Enhanced Annuities: Caring For At-Retirement Needs

By Mick James

People are born. They grow up, go to work, earn money, save some of it, pay taxes and eventually retire. They hope the money they have saved, along with what the state might chip in and what support their families might provide, will see them through their non-working years.

In the U.K., most workers believe they will need to plan for their own retirements, and are not expecting any support from the government. Workers also want to be able to purchase insurance and financial products that reflect their individual risks. This market profile differs notably from that of other countries: in some, pooling of risk and community rating are normal, and in others, the idea that the state will look after citizens is alien.

The U.K.'s International Longevity Centre's recent report "Making the System Fit for Purpose" (*http://www.ilcuk.org.uk/index.php/publications/publication_details/making_the_system_fit_for_purpose*), says that for customers, the three most important elements for retirement income are:

- A guarantee of money to pay bills into their 90s;
- Certainty that retirement income will, at least, keep up with inflation; and
- Flexibility to receive more income or less, depending on yearly needs.

Annuities can provide a guaranteed fixed income for life in exchange for a lump-sum payment, making them a good way to meet the first two needs. This article will discuss the growth and development of the U.K.'s enhanced annuity market, the recent legislative changes restricting its growth, current market drivers, and the building blocks that might enable this annuity framework to translocate to other markets.

HOW DID THE U.K.'S ENHANCED ANNUITY MARKET DEVELOP?

The U.K. market began gradually in the mid-1990s, with a simple proposition from two specialist insurers: As an unhealthy smoker is likely to die sooner than a healthy non-smoker, smokers with a pension pot can receive an annuity with enhanced terms that will provide a higher monthly income than would a standard annuity, because it would not need to be paid for as long. Not surprisingly, smokers with large pension pots and savvy Independent Financial Advisers (IFAs) were enthusiastic

about this proposition, and in 1995, the first "official" enhanced annuities were introduced and the market was born.

The number of impairments that can be underwritten for annuities rapidly grew to encompass other lifestyle factors as well as moderate and even severe medical conditions such as cancer, cardiovascular conditions, kidney failure and stroke. Mainstream life insurers soon took an interest in offering these annuities as well, to prevent being selected against in the risk pool and to select against their competitors in the standard annuity market.

The popularity of these annuities, as well as their complexity, surged in the U.K. over the next decade-and-a-half—by 2007, the market was approximately £1 billion and growing fast. Insurers and reinsurers knew they needed to develop ways to streamline the underwriting process, which resulted in the development of tools such as dedicated automated underwriting and data exchange platforms and the Common Quote Request Form (CQRF), which standardized the deep level of information-gathering from pre-retirees needed for speedy and strong underwriting. (A sample of the CQRF can be found at *https://www.retirementadvantage.com/downloads/06-15-common-quotation-form.pdf*.) The market has since continued to surge, and by year-end 2013, reached nearly £4 billion—approximately one-third of the U.K.'s entire annuity market by premium size.

The enhanced annuity market's rapid growth was assisted by the fact that in the U.K.—at least prior to April 2014—pension holders were required by law to annuitize their individual defined contribution (DC) pension pots.

Life insurance companies that managed employee pensions routinely sent pre-retirees a "warm-up pack" well in advance of their anticipated retirement dates. In the pack was information about pension rollover options and an offered annuity rate, should the pre-retiree opt to roll the pot into one of the insurer's standard annuities. In 2013, the Association of British Insurers' compulsory code of conduct on retirement choices required pension and annuity providers to educate pre-retirees about the "open market option" for annuities prior to retirement, and so included information to encourage pre-retirees to go into the open market to research other annuity options.

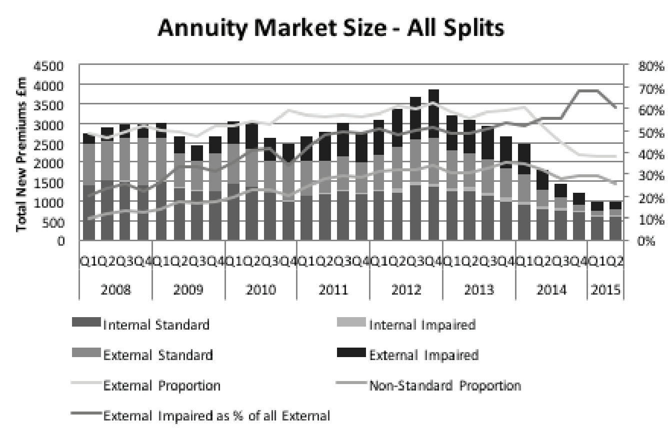
Not surprisingly, most pre-retirees (10 years ago this could easily have been 80 percent) took the simplest option, rolling their pension pots into annuities sponsored by the same life insurance company with which the funds were accrued without ever checking competitive annuity rates from other providers.

The government was concerned that too few people were using the option of shopping for better rates, and that this internal rollover to the existing insurer was ultimately creating poor outcomes for customers. As the low interest rate environment that emerged after the 2008 financial crisis stretched on, returns from annuities came under increasing pressure and customers were starting to perceive annuities as poor value.

The result of this pressure was a sweeping revision to the pension system in 2014 that effectively did away with all restrictions on how retirees could use their pensions. Customers now had a choice: they could purchase an annuity from any provider, take their pension pots in cash, or leave the pots invested on an insurer's platform, drawing down funds as and when required.

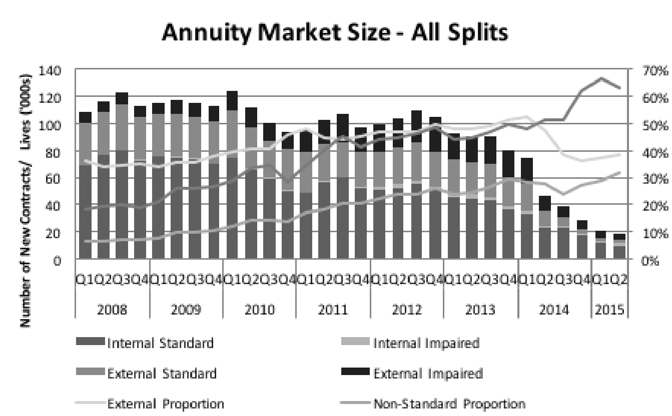
The following graphs demonstrate the significant impact this has had on annuity volumes as well as the significant gains experienced by income drawdown platforms. It is useful to note that the shape of the graph is impacted significantly by the requirement that began in 2013's first quarter to price on a gender-neutral basis, which caused a surge in male annuity sales into the third and fourth quarters of 2012.

FIGURE 1 U.K. ANNUITY MARKETS BY VALUE



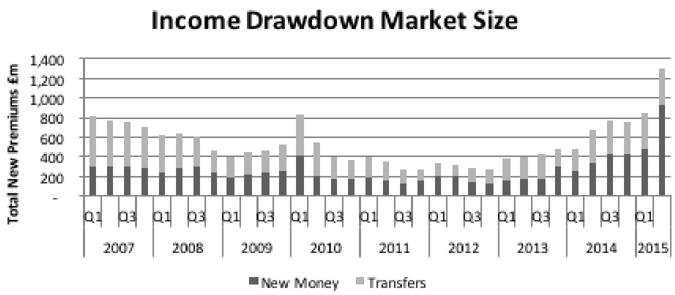
Source: ABI Market Statistics

FIGURE 2 U.K. ANNUITY MARKETS BY CASE COUNT



Source: ABI Market Statistics

FIGURE 3 U.K. ANNUITY MARKETS – INCOME DRAWDOWN MARKET SIZE



Source: ABI Market Statistics

Although annuity sales have, not surprisingly, slumped over the past two years, enhanced annuities are still a sizable market in the U.K. They hold a strong share of the at-retirement market, and all expectations are that the product will continue to thrive, as these products continue to offer individuals with impaired longevity the opportunity to receive larger annuity amounts.

Going forward, we anticipate enhanced annuity customers will start to top-slice their vested pension pots, using a portion of the funds to buy an annuity to deal with the longevity issues while keeping the rest on a drawdown platform.

ABOUT THE CURRENT EA MARKET

The following table provides some examples of the types of enhancements U.K. customers are typically receiving.

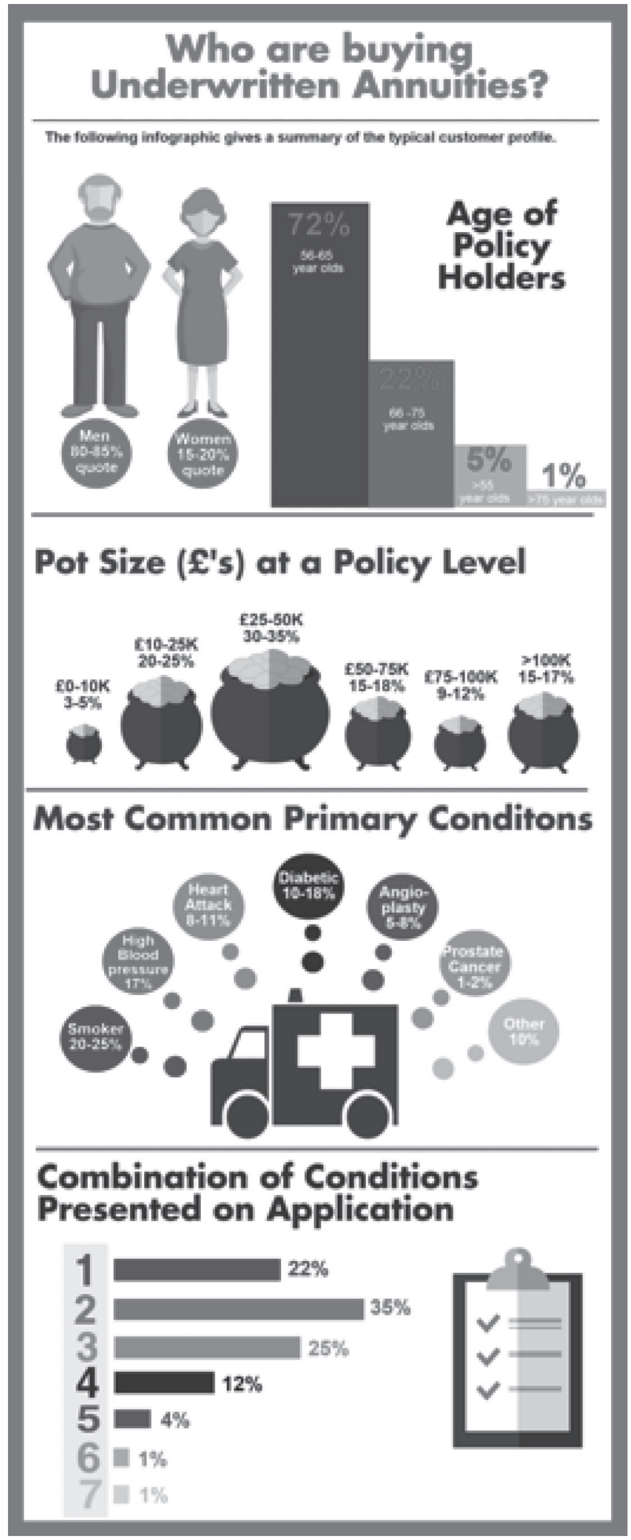
FIGURE 4: IMPAIRMENTS AND UPLIFT

Condition	Rating	Notes	Uplift
Lung Tumor	111pm x9yrs	IIIA, 1yr	76%
Breast Cancer	32pmx8yrs	T2,G3	17%
Heart Attack	100	MI<1year	16%
Smoking	74	15cpd	12%
Diabetic	35	Dx 6yrs, good control	6%
Overweight	25	BMI 39	5%

Source: RGA

For underwriting, companies leverage years of medical and underwriting expertise gained developing research-based underwriting manuals for life assurance. Correctly estimating the impact of health conditions on mortality is fundamentally the same for underwritten annuities as for life assurance—just the emphasis is different. For life assurance contracts, the risk is in underestimating the impact of an impairment, whereas for underwritten annuities, overestimation is the risk.

FIGURE 5: THE ENHANCED ANNUITY BUYER



Source: RGA

Underwriters will use standard metrics to explain the extra risk, such as:

- Percentage extra mortality,
- Flat per mille extra, and
- Years to age.

However, when this is translated through to the risk cost it is derived to be actuarially equivalent at point of sale to the true risk profile with different conditions evolving differently relative to base mortality. For example, different conditions will need to be treated in different ways:

- Ever increasing (e.g., degenerative neurological conditions),
- Temporary Increase (e.g., most cancers), and
- Persistent differences (e.g., smoking).

The following infographic gives a summary of the typical enhanced annuity customer profile.

FIGURE 6: THE MOST COMMON CONDITION COMBINATIONS

Condition 1	Condition 2	Condition 3
High Cholesterol	High Blood Pressure	
Diabetic	High Cholesterol	High Blood Pressure
Smoker		
Smoker	High Cholesterol	High Blood Pressure
Smoker	High Blood Pressure	

Source: RGA

FIGURE 7: EXTRA MORTALITY LOADINGS

EXTRA MORTALITY LOADINGS AT A QUOTES STAGE	
% Extra Mortality	% of all quotes
0-25% EM	25-35%
26-50 EM	15-20%
51-100 EM	30-35%
101-250 EM	15-20%
251-500 EM	1%
>500 EM	1%

Source: RGA

CHALLENGES

While markets around the world might develop products such as enhanced annuities which better meet customer needs not all customers will flock to them.

Education might be key, but, in the U.K. as well as several other countries, functional (which differs from true) illiteracy and innumeracy can present some problems. Around 16 percent of adults in England can currently be described as "functionally illiterate," with literacy levels at or below those expected from someone 11 years of age. Many are also below average for numeracy.

The U.K.'s International Longevity Centre's "Making the system fit for purpose" research report points out that only half those with DC pensions said they understood what an annuity is quite or very well, and just 20 percent of those with DC pension pots understood what an enhanced annuity was.

These shortfalls exist elsewhere in the world as well, which means the enhanced annuity industry faces sizable global challenges in helping target customers to understand these annuities.

An additional challenge is a sufficient advisory population, which could help with education. In the U.K. there is currently only around one advisor per 1,500 members of the working population, so U.K. advisers never see the vast majority of the retiring population. Asian markets might fare better, as their ratio is one to two advisers per 100 members of the working population.

Add to this the growth of the "do-it-yourself" attitude about financial services in the U.K., and the potential clearly exists for an explosion of poorly equipped customers to make poorly informed decisions about their pension pots.

AND SO?

Pre-retirees are highly concerned about the possibility of their pension pots running out before they die. Enhanced annuities clearly offer a fair deal for customers seeking to create a hedge for their longevity risk.

Enhanced annuities can be a useful option for many markets around the world. As the average ages of populations in many countries are rising fast, an effective longevity hedge becomes more important and enhanced annuities provide a useful alternative. The tools and processes for underwriting these annuities efficiently and cost-effectively already exist and have been tested on an industrial scale, meaning the technology can quickly be translocated into other markets where customers are looking for a fair deal for retirement. ■

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