Hot Topic

Budget 2014 – Annuity reform, key implications for the insurance industry

Summary

On 19th March 2014, the Chancellor announced that savers would no longer be compelled to purchase annuities upon retirement. This represents one of the biggest changes to the UK pension regime for almost a century. Is this the Armageddon feared by the industry or just an evolution of the pensions framework which has been on the horizon for some time? Reactions in the market have been mixed but a majority have welcomed the announcement.

There is no doubt that the changes introduce very significant challenges to firms with a heavy reliance on annuity business. But it also presents opportunities to firms that are able to develop innovative new products and services for customers who'll want to leave assets invested longer into retirement. Even firms that believe these changes will be advantageous to them will need to rapidly change and refine their offerings in the face of such sudden change and fierce competition. On balance, there will inevitably be some winners and some losers.

Key changes

While some areas of the budget announcement are still under consultation, the government has already decided to implement significant changes to the insurance industry.

The changes cover two main areas, which will be in force from April 2015:

- A new tax framework: all restrictions on access to pension pots will be removed. Savers will still be able to take 25% of their pension pot tax-free when they retire. Any further amount being withdrawn will be taxed at the marginal income rate instead of 55%.
- New financial guidance: insurers and trust-based schemes will have to offer to each of their customers a free and impartial 'guidance guarantee' at the point of retirement.

These changes will have very far reaching implications across the entire business. In this note we identify where the changes will be felt.

Strategy

The life insurance industry is already going through significant change with declines in traditional with profits business, the emergence of closed fund firms, specialist annuity writers and wealth managers. Within this environment, that has seen many strategies to specialise, some firms have continued with a waterfront strategy offering the full product range. This is often with a high proportion of new business value being generated from pensions annuities. We are also seeing the market prominence of firms who have anticipated the customer agenda, including RDR, become regarded by the analyst community as being well positioned for future success.

Not only will firms who currently generate a significant proportion of profits from annuity business need to re-think their strategies, but savings and investment firms will need to consider whether their strategies will continue to serve them in a new world. The market will potentially become much more competitive as firms try to hold onto customers' investments longer into retirement.

In our view it is clear that all firms with any involvement in retirement savings and investment will need to review and possibly reconsider their strategy whether to manage the downside risks or upside opportunities.

New products for the new environment

Whether it is redefining the annuity product to make it more appealing to customers, developing the features of an income drawdown product, offering innovative guarantees or developing better planning tools so that retired people can plan their expenditure with more confidence there will be very extensive opportunities to innovate and differentiate the offering.

Pension providers will need to turn their focus towards developing pre-and post-retirement investment and income drawdown offerings. While the sales of annuities will undoubtedly suffer, it may be too soon to predict the products demise altogether. The product has been around for a long time and annuity conversion for parts of retirement savings will continue to make sense for some savers, depending on the prevailing annuity rates and personal circumstances.

With interest rates at historical lows, life time annuities will continue to be poor value for money for young pensioners with investment horizons of over 20. It is likely that these pensioners will prefer to take additional investment risks with their savings in the hope for better long term returns. But there remains a strong case for the eventual purchase of annuities by elderly savers. Research has indicated that people become increasingly risk averse in retirement, and investment strategies may eventually converge on savings accounts or bonds that will yield less than the investment strategies implicit in annuity pricing by insurers.

The new budget proposals will shift advice from the question of 'what age to retire at' to the more important question of 'what income do I want to retire with'. Securing this minimum income should become the focus of retirement strategies. This may involve the gradual purchase of annuities to complement or replace other sources of investment income such as dividends and rental income. Linked also to this question will be how the industry supports customers who will need to accumulate and de-cumulate at the same time – all linked to the ever increasing retirement age.

To facilitate such strategies we could see a return of the guaranteed annuity option in some shape or form, which could be added by insurers to post-retirement savings propositions. However, this is likely to only make sense when interest rates start to increase, and the fact that many annuities with the best rates need to be underwritten will add further complexity.

It would seem clear to us that these changes will make it more important than ever to have a clear customer proposition that is flexible, low cost and accessible for managing wealth, but also providing flexibility for providing a regular income or lump sum cash payments whenever customers want them. Many commentators are already pointing to those that have modern platforms and wrap products being winners from the announced changes. But firms should really challenge themselves as to whether the advantage is sustainable and continue to innovate and stay ahead of the competition and new entrants.

Existing Annuity Product

For those that see ongoing competitive advantage in being an annuity writer, either through their investment approach or longevity expertise, there may initially be an opportunity to take advantage of those that no longer see a future in annuities by buying up books of bulk purchase annuities (BPAs). After the initial shake up of the market, the opportunities for an ongoing supply of BPAs emerging from Defined Benefit (DB) pension schemes is much less certain, as trustees may become very reluctant to do BPA deals if significant numbers of DB members opt to take transfer values at retirement. Indeed this issue has been recognised by the government as they consider whether to close the door on the ability for members of private DB schemes to transfer their benefits to a DC scheme

There will of course continue to be a number of retirees that purchase an annuity but with such a major dislocation in the market, underwriting and pricing will become a major challenge. Existing experience data will immediately become less applicable for the future and people purchasing annuities are likely to be the healthiest, potentially resulting in annuity rates becoming even less attractive than they are currently. Arguably, people in the worst health are even less likely to purchase an annuity, causing a disproportionately large hit on the impaired life specialists.

The industry will also need to consider an active campaign to set out the virtues of an 'income for life' product and to point out two facts widely underestimated or ignored by the general public. This is the remaining life expectancy at retirement and the likely cost of and need for long-term care. Here, the longevity expertise that exists within the life industry should be a positive differentiator from other competitors for retiree's investment funds.

Much of the added life expectancy will be of poor quality and many will have expensive care needs. While annuities are no magic bullet here, they are likely to provide some certainty of income to pay for possible care needs, protecting house and wealth that may otherwise need to be put towards funding the cost of care before the government steps in.

The interaction between the new pension proposals and the recent long-term care proposals also requires further consideration. If pension pots are cashed-in and converted to buy-to-let properties, will these investments be counted towards the personal wealth that needs to be put towards care cost before the government steps in? And if so, this would seem an unintended consequence of the new rules and may yet make the purchase of annuities attractive if such income has a more beneficial treatment.

Operations

In retirement, after the transition period leading up to April 2015, it will no longer be necessary to take out income drawdown products. But investment products that are likely to stay in place longer will be subjected to further requirements for regular income payments, lump sum cash payments and other ad-hoc withdrawals. This could potentially place a significant strain on the operational capacity of firms and have significant cost implications. Also, if the customer incurs charges for these services within existing product arrangements, then these may be considered unfair or expose the firm to the risk of transferring funds to a more competitive product provider.

Investment strategy

Approximately £11 billion is invested by individuals into annuities each year. 60% is invested by insurers in non-government fixed interest securities (mainly corporate bonds).

The UK annuity writers have traditionally been well matched on a cash flow basis. However, the change in law will create uncertainty with respect to retention of internal vestings and will potentially need a larger allocation to liquid assets in the short term. A new balance between liquid and illiquid assets will have to be struck. There is a possibility that over time, UK annuity writers may pursue a strategy of front loading their books with liquid assets and retaining illiquid higher yielding assets for the longer duration book.

The government has been trying to encourage the insurance industry to invest in infrastructure projects and the yields and long durations of these investments have been particularly attractive for backing annuities. It is possibly one of the unintended consequences of the government's changes that these investments may become less attractive. However, we believe that the bulk annuity market will continue to provide support to the infrastructure market.

Despite the changes, we would expect alternative assets remain attractive to improve the capital and reserving position. Companies will still be interested to match their back books with high yielding assets.

An impact on the UK gilt curves may also be expected over the long term. As mentioned, the inflow of annuity money tends to be invested into the new issue sterling corporate credit market. A possible reduction in the income received from selling annuities may widen the spreads for sterling corporate issuers at the long end.

With the increased flexibility of future lump sum payment, we may see a shortening of duration in the GBP market. It is therefore possible that, over time, the gilt curve should steepen and the credit curve should go from flat to become more normal and hence upward sloping. This is as demand from annuity writers shifts from long sterling credit to Gilts.

Any impact on the yield curves will have consequences in terms of pricing and reserving. Companies should reconsider their approach in order to maximise their capital position.

The asset strategy going forward will be affected by these changes and will also depend on the type of new products developed by companies. Enhanced variable annuity type products or longer term savings products will require very different asset strategies.

Customer and Digital

All of the opportunities for innovative new products go hand-in-hand with a need to make your firm genuinely customer-centric and align your digital strategy to the customer needs. In our view the changes announced in the budget will accelerate the urgency of this need.

Even before this announcement the life and pensions market was in a state of transformation.

Digital is one of the main drivers of change, reshaping customer expectations, increasing comparison and opening up the market to a new breed of data-rich entrants and start-ups. In a market where the depth of customer-centricity will increasingly be the key differentiator, digital opens up sharper ways to engage customers, understand their needs and provide customised solutions.

The industry now faces a perfect storm. And it is not clear that the eventual winners will be selected from the established incumbents. The changing customer and 'gamechanging' nature of digital technologies may mean that the eventual winners come from outside the industry.

We believe the competitive threat posed by the technology, mobile and internet giants is very real. Their ability to reach customers across the market, and then use this reach to capture, process and interpret data on a vast scale and at huge speed is truly differentiating. It is this combination of scale, access to data and high speed precision analytics that life and pension businesses will need to match. The challenge is can they?

Advice & Conduct Risk

The Government's promise of delivering free, face-to-face guidance for people with defined contribution (DC) pensions at retirement could cost as much as £120m a year.

Approximately 400,000 people will need access to free guidance this year as they decide what to do with their defined contribution pensions pot, now the system has much more flexibility and choice. This equates to a minimum requirement of 400,000 extra hours of guidance this year. This could lead to a need for an additional 500 suitably qualified people to deliver this guidance, risking demand outstripping supply.

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The free face-to-face guidance guarantee at retirement needs to be paid by someone, but questions remain over who will shoulder this substantial burden. The most likely outcome is that pension scheme members will ultimately end up paying for the free advice indirectly, as providers pass on some or all of the costs in member charges.

Managing a retirement fund on an ongoing basis involves considerable risks. To get real value from these changes people will need to understand that guidance is not just a one-time event. Help is likely to be needed several times across what might be a 30 year retirement.

As well as the cost of providing free face-to-face guidance at the end of a pension accumulation phase, insurers could also assume the conduct risk associated with this advice and the need to demonstrate appropriate customer outcomes.

Market Consolidation

At this stage, it remains a little too early to gauge the ultimate impact of restructuring and/or market consolidation. However, what is clear is that this recent announcement represents yet another potentially key driver of likely mergers and acquisitions (M&A) over the next 12 to 24 months, within a European life market that already faces the challenge over optimal business models under Solvency II. We know that a number of the lead players in the market have well developed plans to further differentiate themselves from the competition.

With the share price of 'monoline', enhanced annuity providers (historically the market darlings of the sector from a valuation perspective) recently hit the hardest, this leaves both sector players and financial investors needing to closely re-examine the primary drivers of shareholder value. In particular, whether the market's reaction represents a temporary dislocation of price to be arbitraged or a real, longer term change in consumer behaviour. This may include a focus on the 'asset gathering' strategy employed by a number of UK providers in light of the increase in ISA allowance.

Scale, capital efficiency and diversification have long underpinned the strategies of Europe's largest life companies and recent events appear to have validated this. Thus, to the extent that consolidators or vendors seek to pursue/achieve this through non-organic means, this will open up the possibilities for M&A (including the sale of legacy annuity books and capital-led activity), risk transfer and joint ventures.

Next steps

Never before has this industry faced such an overwhelming need to deliver change quickly. In this industry being big and having scale has always been considered to be a competitive advantage. Now the critical competitive advantage will be speed and agility.

Agility as much as clarity of strategy will separate the likely winners from the losers. Constrained by unwieldy systems, most insurers are too operationally inflexible to deliver the right change at speed.

The hard earned experience of this industry demonstrates that it simply isn't possible to re-engineer a high-cost complex business into a low-cost agile one. It's too expensive and time consuming. We believe winners will need to execute 3 strategies:

Be customer centric. Be clear on what customers need, build propositions that meet their evolving needs and be recognised by the regulator for building the right model.

Start from scratch and get to market quickly. New greenfield operations could be quickly set up by existing players to capitalise on unfolding market opportunities. While establishment costs for greenfield operations have in the past been quite high, rapid developments in technology mean they can now be delivered cheaply. These operations would resemble the start-ups and new entrants that life and pensions businesses are increasingly competing against.

Acquisitions and joint ventures to rapidly tap into a new set of go-to-market capabilities.

The traditional approach to systems and process change is too slow to work in the digital age. It's time to approach change in a different way, in which the focus on planning and design gives way to speed, agility and the quality of testing and adaptation. Nobody can say with certainty what the winning bets will be in this market. It will therefore be necessary to place a number of bets, and learn, react and mobilise quickly, to stay ahead of the game.

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