Response from MBE International the HMTs consultation 'Creating a Secondary Annuity Market'

To

HMT

From

Date

16 June 2015

Dear Sir / Madam

Please find our response to the questions asked within your 'Creating a Secondary Annuity Market' consultation. MBE International is a consultancy primarily focused in serving clients from the UK life and pension industry. MBE has specific experience in product and proposition development in the UK retirement market.

Positioning Statement

MBE International Actuaries are supportive of the proposed secondary annuity market however we do feel that for it to operate in a suitable manner for those selling their current income a number of consumer safeguards around its operation must be put in place along with electronic facilitation of the market. These developments will bring confidence to the market and therefore both sellers and buyers will be willing to trade resulting in a fair value being achieved.

Key terms

Seller – The current annuitant holder who is considering selling or exchanging this income. This can include the dependent on an annuity contract.

Buyer – The purchaser of the income currently owned by the seller.

A.1 [QUESTION]

A.2 The government welcomes views on how it envisages the secondary annuities market working, and its proposed approach on the scope of these reforms.

1. In what circumstances do you think it would be appropriate to assign one's rights to their annuity income.

There are many circumstances where it may be appropriate for one to assign their income to someone in exchange for a cash payment or a different income stream. After all for many years a large proportion of those purchasing pension annuities basically rolled over into this product without any real future financial or income planning.

We believe that for a secondary annuity market to ensure that those looking to sell or exchange their current annuity income (the *seller*) to achieve 'fair' outcomes those selling should ideally go through a formal financial assessment with a regulated Chartered Financial Planner (CFP). The CFP will work through a process that allows the seller to understand the impact of their wants and decisions now and in the future. We feel the advice should ultimately make recommendations as to whether clients should proceed with their proposed actions or not. Clearly there will be a number of situations where it is not appropriate for annuitants to sell all or part of their income however this should come out as part of the financial planning process.

It is worth noting that to fully know the client a health assessment should be conducted into the seller and if appropriate their dependant. This could be a costly part to the process unless an automated approach is taken by the medical underwriters. It is likely that the current health of the seller (and/or) their spouse is a key factor in the decision to 'sell' and is key investment factor to the buyer.

The cost of this advice should be borne both by the seller and the buyer. The sold income is effectively a new class of income producing asset and therefore a buyer would pay a sourcing fee for other types of assets sourced (eg per trade commission etc). This sharing of the cost support the bring together of the buyers and sellers.

MBE proposes that a regulated CFP qualification and advice-monitoring infrastructure is established to ensure that those considering selling their income receive consistent financial advice on the subject. With this in place we believe a wide number of pension annuitants can consider assigning their annuity income over to someone else.

2. Do you agree with the government's proposed approach of allowing a wide range of corporate entities to purchase annuity income in order to allow a wide market to develop, whilst restricting retail investment due to the complexity of the product? What entities should be permitted and not permitted to purchase annuity income and why?

We propose that retail investors should only be able to access this market through pooled investments (OEIC for example) through a regulated investment product provider. However, sometime after establishment of the market it may be appropriate to allow individuals (and other bodies) to invest in the market.

All financial markets that are long term focused still tend to attract investors that are short term focused. It is likely that a certain (small) percentage of retail investors will be very interested in buying annuities through this market without a view of the long term. With this in mind we feel that sellers of their individual annuities should be the only sellers using this market. We anticipate further trading by the investors as they for example package up incomes to 'sell on' to a further investor. This further trading (such as packaging up individual loans) will not be via this market.

The balancing challenge will be to allow enough investors into the market so to ensure that a fair price is being offered (i.e. a range of quotes) to those selling their incomes, against allowing many different 'types' of investors in. We believe that all those investing in the market must demonstrate the controls and sound principles - as is required for all regulated firms conducting financial business in the UK.

We believe the following non-retail investors will definitely be attracted to this market:

1. Investment houses – as this is a new asset class they may be interested in the risk adjusted return achievable (low credit risk etc), and diversification advantages.
2. Insurers and pension funds looking to hedge their longevity risk, increase asset diversification and other capital efficiencies.
3. Intermediaries looking to sell on the income they have purchased. These intermediaries could be retail pooled product providers.

We believe that it is very likely that list will continue to grow once the regulated market becomes established.

3. Do you agree that the government should not allow annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their existing annuity provider ('buy back')? If you think 'buy back' should be permitted, how should the risks set out in Chapter 2 be managed.

We believe that allowing a provider to buy back the income from the seller is fraught with problems. In addition to this we believe that a provider allowing a newly developed surrender value calculation would be a very difficult issue to allow for in force annuity contracts.

We believe 'buy back' where the discussion has been through the seller (or their advisor) and the original product provider offers a conflict of interest and potentially leads to sub-optimal outcomes compared to that what could be achieved if the client uses the regulated market.

It may be the case that the original provider of the annuity buys the income from their annuitant (the seller) but it is proposed that this does not result in the cancellation of the contract but simply the income is then paid back to the original provider.

We are keen to see a market where the seller is anonymous during the offer and acceptance process. If this is the case This will help to ensure that original providers cannot target their existing annuitants. Obviously at completion of the income sale the identity will be known unless a clearing system is developed that allows either side of the transaction to remain anonymous

4.Do you agree that the solution to the death notification is best resolved by market participants? Is there more the government should be doing to help address this issue?

Reporting the unfortunate death of an individual has long been a difficult part of administering an insurance contract. In many cases the suspending of the bank account on death informs the insurer of the death of the policyholder. Of course for a percentage of lives this process does break down.

The death of a spouse (2nd life on an annuity policy) before the policyholder (1st life on the annuity policy) often is not reported to the insurer. Annuity providers regularly perform checks on the status of their annuitant book using third party data providers to try to identify the existence of the lives in their book.

A lifetime annuity policy stipulates that payments are to death and any annuity payments (outside of guarantee periods) after death are liable to be paid back by the estate. In such a case where the annuity payments continue after death this process of claw back is expensive to administer.

The selling of the annuity income increases the need for optimal death reporting as employing the principle of claw back will add further administrative overheads. With this in mind we suggest the establishment of a centrally controlled death register at national level. This database would be accessed by those administering annuity contracts in a controlled manner. Clearly this involves not only the establishment of an electronic register but also changes to the processes used by the those involved when a death is notified.

The establishment of a central electronic register would help insurers reduce the administration of annuities and the secondary annuity market which would be expected from investors in a secondary annuity market.

5.Do you agree with the proposed approach of the government working with the FCA regarding the fees and charges imposed by annuity providers?

The annuity provider administration of an arrangement for the change of the beneficiary and payment details will include policy system and banking/payment changes. The costs for a provider will break down into development costs (system and process definition) and on-going administration costs. The amount of system development will largely depend on the nature of sale options available to the seller. If the seller is only allowed to sell the income in line with their current contract then then there is very little development likely to be required. If, however, the seller can decide to sell only the 1st life income on a joint life policy for example the income payments (ie the sold income contract) to the buyer are not aligned with the annuity policy and therefore more development will be required. Development costs will be variable by provider and are difficult to estimate at this stage.

Once the administration system development and process mapping have been completed then processing the sale of the income and banking changes is simple to understand the widget cost. The regulator would then ensure that the actual cost to the seller/buyer of making the relevant administration/banking changes should be at or close to the cost incurred by the annuity provider.

6.Do you agree that the scope of this measure should be annuities in the name of the annuity holder and held outside an occupational pension scheme?

We agree that the initial scope of the secondary market should be annuities where the contract is between the beneficiary and an annuity provider. In time it is envisaged that the market may be expanded to include trust-based pensions. It is likely that the incorporation of these types of pensions will take longer to bring into the secondary market due to the challenges of developing the capability for a range of pension providers.

7.Are there any other types of product to which it would be appropriate for the government to extend these reforms?

Clearly this consultation is focused on pension products which have historically locked individuals in for life and are virtually compulsory. It may be appropriate to extend this to 'purchased life annuities' also. In time we would see all pension incomes being within scope.

Legislative Changes

A.3

The government welcomes views on how it proposes to change the tax rules relating to the assignment of annuity payments.

8.Do you agree that the design of the system outlined in chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the government would need to apply to individuals who had assigned their annuity income?

Personal taxation is not an area of expertise for MBE International and therefore no response is offered.

9.How should the government strike an appropriate balance between countering tax and avoidance and allowing a market to develop?

We see the key principle that government is already focusing on is that taxation parity must be achieved. Clearly recycling monies to obtain tax relief should be avoided. We believe that the vast majority of sellers will understand that approach. We also feel that in the first few years after launch there should be one monitored market to ensure that all market stakeholders (sellers, buyers, advisors, intermediaries) are performing adequately. We believe the compliance monitoring by advice firms and buyers is required to ensure that the client received suitable advice and understands the importance of the decisions they make. We also feel that overall market compliance should be applied and a regular basis to ensure the market is operating fairly.

Consumer Protection (Chapter 4)

A.4

The government welcomes views on how it proposes to ensure consumers are appropriately informed when making decisions relating to the assignment of their annuity income.

10.What consumer safeguards are appropriate – is guidance sufficient or is a requirement to seek advice necessary? Should the safeguards vary depending on the value of the annuity?

To give confidence to sellers and buyers we strongly suggest that the seller receives financial advice from a regulated financial planner who is trained in this advice space. Without this it is likely that the market will not attract investors (the buyers) due to concerns around conduct risk and potential future recourse. The investors buying the income will require confidence that the seller has worked with a regulated financial advisor and the decision to sell their income has been fully investigated and the terms agreed to this sale are fully understood.

We propose that a seller must work through a financial advisor to access this market. There will be some sellers who want to do something against the advice from their financial advisor. To help deal with this situation it is proposed that the buyer has access to key aspects of the advice (anonymously of course). The key aspect of the advice would be 'Have you advised your client to sell their income?' The buyer can then decide the level of conduct risk applicable with purchasing an income.

11.What is the best way to implement these safeguards? Should the safeguards include expansion of the remit of Pension Wise?

Pension Wise is still in its infancy so it is very difficult to assess whether they are the best method to deliver an appropriate level of advice to sellers here. What is key is that advice standards need to be defined and financial planners trained to ensure they are confident that they can take in the various aspects to allow them to give consistently high quality advice. We propose further consultation between HMT and the advice market stakeholders to ensure optimal outcomes are achieved for sellers and buyers.

12.Should the cost of any advice or guidance be borne by the annuity holder (mirroring the arrangements for conversion from a defined benefit scheme)? If not, what arrangements are appropriate?

The sold income represents a new financial asset class for investors. When an investor buys any form of financial asset they usually incur fees (or taxes in some classes) therefore some sharing of the cost of advice should be possible. This should be on a prescribed basis however – i.e. a fixed monetary amount is paid by the investor. The investor can then load their offer to the seller for this cost directly. Without some form of sharing of the costs it seems likely that a great deal of customers with small annuity pots will not be able to access this market.

13.Do you agree that the government should introduce a requirement on individuals to obtain a number of quotes? How else should the government best promote effective competition to ensure consumers obtain a competitive price?

We envisage an electronic aggregator being used to supply quotes to the seller. The information and technology required to allow buyers to offer terms to buyer an income from a seller are very similar to that availability in the individual OMO annuity market. For a market to demonstrate value for a seller there must be more than one quote available. Establishing a market for investors that as long as an appropriate risk adjusted return is available then we envisage a fair market to come into existence.

14.Does the government approach sufficiently protect the rights of dependants upon assignment? If not, what further steps should the government take?

- **Should the government or FCA issue guidance to annuity providers about the protection for dependants?**

- **Are there particular classes of beneficiary which require special consideration, for example minors or following a divorce or dissolution of a civil partnership?**

- **Are there specific equality impacts that should be considered in this context?**

The issues mentioned in question 14 are very sensitive and therefore it is likely that specific legislation may be required to ensure protection is maintained to avoid (for instance) the 1st life deliberately acting against the 2nd life.

Firstly we propose that all parties to the annuity policy should be fully engaged in the advice process mentioned earlier. In particular this implies that the seller understands the issues involved and the advice the advisor is giving them. This will go some way to ensure that they understand what could happen to their future income. It goes without saying that quality advice can reduce the risks described in question 14 considerably.

Where the seller is wanting to sell dependant income too we have the following proposals:

- Where the dependant is a minor, or subject to a power of attorney then it should be legislated (or otherwise) that the advisor has a fiduciary responsibility to take the dependants needs/risks into account in delivery their advice.
- Regarding issues of divorce, we are very concerned that the secondary market could be used to reduce the marital assets before divorce proceedings have begun. However there is recourse available in the courts for this type of deliberate behaviour. Again it is key that the dependant is involved in the advice process around potential selling income.

15.Should the government permit the principal annuity holder's income to be assigned while dependants retain their own income steam? Should the decision on whether do so be left to the discretion of the parties to the transaction?

There should be flexibility on what income is being sold. A key enabler of this is to understand the policy characteristics. The advisor and the investors need to understand all aspects of the annuity policy. It is likely that buyers will be able to calculate a price for a high percentage of request from sellers.

It is therefore possible, for example for a joint life annuity, that the income can be sold for the 1st life (i.e. current income) and then the contingent dependants income will be retained by the dependent of the seller. However, providers' administration systems will need to be able to administer such structures.

The decision as to what income should and should not be sold will be a discussion between the seller (and dependant) and financial advisor.

16.How can the proposed consumer protection for the assignment of annuities ensure that any impact on means-tested entitlement is understood by those deciding whether to assign their annuity income?

We propose that the income that would have been received by the seller before sale is used in the means-tested benefit computation. In essence the means-testing entitlements assume that income has not been sold. Legislation can define this and therefore financial advisors will include this in their advice to the seller.

17.Should those on means-tested benefits be able to assign their annuity income?

As mentioned in the answer to question 16, the means-testing calculation should assume that no income has been sold. With this in place the decision whether to sell annuity income or not will not impact the means-tested calculation.

18.What are the likely impacts on the government's proposals on groups with protected characteristics? Please provide any examples, case studies, research or any other types of evidence to support your views.

Investors in the market will want to understand the expected return they can achieve by buying income from sellers. The key factor that determines their expected income is the life expectancy of the seller or sellers. A number of the protected characteristics are significant risk factors that help investors estimate future life expectancies of individuals.

There are, however, a number of the protected characteristics that are not used for this purpose. Race, religion/belief, gender reassignment, pregnancy/maternity, marriage/civil partnership and sexual orientation have not been used in the pricing or underwriting of annuity business and therefore it is unlikely that there will be any desire to use them here help make sellers offers.

Historically the sex of a life would have been used to potentially offer different rates to males and females. Since 21 December 2012 this has not been used as a rating factor in insurance products. This is a key factor in understanding life expectancy and therefore investors would be very keen to use it IF they were legally allowed to. The sex of an annuitant is a key factor in determining the longevity of the contract and therefore if this cannot be used it is likely that sellers will receive, on average, a lower offer so to reflect this increased risk.

This leaves age and disability. To clarify when we mention the term disability we actually mean the 'health of an individual' rather than whether someone is what is commonly referred to as 'disabled'. Both age and the health of an individual are key to understanding life expectancy and investors would want to use this information given to them by the seller.