“Drawdown Will Eventually Replace Annuities”

Tom Boardman
Annuitisation

- Puts capital at risk in exchange for receiving a mortality cross-subsidy
- Does not have to take place at the time an annuity is bought
- Provision of a death benefit can delay the timing of annuitisation
- Can be applied to annuities with unitised investments
- Annuitisation is the most effective and efficient way of maximising retirement income
Total 2007 UK retirement income market

- Conventional annuities now account for 68% of the total retirement income market compared to 67% in 2001.
- Income Drawdown accounts for 27% of the market compared to 28% in 2001.

Source: ABI

<table>
<thead>
<tr>
<th></th>
<th>Total Market £15,039m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional Annuity</td>
<td>£10,279m (68%)</td>
</tr>
<tr>
<td>Income Drawdown</td>
<td>£4,012m (27%)</td>
</tr>
<tr>
<td>Investment Linked Annuities</td>
<td>£748m (5%)</td>
</tr>
</tbody>
</table>
Total 2007 UK retirement income market

- Nearly 450,000 new Annuities
- 44,600 new Income Drawdown cases
- A long way to go before Drawdown replaces annuities!

Source: ABI

- Conventional Annuity
- Investment Linked Annuities
- Income Drawdown

Total Market 513,130 cases
Less than 5% of the annuities purchased were with funds over £80,000

Source: ABI
The lifetime income guarantee provided by an annuity is funded by investment growth, the annuitant’s own capital and the capital released by those dying early …

Expected composition of each annuity payment for a male aged 65 purchasing an annuity for £100,000 providing an income of £7,773 payable at the end of each year to all annuitants still alive.

**ANNUITY WITH NO DEATH BENEFIT MALE 65 - £7,773**

[Graph showing the expected composition of each annuity payment over time, with labels for Growth after charges, Capital, and Cross-Subsidy.]
In the early years the investment growth is the most significant constituent of the income payment and the cross-subsidy is small …

Limited cross-subsidy

Investment growth significant

Source: Own analysis using 100% PNMA00 medium cohort 2007
As annuitants get older the impact of mortality cross subsidy grows rapidly …

Limited cross-subsidy

Significant cross-subsidy

Source: Own analysis using 100% PNMA00 medium cohort 2007
The funds of those dying in a year are spread over the lives surviving …

The scale of the mortality cross subsidy at older ages makes annuitisation essential for anyone without extensive alternative wealth.

Source: PNMA00 100% medium cohort; 2007 Mortality cross-subsidy = qx / (1-qx)
At age 85 the cross-subsidy provides half of the guaranteed income and continues to grow in significance ...

Source: Own analysis using 100% PNMA00 medium cohort 2007
It is not a question of IF but WHEN pensioners should fully annuitise …

Limited Value from annuitisation – Death benefit seen as more valuable
Annuitisation increasing essential to provide income for life

How can we change the rules to better meet pensioners’ needs?
Money Back Guarantee – The Consumers’ Perspective …

On death any excess of the original purchase price over the gross annuity payments already received is returned to the annuitant’s estate.

THE CONSUMER BENEFITS

- Removes single biggest consumer objection to annuities: “If I die soon after I retire, the annuity provider will keep my fund”
- ‘Live or die’ guarantee of getting your money back provides a simple underpin in the mass market
- More readily understood than continuation of current income for a limited period
Money-back annuities provide a guaranteed return of capital and allow full phasing into annuitisation …

**BENEFITS UNDER A MONEY-BACK ANNUITY - MALE AGED 65**

<table>
<thead>
<tr>
<th>PURCHASE PRICE</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>20,000</td>
</tr>
<tr>
<td>70</td>
<td>40,000</td>
</tr>
<tr>
<td>75</td>
<td>60,000</td>
</tr>
<tr>
<td>80</td>
<td>80,000</td>
</tr>
<tr>
<td>85</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**PROPORTION OF FUND ANNUITISED UNDER A MONEY-BACK ANNUITY FOR A MALE AGE 65**

- **Accumulated Income**
- **Death Benefit**

- **Annuited**
- **Not Annuitised**
Charging for longevity insurance …

Any scheme designed to pay guaranteed income to those who live beyond their life expectancy requires some form of cross-subsidy.

Two charging methods for securing a guaranteed lifetime income:
- All or part of the capital of those dying early is used
  – the traditional lifetime annuity approach
- All policyholders pay an extra charge up to time of death or fund exhaustion
  – the Variable Annuity approach
Annuity charging approach …

- Cross-subsidy to those living longer from those dying earlier
- Those dying earlier lose out significantly
- Those living longest benefit most
- Achieves highest lifetime guaranteed income
Variable Annuity charging approach

- Fund charges made for guarantees
- Those dying early provide only a modest cross-subsidy to those living longest
- Higher death benefits
- Lower guaranteed lifetime income
- Any move to providing higher guaranteed incomes closer to the levels provided by annuities will require high charges
- Higher income and higher charges will exhaust the fund
Comparison between US Variable Annuity GMWB and UK flexible lifetime money-back annuity

US 5% GUARANTEED FOR LIFE MINIMUM WITHDRAWALS & UK FLEXIBLE LIFETIME MONEY- BACK ANNUITY

Income depends on investment performance. 50% floor provided by automatic switch to Guaranteed annuity

Source: Own calculations Male age 65 income taken yearly in arrears; US 6% p.a. growth rate & 0.6% p.a. Living Benefit charge; UK 6% growth to age 90, 4% thereafter & 100% PMA92 (U2003)
The risks of Income Drawdown …

- **Longevity risks**
  - Outliving capital or reduced income
  - Leaving unintended bequests
  - Failure to leave intended bequests

- **Investment risks**
  - Under performance
  - Taking income when market are depressed
  - Yields at fixed annuity purchase date

- **Mortality drag and Mortality improvement risk**

- **Advice and Servicing costs**
In Summary …

- Annuities have a central role as part of any holistic retirement income plan
- Annuitisation is the most effective and efficient way of maximising lifetime income
- There may be a role for more drawdown as a prelude to annuitisation
- Money-back annuities can improve the mass market proposition
- Drawdown will **NOT** eventually replace annuities
- The motion should be defeated
“Drawdown Will Eventually Replace Annuities”

Tom Boardman