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Tradable Annuities – A New Market?

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Disclaimer

Still a moving target with some detail still to be finalised. The FCA will be consulting during 2016 and their guidance and rules will affect the final form of a market. Opinions are those of the author and not those of the IFoA

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Legal Framework

- Initial consultation launched March 2015. Response to consultation December 2015
- Government has indicated a strong desire to proceed with a secondary market in annuity contracts
- Tax penalties for unauthorised withdrawals to be removed for this type of transaction
- Other enabling legislation such as policy assignability and regulatory framework will be effected as necessary by secondary legislation
- Target launch date April 2017 (probably 6th)

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03 February 2016 3

Government's Key Wishes for a Market

- A number of bidders to ensure a competitive market
- Consumers (and/or Advisers) can, and DO, shop around easily for multiple quotes
- Consumers get good information and guidance – probably through an expanded Pension Wise service and are adequately protected
- Continuing the mandatory advice requirement which was embedded into Pension Freedoms part 1
- Incumbent provider can bid on their own annuities in some way

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03 February 2016 4

Scope And Comparison With Existing Pension Freedoms

• All annuities in individuals name are in scope (usually from DC) • But fully bulk bought out annuities also in scope	• Undrawn down DC pots (in scope)
• Annuities held by trustees in Scheme maybe in scope	• DB benefits may be transferred to DC arrangement then drawn down but only with advice (in scope/out of scope)
• Scheme pensions all out of scope	• Some DB schemes will not permit transfer (out of scope)

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Scope

- Annuities bought by safeguarded and non-safeguarded funds to both be in scope because consumers (and potential buyers) often cannot easily tell the difference
- Trustee held annuities (and deferred annuities) can be assigned, but Trustees will have to consider impact on scheme financial health
- All annuities including those bought after 6 April 2015 will be in scope.
  - Personal circumstances may change for any annuitant
  - Liquidity option may help reinvigorate sales of new annuities

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03 February 2016 6

Route to Market – Legal and Regulatory Constraints

- Potential vendors or their agents will have to conduct their transaction through an FCA Authorised "Intermediary" (which may become a new regulated activity)
- Incumbent provider life offices will not be able to deal direct with the consumer
- Third party buyers with the appropriate permissions may deal direct with consumers
- Investors will also need to subject themselves to UK regulation (possibly with a new regulated activity of holding annuity policies)

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Who is a potential investor?

- Still very uncertain who exactly can be an investor. Consultation response is very cloudy and contradictory on some of the issues
- Individuals holding in own name are definitely not allowed
- Still subject to final thinking/FCA consultation, but probably securitised blocks or funds which are sold to retail investors are not allowed
- Leaving:-
  - Life offices, pension funds and other carriers of longevity risk seeking to "match" off risks
  - Institutional investors with experience in longevity markets
  - Asset securitizers

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Uncertainties

- It seems that investors will need to be subject to FCA regulation, so therefore will need to be UK based
- Regulation of the purchasing investor is claimed to be for the purpose of protecting vendor consumers. Why?
- Extra layer of regulation may turn off some potential buyers and depress prices offered to consumers
- Government indicate that they are not averse to a tertiary market building up which may fall outside a regulatory overlay
- And tertiary buyers may be based overseas

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What Might A Market Look Like?

- Pension Wise and mandatory IFA requirements
- "Intermediaries"
- Value chain and the consumer journey
- Other consumer protection
- Market size
- Underwriting and pricing bands
- Significant hurdles
- Life office specific issues

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Consumer Protections

Enhanced Pension Wise will be heavily signposted

Mandatory Advice for "value" above a threshold
£30K for Pension Freedoms 1
But probably expressed as an annual annuity amount for this market

FCA will determine other consumer protections
Second line of defence
Mandatory risk warnings/questions
Spouses/Dependents sign off?

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Intermediaries

- Regulated Activity. Limited number of approved (or "licenced") intermediaries. But essentially "Dealing as Agent" (in annuities)
  - To protect direct to market consumer by having Reg'd entity in value chain
  - To help prevent private tax avoiding assignments
- Slightly unclear whether IFAs can perform this role - probably not
- Intermediaries may be platforms/bidding portals or buyers' agents

03 February 2016 12

Consumer Access Points

- IFAs
- Pension Wise referrals

- Life Office Referrals?
- D2C Advertising / Google

- Does the consumer have a preference for one-stop shop?
  Or are they happy to contact multiple buyers?
- Government wants market to develop naturally

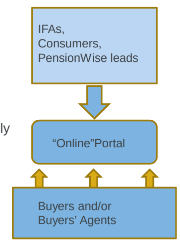
Consumer Journey

- Engagement mechanism will depend on number of participants and the size of the market
- Ease of Customer Journey will depend on how streamlined and how much co-operation there is for common activities such as gathering underwriting data
- Marketplace could therefore take one of many forms

Single Portal

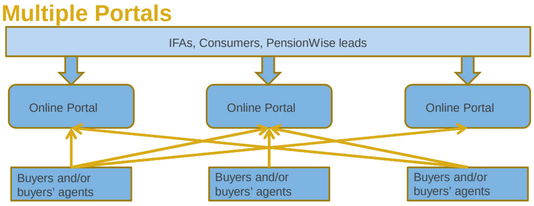
Competition Issues
- Cost restraint mechanism?
- Funding/Budget?
- Portal has a monopoly on it's own pricing

Comparable
- none



Operational Issues
- Live Support
- Telephone Option
- Written Option
(consumers mainly over 65 and not all tech savvy)
- Who carries out and is responsible in law for due diligence function?

Multiple Portals



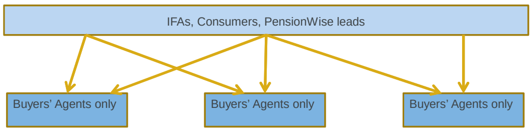
Comparables (Consumer / IFA)

Moneysupermarket
Assureweb

GoCompare
The Exchange

Comparethemarket
Nucleus

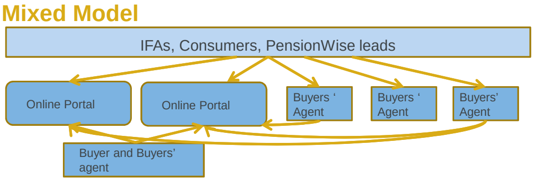
No Portals



Comparable

- Banking
- Most off-line markets
- Most non-finance markets (eg building work)

Mixed Model



Comparables (Consumer / IFA)

Moneysupermarket, Gocompare etc
Assureweb, The Exchange etc

Life Office Direct
Life Office for Advisers

Market Size and Shape

- Market shape will almost certainly be front-end biased
- Size will impact number and variety of participants
- In 2013, 6m annuities in payment in the hands of 5m pensioners, and £13.3bn paid out annually
- Government's implied guesstimate is market could produce £1bn of tax over first 2 years – suggesting annuity sales of £5-£10bn.
- IFoA's YouGov survey suggested that 45% might consider selling (or don't know)
  - But only 5% said they would be more or less "certain" to do so
- Pre-pension freedoms, 75% of DC pots were annuitised. Post freedoms this has fallen to c.40% - suggesting 35% of annuitants would rather not have the annuity
- So pick a number between l<£1bn and >£25bn
- Poor value (perceived or real), unsuitability, second thoughts, professional advice or intertia will limit market

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Anti-Selection and Underwriting

- Large information asymmetries – in both directions
- Potentially quite different problems to other products
  - GWOL has no underwriting but can use product terms to limit selection effects
  - Term Assurance can use other selection limiting tools – temporary premium loadings or suicide clause
- Underwriting will allow risk-based pricing
- Critical for filtering high risks
- "Average" mortality pricing with no underwriting could create a "market for lemons" for that bidder
- Possible scope for organised anti-selection (eg IFAs marketing to hospices)
- Underwriting is a barrier to market for some consumers

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Application of Underwriting – By Value Band?

Low Value Band – say up to £5,000 of value equivalent

- Use limited or no underwriting?
  - Cost saving but possible anti-selection problems
  - Satisfies the "just give me a number and pay it" school of thought, but is that TCF compliant?
- Offer consumer the choice of a default non-underwritten low value quote or to undergo underwriting to improve it.
  - Same anti-selection problems
  - If the same company offers both options then it is bidding against itself by providing a put option against themselves
- Offer consumer the choice of a default non-underwritten low value quote or to undergo underwriting and have offer re-priced up or down
  - How does consumer assess whether the "gamble" is worth it? Scope for litigation is enormous

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Application of Underwriting – By Value Band?

Medium Value Band – say £5K to £30K of value equivalent

- Same underwriting options as for lower value band
  - Same issues apply
- Only make offer on an underwritten basis?

High Value Band – say >£30K of value equivalent

- Underwritten pricing only
- More stringent underwriting terms as value increases

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Low Value Band – Vox Pop Commentary

- Non-underwritten
- Probably conducted online in an instant auction
- Quick, slimmed down paperwork
- Rapid completion and payment
- And yet still give 14 day cancellation right?

Lessons from US Structured Settlement Market

- Considerable value in slowing down the transaction
- Organising an underwriting interview will be a deterrent to death-bed sales
- Drawing out the sale and completion process will allow time for consumer reflection which may be more valuable than cancellation period

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Does Underwriting Affect Prices?

Huge variation in quotes in primary enhanced annuity market

	Annuity pa
Best company	£6,621
2nd Best	£6,407
3rd Best	£6,386
4th Best	£6,384
...	...
Worst	£5,531
Declined to offer	2/11

+19.7%

	Annuity pa
Best company	£12,386
2nd Best	£8,146
3rd Best	£7,592
4th Best	£6,170
...	...
Worst	£5,928
Declined to offer	2/11

+108.6%

Male, aged 70, purchase price £100K
Single Life, no incs, no g'tee
N/s, overweight and high blood pressure

Male, aged 70, purchase price £100K
Single Life, no incs, no g'tee
Smk, overweight and light respiratory problems

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Does Underwriting Affect Prices?

Underwriting broadens the spread compared to non-UW

	Annuity pa
Best company	£6,621
2nd Best	£6,407
3rd Best	£6,386
4th Best	£6,384
...	...
Worst	£5,531
Declined to offer	2/11

+19.7%

Male, aged 70, purchase price £100K
Single Life, no incs, no g'tee
N/s, overweight and high blood pressure

	Annuity pa
Best company	£6,386
2nd Best	£6,148
3rd Best	£5,883
4th Best	£5,828
...	...
Worst	£5,151
Declined to offer	4/11

+28.3%

+24.0%

Male, aged 70, purchase price £100K
Single Life, no incs, no g'tee
Not underwritten

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How might a policy price up?

	Price after trading expenses
Very Good Health	£62,500
Reasonable Health	£58,600
Impaired	£38,800
Severely Impaired	£22,100
Death Bed	No offer

Man aged 70, single life, no esc, no remaining g'tee
£5,000pa

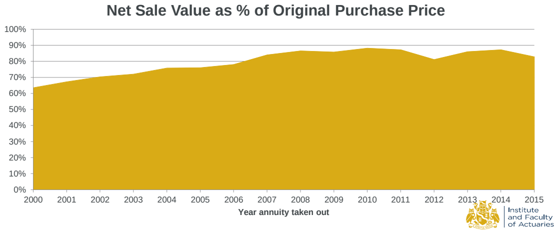
- Cost to buy £5,000pa at age 70 (good health) = £78,400
- Best offer* is 80% of replacement cost

*Author's estimate of his own bid and not necessarily representative of other bids

03 February 2016 26

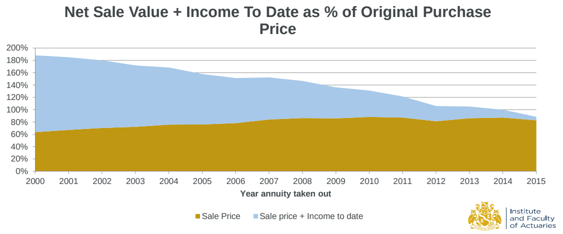
Outcome From Sale

Net Sale Value as % of Original Purchase Price



03 February 2016 27

Total Outcome From Annuity



Incumbent Provider as Bidder

- The biggest volte face by government from the original proposals is that they intent to allow incumbent provider to bid on their own policies
- Some incumbents will, others won't
- Government indicate that it will have to be indirect through an Intermediary and not by offering a "surrender value" direct
- Not clear if this bidding through an Intermediary will be blind, and to whom
- Incumbent retains veto over transaction
- All the more critical that any market is true and fair

Significant Hurdles – Legal and Operational

- How to deal with spouses, dependents etc to protect them
- How to deal with vulnerable vendors
- Second-line-of defence requirements
- Government and the FCA want a "Value-o-meter". How will that work? Will it create unreasonable barriers to market?
- Will gender neutral pricing apply?
- FSCS treatment
- Death tracking

Measuring Good and Bad Value

- Very difficult to tailor to consumer circumstances
- Bidding Company will merely confirm their own underwriting result
- Third Party will probably not fully allow for individual features
- Use of reverse engineered annuity rate is a possibility but has many faults
- Should reasonable bid/offer spread be deducted? – there is always a trading spread in any goods or assets
- Production of lots of false positives quite likely
- Litigation against the provider of the Value-o-meter?

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Life Office Issues

- Life office bidding on own policies may provide ammunition for CMCs litigation
- Life Offices buying back will need to be careful not to be seen as predatory and encourage/require shopping around or there may be litigation and regulatory consequences
- Does contract cancellation annul the liquidity/illiquidity argument for the Matching Adjustment under S2?
- At high volumes of “buy-back and cancel”, assets will need to be sold and this may impact market spreads

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Questions Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

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

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