The future for underwritten annuities

The UK's fast-growing underwritten annuity market shows few signs of slowing, but local and global economic and regulatory changes could lead to substantial alterations in how providers price, underwrite, and distribute this product line. Jason Hurley outlines how insurers can prepare themselves for these changes

The contraction over the past two decades of defined benefit plans and concurrent growth in defined contribution plans means an increasing pool of UK retirees will be coming into the market and seeking investment options for their lump sums. As many of those retirees will be in less than perfect health, the option of underwritten annuities is attractive.

Underwritten annuities, first introduced into the UK pension annuity market in 1995, are already a significant market presence. According to research by the insurance and pension consulting firm of Towers Watson, UK sales of underwritten annuities have more than quadrupled since 2005, rising from that year's total of £638.7m to £2,468m in 2010, and currently comprise more than 16% of the overall market. Currently, there is no sign of slowdown: First-half 2011 underwritten annuity sales of £1,430m could, according to Towers Watson, lead to an estimated £2.8bn of sales by the end of the year.

What is driving this growth? Several factors: Firstly, the move to defined contribution schemes. Secondly, awareness of the product has grown since its introduction. More and more defined contribution pensioners today are seeking to avail themselves of the financial advantage an underwritten annuity can provide for those with impaired health. As an example, a pensioner could experience period payment increases of typically 10% to 25% – sometimes even double or more – over what would have been available via a traditional, non-underwritten, annuity.

Thirdly, increased regulatory pressure on advisers to do the best for their clients, aided by sophisticated new online systems that enable more focused support. Fourthly, directives such as 'Treating Customers Fairly' and other regulation, have led to clearer communication between pension providers and their customers.

On top of all this is the anticipated growth that this market is due to experience. The pool of potential buyers for these annuities – individuals retiring with lump sums in defined contribution plans – is about to mushroom. The very sizable baby boom cohort (those born 1946-1961) is now moving into the retirement phase of life, so the number of individuals retiring each year will rise and stay high.

Although the current crop of retirees have, as a group, higher life expectancies than past generations of retirees, many also have health factors that could compromise their longevity. Whether due to illness, lifestyle, environment or occupation, such factors are making underwritten annuities a favoured choice for many, as the option can ultimately provide both higher incomes in retirement and better incomes for surviving spouses.

For annuity providers either in the underwritten annuity market or contemplating entry, all of these are positive trends. Already, it is clear that a typical retiree is willing to undergo a bit of underwriting – answering some medical questions, undergoing a telephone-based interview, or allowing the insurer access to their medical records – in order to increase the amount of their pension payouts.

Providers must be aware, though, of the factors that could diminish this product's otherwise rosy future. Low interest rates dampen fixed annuity sales, and on top of this asset values are currently depressed and volatile. The depressed asset values could slow anticipated demand, as those reaching retirement age might consider delaying retirement in order to increase the funds in their pensions.

Coming regulatory changes could also impact future growth in the underwritten annuity market. Three items – Solvency II, the recent Gender Directive-related ruling, and the Retail Distribution Review laws – will generate significant market change for the annuity market as a whole.

Solvency II's approach to calculating insurer capital, now slated for early 2014 implementation, will create substantial capital alterations for the investment component of a range of life insurance and annuity policies. For providers of all annuities, guarantees, long a prime selling point, may be scaled back, and require a new approach to product pricing, market positioning, advice given to consumers,

and to how providers structure their capital.

The March 2011 ruling pertaining to the European Union's Gender Directive will lead to the use of gender-neutral terms in all life insurance and annuity products. This change, due to go into effect on 21 December 2012, may lead underwritten annuity providers to use more rating factors. Insurers may also aim their marketing strategies specifically at men. In the short term there is good news: a 'buy now before rates change' message to males considering retirement.

A third regulatory item that could have an impact upon sales of all annuities is the upcoming Retail Distribution Review. Due to become effective on 31 December 2012, these laws will require financial advisers to charge a fee when providing advice about pension annuities. Pension annuity providers may respond to this by developing simplified pension annuity products, with online applications and automatic underwriting. It could also lead to more providers offering pension annuity products directly to the public, without an adviser.

Online systems providing instant quotations are already familiar to most term life and annuity buyers. Such systems have grown greatly in technological sophistication over the past decade, using customised rule sets and providing quick point-of-sale decision turnarounds. As the underwritten annuity market moves to a more automated approach, providers will be challenged to enable efficient checking of the quality and validity of medical information provided.

Underwritten annuity providers have already introduced over-disclosure checks, using the delay between offering a quote and receiving the pension funds, to verify information provided in applications against doctor's reports. As the technology and speed of application improves, the question will be how insurers can do these checks without inconveniencing either the customer or the sales agent.

Over the nearly two decades underwritten annuities have been sold, they have developed into a high-volume, low-margin, commoditised product. Providers of these annuities can compete by distribution, scale and efficiency, but in the long term, the providers that do best in this market will be those with the best risk management practices. ®

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