

Banned! Underwriting Annuities by Gender: Where Do We Go From Here?

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Summary

- As expected on 1 March the European Court of Justice banned gender discrimination in annuity rates. What was less expected was the 21 month window offered, with discrimination only outlawed from 21 December 2012 giving providers plenty of time to consider how to manage the change.
- The ruling provides an opportunity for insurers to take a more sophisticated approach to underwriting annuities and for consumers to review their options to ensure that they maximise their benefits with a sound, sensible and flexible exit strategy.
- Financial advisers should continue to monitor the annuity market carefully to see if rates move, ahead of the December 2012 deadline. The use of the Open Market Option will be particularly important in this regard, in case some uncompetitive annuity providers decide to reduce their rates now to benefit from policyholder inertia.
- Once a client hits the age of about 70, the adviser should be looking at two factors: annuity rates and performance of different holdings within the drawdown plan. Since it is not always possible to sell funds at their highest price and buy annuities when rates are at their peak it is important to capture gains and use these to lock into increased lifetime income.
- Despite consumer antipathy towards annuities they do provide important benefits such as a guaranteed, fixed lifetime income. With the removal of the requirement to annuitise by age 75, there is a real risk of clients staying in drawdown too long and unwittingly finding their drawdown investments becoming increasingly unsuitable for their needs.

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CII Introduction: The landscape for retirement is changing. The UK Government is in the process of implementing a number of reforms to pensions to try to incentivise long term savings – including abolishing the requirement to annuitise by age 75. Changes are also afoot at the EU level and, on 1 March the European Court of Justice banned underwriting by gender. This thinkpiece considers the potential impacts of this ruling on the UK annuities market and the consumer within the context of the other reforms that are taking place. It argues that the ruling may not be a bad thing – the insurance industry will have to find more subtle ways to underwrite annuities and rates may not fall as expected. The overall result could be a better outcome for all.

March 1 came and, as widely predicted the ECJ backed up the Advocate General's view and banned gender discrimination in annuity rates. What was less widely expected was the 21 month window offered, with discrimination only outlawed from 21 December 2012. This window should give providers plenty of time to consider how to handle the change.

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I think that it is likely that we will see a more sophisticated approach to underwriting annuities. Simple differentiation based on gender alone has always been a very crude way of estimating life expectancy. My late grandmother and Queen Elizabeth the Queen Mother were both born in 1900. Both were females, but whereas the Queen Mother died in 2002, my grandmother died in 1972 a full 30 years earlier. This example highlights very strongly that gender alone does not determine life expectancy!

Annuity providers were not just sitting there waiting for the announcement. One cut its rate guarantees so that no quote was guaranteed past 28 February. Another announced that it was equalising its male and female rates ahead of the ruling; something it is very easy to do when your rates are not competitive! Others had planned to close for new business for an indeterminate period until they knew what the market was doing.

Before the announcement, the doom-mongers were saying that male annuity rates would be equalised down to match female annuity rates. There were 'buy now while stocks last' signals coming from some providers looking to cash in on the uncertainty. Now we have some clarity and it is clear that clients who were not planning to buy an annuity this year do not need to take any action. Rates could still move up with interest rates, before the impact of equalisation is felt.

We will continue to monitor the annuity market carefully and would recommend advisers in this area of advice to do likewise. If it is clear that rates are moving ahead of the December 2012 deadline, we will take appropriate action. Otherwise we expect it to be

business as usual for some months to come. Before this announcement, we always recommended the use of the Open Market Option, and this will be particularly important now, in case some uncompetitive annuity providers decide to reduce their rates now to benefit from policyholder inertia.

There seems to be a general expectation that rates will be equalised down...but I do not believe this will be the case.

There seems to be a general expectation that rates will be equalised down, with men getting annuity rates similar to those currently offered to women, but I do not believe that this will be the case. The annuity industry has been given 21 months to consider how to underwrite people buying annuities more effectively, and hopefully this will result in a better outcome for all of them.

Of course since June 2010 there has been no legal requirement to secure pensions at 75, but the memory of the late Henry Allingham highlights why 99% of people need to buy annuities, and the question is not whether, but when.

Henry died in 2010 aged 113, meaning that the annuity which he purchased at 65 paid him an income for 48 years.

For those readers unfamiliar with Henry, he was one of the last survivors of World War I. Henry died in 2010 aged 113, meaning that the annuity which he purchased at age 65 had paid him income for 48 years, giving him excellent value for the money invested. Of course Henry had no idea how long he was going to live. What he did back in 1962 was to buy insurance against living 'too long', and his 48 years income was the return on that longevity insurance.

With more than 1,000 clients of our own taking income withdrawals from their pension funds we see all too often the antipathy towards annuity purchase which has developed over the years through a combination of negative press and the advent of new providers who are not active in the annuity market.

It is undoubtedly true that rates today are significantly lower than they were when I joined the pensions profession more than 30 years ago. But there are good reasons for that. In the late 1970's a typical male retiring at 65 could expect to receive a pension for about 14 years; today that expectation has risen to about 24 years. The ECJ ruling has stopped crude analysis based on sex alone, but even the ECJ would admit that people are living longer. In the late 1970's interest rates were well into double figures – as was inflation – driving up annuity rates, but not the value of pensions being paid.

Improving longevity has, however, merely moved the goalposts to later in life with regard to mortality cross subsidy. Today the loss of that cross subsidy, called 'mortality drag', is worth less than 0.5% p.a. to someone going into drawdown at 60. Many people would regard that as a small price to pay for the opportunity to achieve investment growth, the flexibility to vary the pension income and the preservation of

capital on premature death – albeit that that capital will soon be subject to 55% tax.

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However mortality drag reaches 1% p.a. by age 70 and by age 85 it has reached a massive 5% p.a. So for all but a special minority, buying an annuity – or perhaps several annuities – between age 70 and 80, what we call the ‘annuity decade’, is the only sensible approach. Leaving annuitisation to after age 80 is very dangerous territory for clients and their advisers and with the changes to drawdown rules making it easier for clients to remain in drawdown beyond age 75, there is a real risk of clients staying in drawdown too long and unwittingly finding their drawdown investments becoming increasingly unsuitable for their needs.

But how should clients go about annuitising their drawdown funds? Just as we would not recommend a client puts 100% of his fund into equities on one day, so it is essential to understand that there is no one day when an annuity should be purchased.

From about age 70 the adviser should be looking closely at two factors: annuity rates and performance of the different holdings within the drawdown plan. Whilst in an ideal world we would all want to sell funds at their highest price and buy annuities when rates are at their peak this obviously cannot be done. What is important is to capture gains and use these to lock into increased lifetime income.

If a fund has risen by 15% and during the same period market annuity rates have fallen by 5%, then it will be possible to secure roughly 10% more income than could have been achieved at the beginning of the period. So during the annuity decade there should be numerous annuitisation opportunities.

It used to be that larger annuity purchase prices attracted higher rates than smaller ones. Some annuity providers charged a monthly policy fee which had a significant impact on smaller income instalments, and if you had a substantial fund it was usually possible to get annuity providers to ‘bid’ for it.

Things have changed since those days. Policy charges on annuities have largely disappeared, and the size of the purchase price now goes against the

policyholder. This is because annuity providers use the purchase price as a proxy for social status, arguing that large purchase prices mean wealthy clients and wealthy clients live longer than poor ones. This is just one small example of what the ECJ judges are looking to happen. All of this means that buying annuities in tranches between £20,000 and £50,000 will often get more income for the client than using the full fund at once.

And of course the annuities which are purchased may not all be conventional non profit annuities. With profits annuities such as the Prudential’s Income Choice Annuity and variable annuities such as MGM’s Flexible Income Annuity offer clients the advantage of mortality cross subsidy whilst retaining flexible income and the opportunity to achieve investment growth.

Just as annuity providers will have to review their positions following the ECJ ruling, so clients will need to review their options on a recurring basis to ensure that they optimise their benefits with a sound, sensible and flexible exit strategy.

Conventional annuities are an excellent way of securing a fixed lifetime income with or without inflation protection and dependant’s benefits, and for the majority of clients the transition from drawdown to guaranteed income will be by means of a series of conventional annuities. However we have recently seen the emergence of other options which will be attractive to many clients, particularly those with a comparatively low dependence on their pension funds.

Retirement planning is undoubtedly one of the most complex areas of financial advice as clients move from accumulation to decumulation and finally to annuitisation as income benefits are secured for life. Just as annuity providers will have to review their positions following the ECJ ruling, so clients will need to review their options on a recurring basis to ensure that they optimise their benefits with a sound, sensible and flexible exit strategy.

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Some recent articles in the series:

No.52: [What Motivates Us to Save? Creating Effective Incentives for Public Engagement in Pensions](#) by Nick Hurman (March 2011)

One of the great public policy issues is the question of how to get people to save for their retirement, especially when peoples' confidence in financial markets and services has long been eroded. In this article, strategy consultant Nick Hurman returns to our series having led AEGON's latest consumer research on attitudes and preferences when it comes to saving for retirement. His findings offer some timely directions for public policy.

No.51: [A Region in Transition: A Political Risk Analysis of the Middle East and North Africa](#) by Adrian Lewers (28 February 2011).

With mass political protests sweeping the Middle East and North Africa, predictions on their political and economic implications are changing almost as quickly as the events themselves. Adrian Lewers of specialist insurer Beazley plc provides an analysis of developments from an insurance risk perspective.

No.50: [Wanted: A Visionary Navigator and Innovative Thinker for Retail Financial Distribution](#) by Lucian Camp (1 February).

The distribution of financial products has undergone significant changes in recent times as firms have begun to utilise new technologies to reach consumers. Lucian Camp notes the progress made by what he calls the "D-I-Y driven distribution revolution" but controversially asserts that financial planning is still failing to engage the mass market. Ultimately, he argues, the industry needs a Bill Gates like visionary.

No.49: [Culture and Ethics: A New Crucible for Regulator Thinking?](#) by Duncan Minty, MSc, Chartered Insurance Practitioner (5 January)

Corporate responsibility and business conduct consultant Duncan Minty argues that culture could form an important part of the regulatory environment. He then begins to develop a framework for how this could be achieved and reflects on the strides already being made through voluntary market led initiatives.

No.48: [A Remarkably Rosy Economic Outlook for 2020?](#) by Vanessa Rossi, Senior Research Fellow in the International Economics, Chatham House, **International Series no.13** (23 December 2010).

Attention is moving from the 2010 rebound in the global economy and world trade towards the outlook for 2011 and beyond. After the gyrations seen in the last couple of years, it is not surprising to see considerable short-term uncertainty: predictions vary given the risk of double dip recessions in the US and Europe. Vanessa Rossi of Chatham House summarises her take on the global economy to 2020.

No.47: [Insurance Contract Law Reform: Bringing the Underpinning Law into the Twenty-First Century](#) by Peter Tyldesley (17 November)

The author examines the problems with English Law regarding the treatment of insurance contracts. He shows that much of the problem stems from trying to underpin a twenty-first century insurance market with law written in Georgian times. He summarises recent steps taken by the Law Commissions and discusses some of their implications.

No.46: [What Happens Once the Ink is Dry? Claims and the Parties' Post-Contract Duties](#) by David Hertzell, Law Commissioner of England & Wales (8 November)

Law Commissioner David Hertzell examines his team's latest review of insurance contract law. He sets out some of the problems with the existing law underpinning insurance contracts, and discusses some solutions to clarify the insurer and policyholder responsibilities especially after the contract is signed.

No.45: [The View from Singapore - Cautious Optimism about Asian Economic Recovery](#) by Mui Pong Goh, Research Fellow, Chatham House, **International Series no.12** (19 October)

Due to its unique vantage point at the heart of Southeast Asia, Singapore is well placed to provide an informed view of global economic developments and their implications for this influential part of the world. This paper discusses the tremendous growth surge underway this year, and reflects on the current wave of cautious optimism regarding the region's economic future.

No 44: [A Passage to India: Towards Robust Economic Growth?](#) by Donald Hepburn, Associate Fellow in International Economics, Chatham House, [International series, no.11](#) (29 September)

Published in the backdrop of the Commonwealth Games, it unpicks some of the underlying economic trends with India's developing economy. The paper begins by identifying the reasons for India's relative success during the financial crisis, before outlining the future prospects for growth and the infrastructural and political barriers to prosperity.

No.43: [Time for collective action? Redressing the damaging effects of cartels on small businesses](#) by Ingrid Gubbay and Antony Maton, Hausfeld & Co LLP (10 September)

This paper, by the authors examine some of the harmful effects of cartels on small businesses and discusses reasons why firms remain reluctant to claim for damages. The paper then moves on to highlight the affordable options open to SMEs for redress, and the opportunities for insurance firms to become the underwriters of collective action.

No.42: [Speedy Recovery or Lingering Crisis in the Gulf Economies?](#) by Vanessa Rossi and William Jackson, Chatham House, [International Series no.10](#) (30 July)

Over a year after covering this region in an [earlier thinkpiece](#), the author returns to examine how the Gulf economies have fared especially following the Dubai property crisis last autumn. Despite the setback, Chatham House's forecasts nevertheless show much promise for significant growth in insurance and financial services over the next 5 to 10 years.

No.41: [Charging fairly for pensions](#) by Steven Cameron, AEGON UK (20 July)

The Head of Business Regulation at AEGON UK summarises the 2012 pension reforms introducing a controversial new charging structure for the National Employment Savings Trust (NEST) scheme which will combine a fund management charge with a charge on contributions. Examining both sides of the argument, AEGON concludes that a combination charging structure is a positive move for all parties.

No.40: [The Future of International Financial Regulation](#) by Eric Pan, Associate Fellow in International Economics, Chatham House, [International Series no.9](#) (8 June)

This thinkpiece summarises the challenges confronting attempts to strengthen the global financial regulatory architecture. Prepared by a prominent regulatory law professor based in New York, the paper helps readers make sense of the various interlocking institutions such as the G20, IMF and European Union, and sets out the key issues and challenges facing them as they deal with the effects of the financial crisis.

No.38: [Successes, trials and tribulations in regional economic recoveries](#) by Rodrigo Delgado Aguilera, [International Series no.8](#) (22 April)

The developing world is seeing the same sort of multi-speed recovery as elsewhere. While the Asian economies have responded well following lessons learned from earlier crises, Latin America and the Middle East seem to have for the most part escaped the turmoil's major effects, but emerging Europe's recovery is still far from over.

No.37: [UK Election 2010 Special: What the Parties Say](#), by Stephen Timms, Mark Hoban and Vince Cable (Published 1 April)

We have compiled an election special as part of our regular CII Thinkpiece series. The three main parties – represented by the Rt Hon Stephen Timms MP for Labour, Mark Hoban MP for the Conservatives and Dr Vince Cable MP for the Liberal Democrats – set out their respective visions for financial services.

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