat Emeklilik in Turkey is a pure endowment policy, for funding the higher education of children or as a means of support when they are leaving home. The accumulated fund is payable upon survival at maturity and there is no payment upon death. The funds are accessible before maturity upon the deduction of a limited surrender penalty in the earlier years.

8.7.1. The premiums are paid in the chosen currency (local currency, USD or Euro), indexed annually and accumulated in funds in matching currency. Funds offer minimum

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[52] For further information https://www.allianz.com/en/press/news/business/life_health/news-2008-07-28.html and http://bh-assurances.fr/en/practical-informations/allianz-invest4life

[53] For further information https://www.allianzgloballife.com/en_GB/products.html

[54] For further information https://www.anadoluhayat.com.tr/urunlerimiz/cocugum-icin-egitim-sigortasi (in Turkish)

investment guarantees for each cohort of business, and has been reduced to levels close to 0% in the recent years, in line with reducing investment returns.

8.7.2. However, once commenced, the guaranteed level is valid for the lifetime of the policy and returns are locked in on a yearly basis. The product benefits from specific life insurance tax advantages and returns based on institutional investment to Eurobonds, which are still relatively high in comparison to the UK market.

8.8. We observe that Child Savings Product products have evolved and been tailored over the years to address the medium-term savings gap in the market. There are examples of these products, typically lower cost in nature, which are sold through the bancassurance and tied-salesforces.

8.8.1. A challenge to introducing them in the UK is the severe reduction in the bancassurance and tied-saleforce model, driven by the RDR (as detailed in section 6).

8.8.2. While there are differences between the UK and Turkey in terms of the economic climate and distribution landscape, we believe that medium term savings remains a universal need, be it for children or for other underlying reasons.

8.8.3. We believe that this sort of product could be a good low cost and easy access solution that could potentially make good use of technology.

8.9. A number of “Variable Annuity Products” were available in the UK over the period from the late 2000’s till about 2017, provided by insurers such as AEGON, AXA and MetLife. These products typically offered a minimum income for life with potential increases to that income amount. The increases were delivered in a variety of ways including bonus payments for deferring the date of the first income benefit, and/or “ratcheting” the guarantee if the fund is at a policy anniversary all-time-high (or all-time-high on a “ratcheting” date).

8.9.1. These products offered flexibility by enabling full access to the fund (with a sacrifice of the guarantee, if taken) and also typically provided a guaranteed sum assured upon death.

8.9.2. We observe that “Variable Annuity Products” offer an alternative that combined some of the benefits of income drawdown and a traditional fixed annuity.

8.9.3. The guarantee features of these products were typically charged for explicitly via an annual charge.

8.9.4. The investment choices were typically limited, generally with the aim of making it easier for the manufacturer to hedge the guarantees involved. The investment strategies also typically involved some sort of asset allocation methodology to mitigate the risk of the guarantee paying out. These included “managed volatility strategies” and/or CPPI (including “individual” CPPI, a customer-specific rather than fund-specific version of this strategy, known as iCPPI).

8.9.5. As interest rates continued to fall in the 2010s, guaranteed income rates fell, and the trade-off between charges versus the income became less attractive. Fund restrictions and management complexity also increased the cost of offering these products. The biggest seller of variable annuities, MetLife, strategically exited the market, in part likely due to the 2016 dip in rates, and in part likely due to wider global strategy.

8.10. A similar type of product was introduced by Just in 2018 called the 'Secure Lifetime Income' product[55]. This product was developed together with the platform Novia and the technology firm Spire Platform Solutions. It offers customers the ability to hold an annuity 'on platform' within a Self-Invested Personal Pension (SIPP). This enables a customer to split their pension pot into a section from which they can draw a guaranteed income whilst retaining the flexibility to invest the remaining section in funds of their choice for potential growth.

8.10.1. Unique features of the product include the offer of a surrender value for the annuity as well as the fact that income is paid into the SIPP rather than directly out to the customer (i.e. so that they can choose if and when to actually take the income).

8.10.2. This product has many of the attractive features of the variable annuities described above, but has had limited take-up. Reasons may include the product being available on an IFA platform (Novia) which is targeted at higher net worth individuals than those who would might need and want a guarantee (as outlined in sections 5 and 7).

8.11. We believe that the features of a "variable annuity" are well-suited to an under-served segment of clients, especially those who we describe in section 7. If new product offerings are re-introduced, potentially they could be repackaged and presented in a new way, for example, an "annuity plus", with fewer variations, to enable easier comparison with a traditional fixed annuity guarantee or a fixed annuity and a surrender or death benefit determined by an allocation to a multi-asset fund price (but without the ratchet, to avoid the need to explain it).

8.12. Another option currently available in the UK is smoothed funds, some of which offer spot guarantees.

8.12.1. A very well-established proposition is the Prudential PruFund[56] which has been popular over the past 10 years. This consists of a range of smoothed funds which invest in Prudential's With-Profits fund, one of the largest With-Profits funds in the UK. These funds were, until recently, also available in various investment plans offering spot guarantees at terms of 7 – 10 years and/or minimum income guarantees (when held in a pension of life bond). The guaranteed versions of the funds, called the PruFund Protected Funds) are not currently available to new customers.

8.12.2. LV= entered this market in 2019 with a Smoothed Fund[57] range which invest in a range of multi-asset, risk rated funds which aim to deliver low volatility. They also offer spot guarantees on these funds when held through a pension or life bond.

8.12.3. Aviva also offer a smoothed fund (launched in Dec 2017)[58]

8.13. These smoothed funds represent a 'next best' option to guaranteed funds for many very cautious investors, but without the guarantee features, they fall short of meeting the needs identified in section 5. We do, however, observe the entrance of LV= to the market as a very positive step, especially with Prudential stepping back from offering guarantees. However, we also note that the planned acquisition by LV= by a private equity firm

[55] https://www.justadviser.com/products/guaranteed-income-solutions/secure-lifetime-income/secure-lifetime-income-literature and https://www.novia-financial.co.uk/investments/guaranteed-income/

[56] https://www.pru.co.uk/investments/investment-fund-range/prufund/

[57] https://www.lv.com/adviser/smoothed-investments

[58] https://connect.avivab2b.co.uk/adviser/aviva-platform-and-investments/smooth-managed-fund/

(announced Dec 2020[59]) could impact their strategy in this space, especially with our observations about the capital requirements of offering guaranteed products.

## *America*

8.14. In the US market, there are various annuity products, targeting the "income in retirement" need. One example is "fixed indexed annuities" that offer greater potential upside than a traditional annuity, with less risk than a variable annuity. These contracts offer a specified minimum which the contract value will not fall below, regardless of the index performance.

8.14.1. "222 Fixed Indexed Annuity Placeholder"[60] from Allianz in USA offers capital protection from market loss, potential indexed interest, and the potential for tax-deferred growth. The income payments start after a minimum of 10 years.

8.14.2. "New Heights 10 Fixed Indexed Annuity Placeholder"[61] from Nationwide in USA is a fixed indexed annuity that offers returns based on the changes in an underlying index. There are also two optional riders that provide guaranteed lifetime income or legacy planning via enhanced death benefit. These optional could be elected at the time of issue for an additional cost.

8.15. These products link your future annuity income to one or more investment market indices (hence the reference to being "indexed"), while still providing minimum income guarantees.

8.16. These products are distinct in the US in the way that they can be distributed without the necessity of involving a financial adviser. This is because the policyholder will receive back at least their original investment (less some early withdrawal charges). However, the guarantee of 100% of original premium in a low yield environment has compressed the upside attractiveness of these products.

8.16.1. As a result there has been continued innovation over the last few years around how these products are designed and managed. Many of these innovations could be considered in the UK market, but a number of challenges would need to be overcome.

8.17. We think that these challenges include:

8.17.1. Availability of actuaries with an appropriate technical knowledge base. UK with profit actuaries and product designers deal with the same core technical issues. However, there are relatively few people in this space in general and even fewer actively involved in product design. This is because these types of products are part of legacy propositions in UK insurers, rather than being actively developed and sold. Knowledge transfer from those active in the US market to the UK market could help address this. This could potentially be facilitated by coordination between the US Society of Actuaries and the IFoA (especially as the SOA includes members with deep insight and expertise of equity-linked guarantees).

8.17.2. UK product disclosure and distribution requirements differ significantly from the US model. The UK requires much more transparency regarding costs, prohibits the payment of commission post RDR and requires a balanced description of product

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[59] https://www.ft.com/content/99a1c7b0-b921-4410-9f08-48aeb4b9f229

[60] https://www.allianzlife.com/what-we-offer/annuities/fixed-index-annuities/222

[61] https://www.nationwide.com/personal/investing/annuities/fixed-indexed/types/new-heights-10

features. The US model allows for products which pay advisers significant commissions and marketing approaches which would be unlikely to meet UK requirements.

8.17.3. A common 'retrospective bias' in how consumer protection is viewed in the UK. For example, there is widespread acceptance by consumers of motor insurance being worthwhile even if the policyholder does not claim. This is arguably because the cover was there 'in case' of an accident and, while everyone will have different experiences, most people will know someone who has had to claim in the past. The challenge with investment guarantees is that they are systemic in nature and typically impact many people at the same time or no-one for prolonged periods of time. In the absence of guarantee pay-outs, there can be perceptions of poor value and potential negative regulatory attention.

## *Asia Pacific*

8.18. Future Cash Flow Funds[62] from AMP Capital in Australia aims to provide orderly, stable, extra income in retirement in the context of low annuity rates. The level income is stable, but payable during a limited period of time. The period is uncertain but there is a minimum guaranteed period over which the fund will last. All capital is exhausted at the end of the fund.

8.18.1. The funds are switched between a multi asset portfolio and a portfolio of index linked bonds in response to market conditions, similar to how CPPI products work. Additionally, some hedging occurs in the multi asset portfolio to further control risk.

8.18.2. Future Cash Flow Funds has been developed for market with similar conditions to the UK and for a similar target client base. However, the take up in Australia does not appear to be large. One of the reasons for the low take up rate could be the fact that all capital is exhausted over an indeterminate timeframe albeit with upper and lower bounds. This feature makes the product complex and would require distributor education to achieve higher take up.

8.19. Wrap Capital Protection[63] from BT Capital in Australia offers exposure to investment growth combined with guaranteed minimum outcome. It is a sophisticated product targeting wealthy client segments, through an advised route and with requirement for a minimum investment. It provides choice and flexibility by allowing access to multiple managed funds available on wrap platforms. Protection element is flexible and can be amended if client needs to change.

8.19.1. The product allows guarantees to be offered in a sustained low interest rate environment and evolved from CPPI techniques used by banks at portfolio level. The provider can hedge market risk element with an investment bank.

8.20. We observe that while the Future cash Flow Funds and the Wrap Capital Protection have been developed for the Australian market, arguably there is enough similarity with the UK to make them compatible. However, two challenges would need to be overcome:

8.20.1. These products rely heavily on investment platform technologies which are not as established in all sectors of the UK market, especially insurance companies (which

[62] For further information https://www.ampcapital.com/au/en/investments/funds/multi-asset-and-diversified/future-cash-flow-range

[63] For further information https://www.bt.com.au/personal/investments/solutions/advised-investments/wrap-platforms/wrap-capital-protection.html and Links to similar products in Europe https://www.axa-mpsfinancial.ie/iprotect and https://www.zurich.de/de-de/privatkunden/vorsorge-und-vermoegen/varioinvest

typically have older technology for their insurance-based investment policies vs. their "modern" platform-based "wrap" propositions).

8.20.2. Many of these products use CPPI as part of their approach, and this is a strategy which has a negative history in the UK (with many IFA's associating it with previous market crashes a 'cash lock' situations), and also not being compatible with an ultra-low interest rate environment.

8.20.3. Communications of the features of these propositions would need to be carefully thought-out to ensure customers understand the features (and limitations).

8.21. In India, a popular product is that Aditya Birla Sun Life Insurance SecurePlus Plan[64]. The product involves making regular contributions for 13 years, after which policyholders can choose to receive a regular income for the following period of 6 or 12 years.

8.21.1. The 6 year benefit option is an income of 100% of the annualised premium contributed, paid in year 14, then 200% of this premium paid in year 15, rising to 600% in year 19.

8.21.2. The 12 year benefit option is an income of 200% of the annualised premium contributed paid each year from year 13 until year 25.

8.22. Another popular product is the ABSLI Guaranteed Milestone Plan[65]. This product offers fully guaranteed benefits on death or maturity with a range of contribution profiles and terms. This product is similar to a 'traditional' endowment assurance sold in the UK in the 1990s and early 2000s.

8.23. Both of the above products have the attraction of offering formulaic pay-outs to customers which can be easily understood in advance. The challenges with offering them in the UK include:

8.23.1. Much lower interest rates in the UK vs. India (e.g. currently 10 year yields on UK gilts are c. 0.25% vs. Indian government bond yields of c. 6%).

8.23.2. Bancassurer distribution model of tied advisers is common in India vs. very limited in the UK post RDR.

8.23.3. Negative perceptions of endowment assurance products in the UK, especially due to the endowment mis-selling scandal relating to products sold in the 1990s and 2000s.

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[64] https://lifeinsurance.adityabirlacapital.com/buy-online/documents/354022/1094618/SecurePlusUpdatedBroucher/6267cfe4-ebe5-3ce4-31ec-bfae5068257f

[65] https://lifeinsurance.adityabirlacapital.com/LIUSBrochures/ABSLI-Guaranteed-Milestone-Plan-Brochure.pdf

Institute and Faculty of Actuaries

**Beijing**

14F China World Office 1 · 1 Jianwai Avenue · Beijing · China 100004
Tel: +86 (10) 6535 0248

**Edinburgh**

Level 2 ·Exchange Crescent · 7 Conference Square · Edinburgh ·EH3 8RA
Tel: +44 (0) 131 240 1300 · Fax +44 (0) 131 240 1311

**Hong Kong**

1803 Tower One · Lippo Centre · 89 Queensway · Hong Kong
Tel: +852 2147 9418

**London (registered office)**

7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP
Tel: +44 (0) 20 7632 2100 · Fax: +44 (0) 20 7632 2111

**Oxford**

1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD
Tel: +44 (0) 1865 268 200 · Fax: +44 (0) 1865 268 211

**Singapore**

163 Tras Street · #07-05 Lian Huat Building · Singapore 079024
Tel: +65 6717 2955

www.actuaries.org.uk

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