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Addendum

Developments in the Management of Annuity Business

Abstract of the London Discussion – ADDENDUM

[Institute of Actuaries, 22 March 2010]

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Mr. Chris Barnard, F.I.A. (in a written contribution subsequent to the discussion presented in the journal – see Telford, 2012): Whilst there have been many annuity developments in the last 20 years, it is hardly surprising that the conventional annuity remains dominant given the small sizes of most annuity purchases, and the general under-education of the population when it comes to financial matters. Unfortunately, I cannot see this changing soon.

Despite this, the annuity market in the UK is very sophisticated, with newer products such as lifestyle and impaired annuities, income drawdown and variable annuities taking increasing market share. But what can we do for the large number of small sized annuity-pots coming onto the market each year? The introduction of Solvency II looks like it will significantly increase reserve and capital requirements for conventional annuities. We can easily allow for this in our pricing, but then the value proposition to most of our customers becomes even less attractive. I am not sure if we can yet efficiently design and administer income drawdown products and variable annuities for small-sized premiums, so what are we going to do for this market segment? I think that this is one of the big challenges for annuity providers.

Variable annuities (VA) may be an attractive proposition on paper. However, I believe that European VA providers see VAs as a good product full stop, and are puzzled by why customers are not buying into the idea. It is a product being pushed by insurers, and some intermediaries in Europe, and not necessarily demanded by customers – at least not yet in their current form. Where VAs have a future, we need to focus on markets where there is a clear demand, driven by the structural need for retirement-oriented products, and market acceptance of products supporting equity investments. The market size should be large enough to guarantee scale economies in VA management, and there should be sales channels available with access to target clients and skills to explain complicated financial products.

I actually prefer the income drawdown concept, which is just a GMWB variable annuity without the guarantee, but seems to be far easier to understand and explain. Income drawdown is risky, but VAs are risky in a different way. They are complicated, high charge and not transparent.

Solvency II sets a very high technical standard for developing a coherent risk management framework. A thorough understanding will be vital for an annuity provider in assessing risks,

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capital requirements, and the implications for strategy and performance. However, Solvency II is not a perfect framework. For example, most of the common stresses are derived from historical data, notably from the recent financial crisis, which may or may not be appropriate in identifying the prospective risks for each individual insurer. Moreover, while some of the proposed rules are sound in theory, they are difficult to apply in practice.

The main challenges of Solvency II are not necessarily technical and intellectual, but practical and commercial. Not until the final rules have been published will the full impact on the insurance industry be known. Solvency II will change the capital requirements for annuity business and will have implications for business strategy, especially for investment strategy. A key question is: have the implications been understood – not only by insurers but also by policy-makers?

References

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