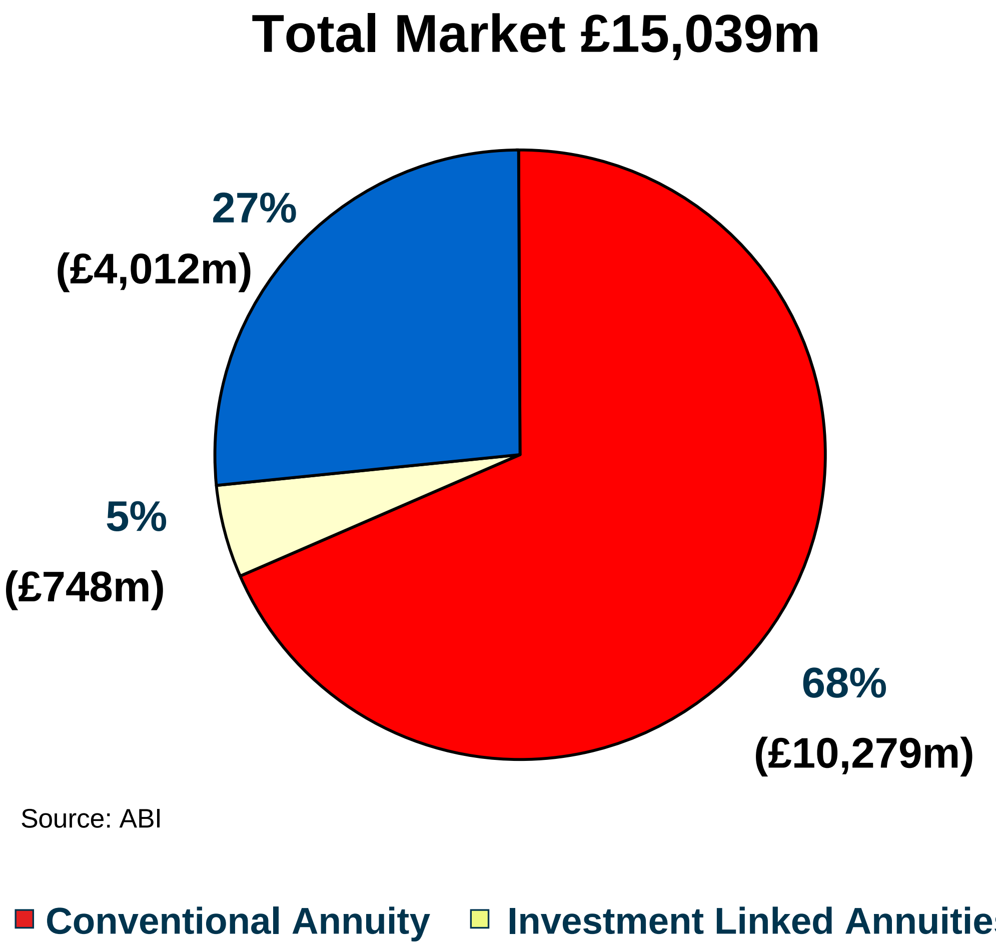
“Drawdown Will Eventually Replace Annuities”

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

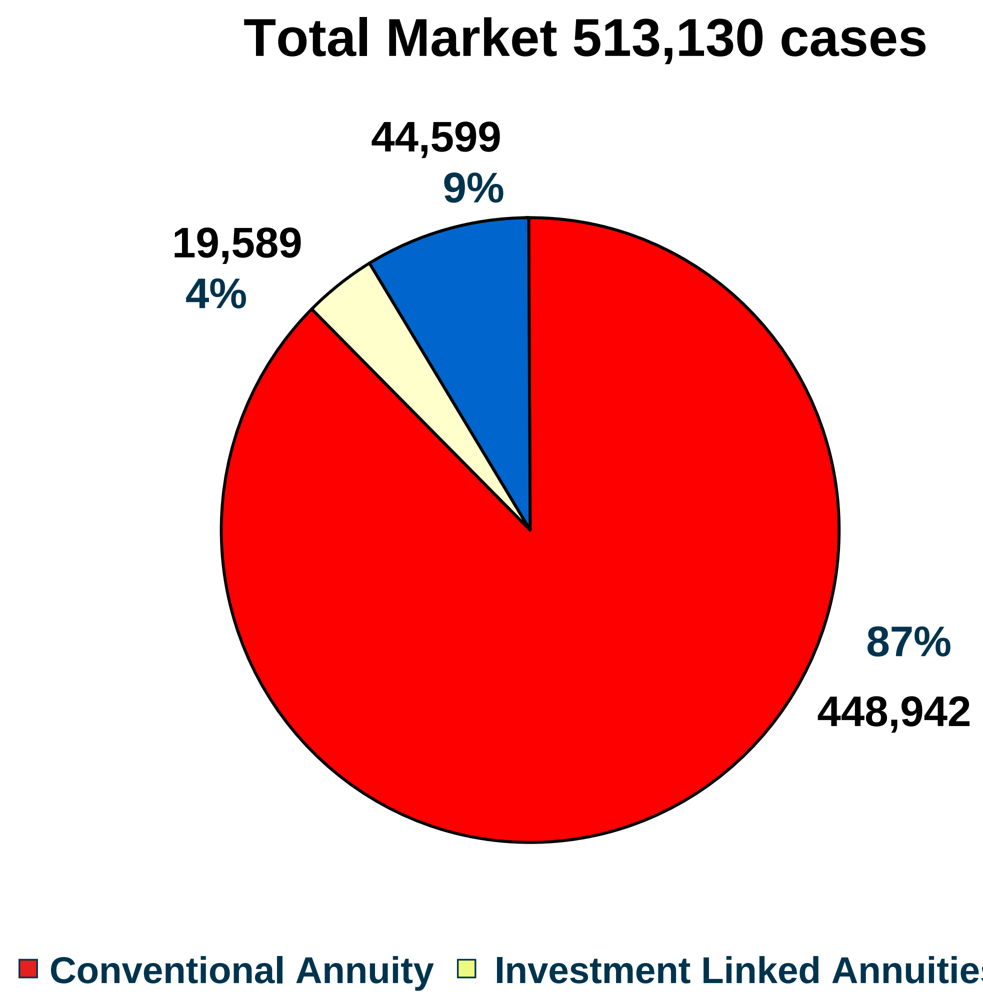
Total 2007 UK retirement income market



Source: ABI

- 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

Total 2007 UK retirement income market

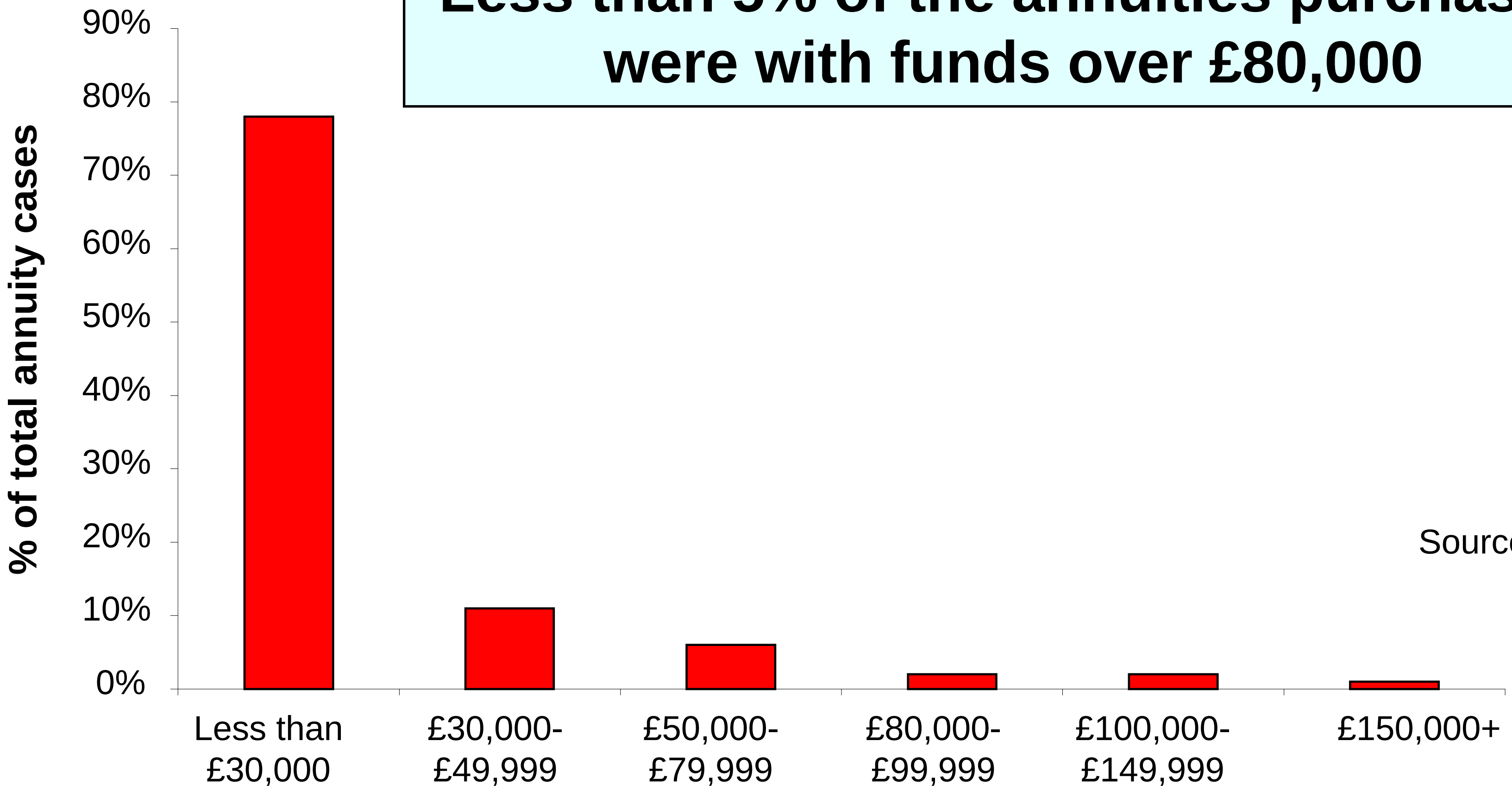


- Nearly 450,000 new Annuities
- 44,600 new Income Drawdown cases
- A long way to go before Drawdown replaces annuities!

Source: ABI

Annuity Funds Distribution 2007

Less than 5% of the annuities purchased were with funds over £80,000

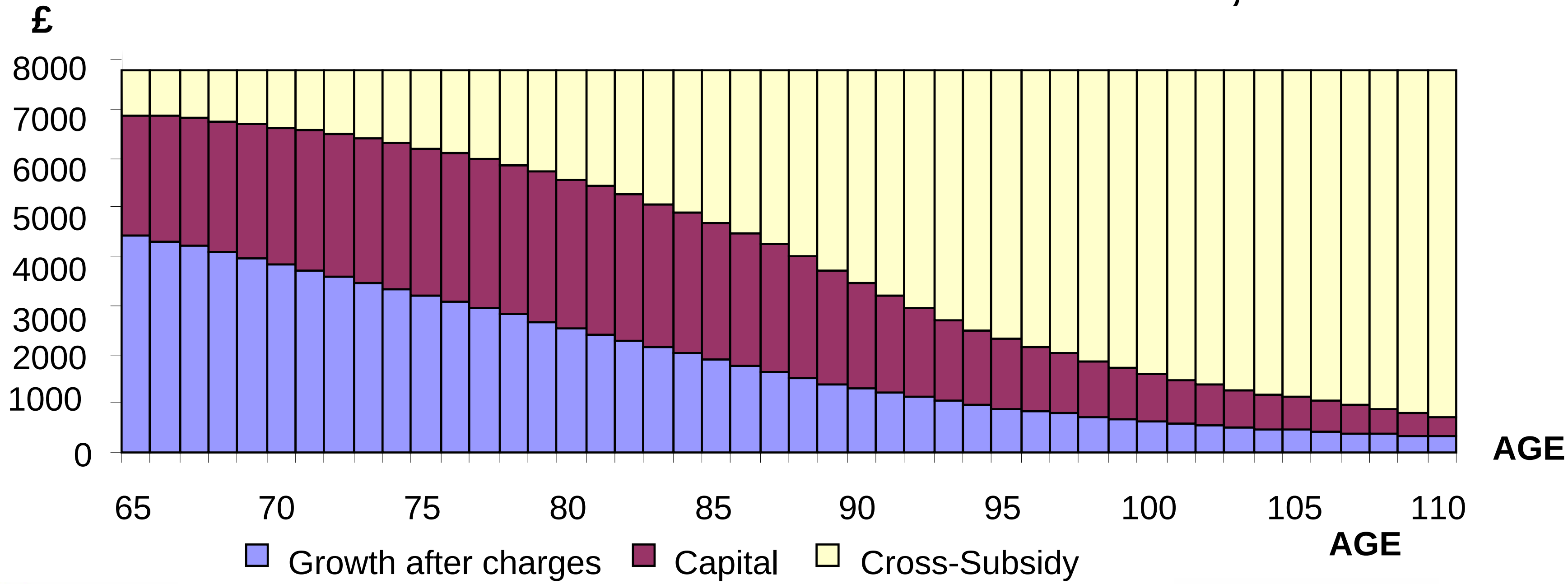


Source: ABI

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 …

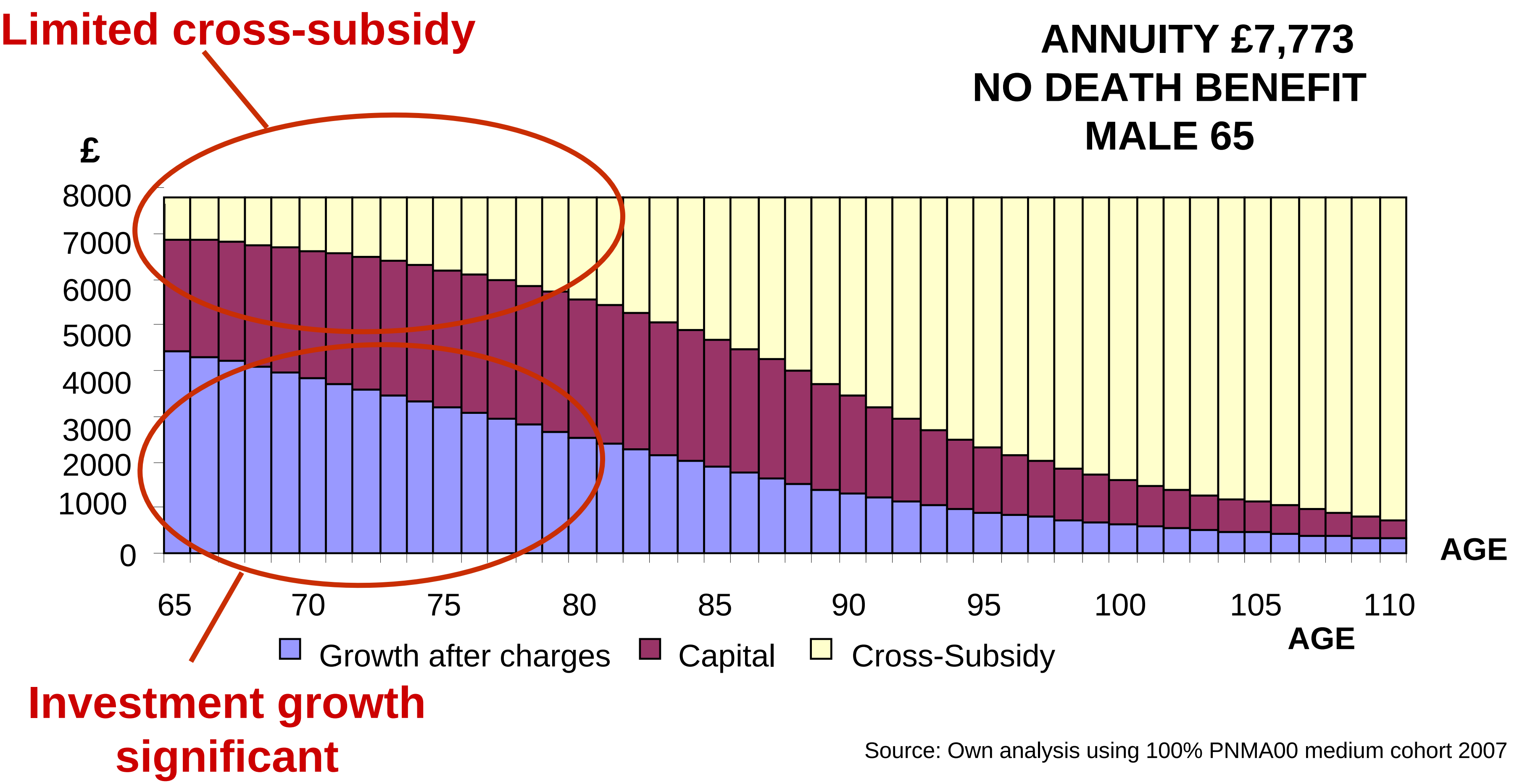
Expected composition of each annuity payment for a male aged 65 purchasing an annuity for £100,000 providing an income of £7,773 payable at the end of each year to all annuitants still alive.

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



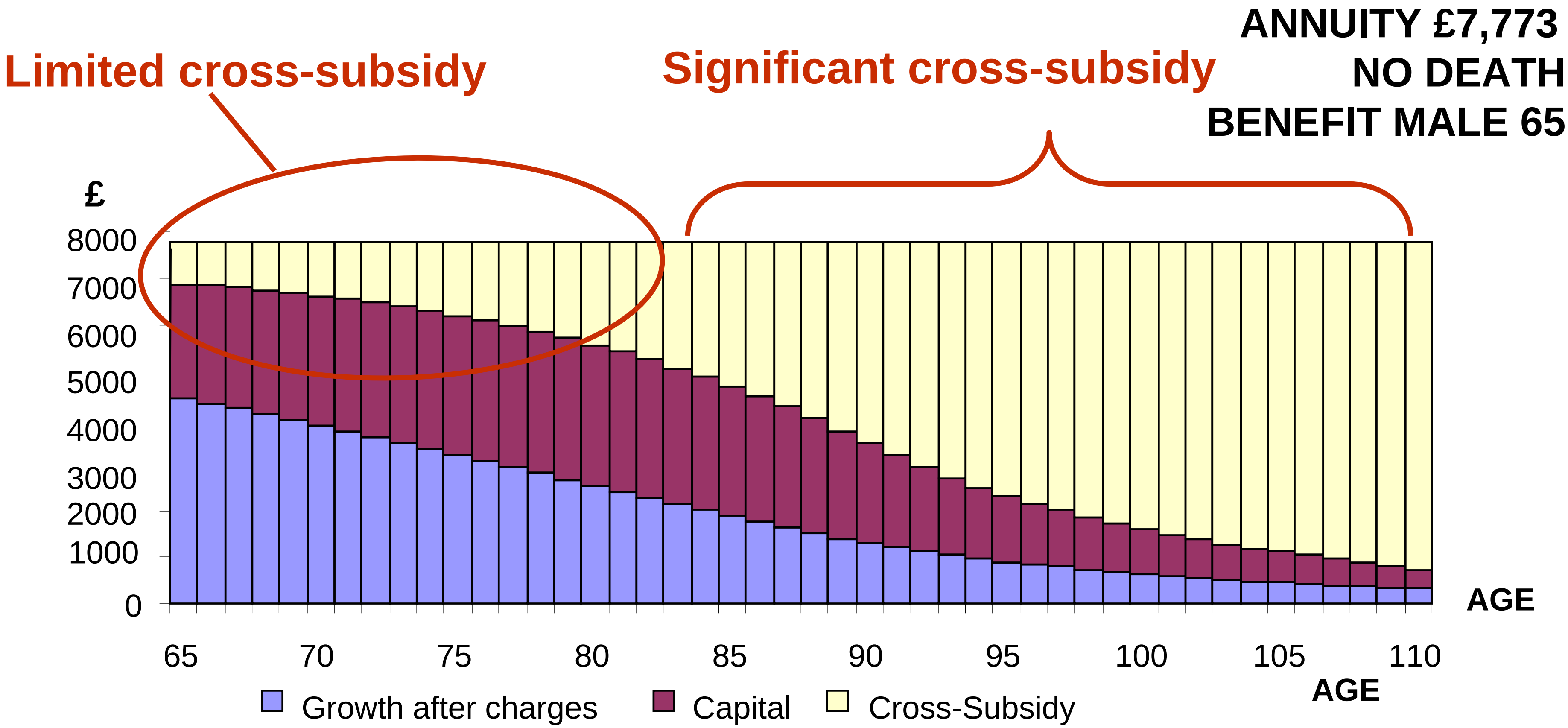
Source: Own analysis using 100% PNMA00 medium cohort 2007

In the early years the investment growth is the most significant constituent of the income payment and the cross-subsidy is small …



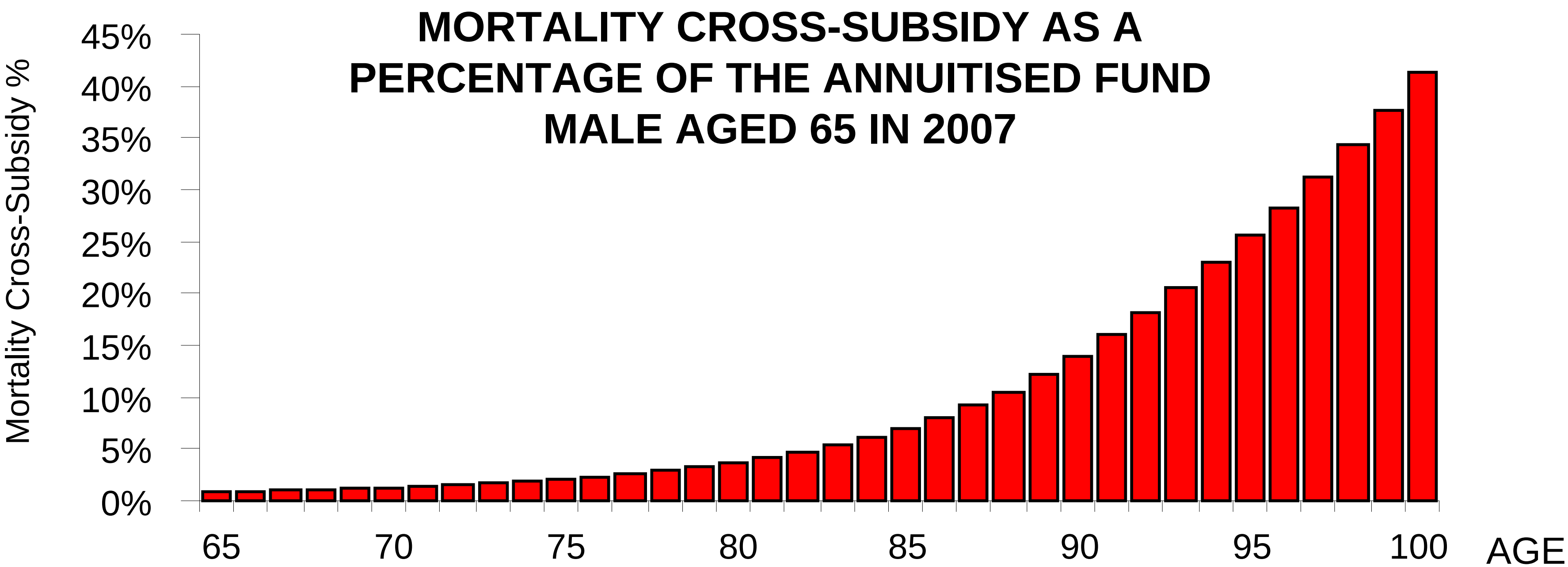
Source: Own analysis using 100% PNMA00 medium cohort 2007

As annuitants get older the impact of mortality cross subsidy grows rapidly …



Source: Own analysis using 100% PNMA00 medium cohort 2007

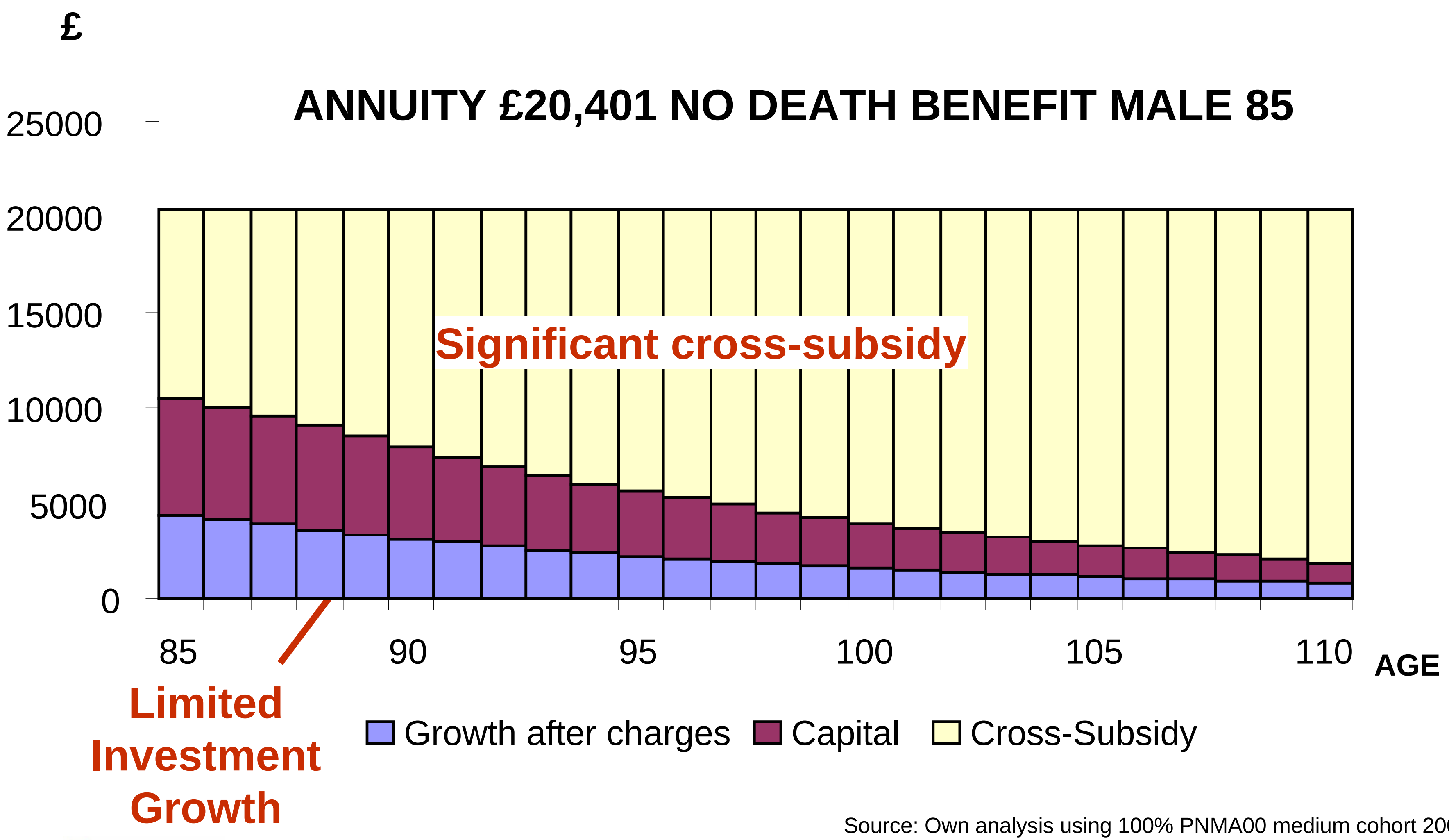
The funds of those dying in a year are spread over the lives surviving …



Source: PNMA00 100% medium cohort; 2007 Mortality cross-subsidy = qx / (1-qx)

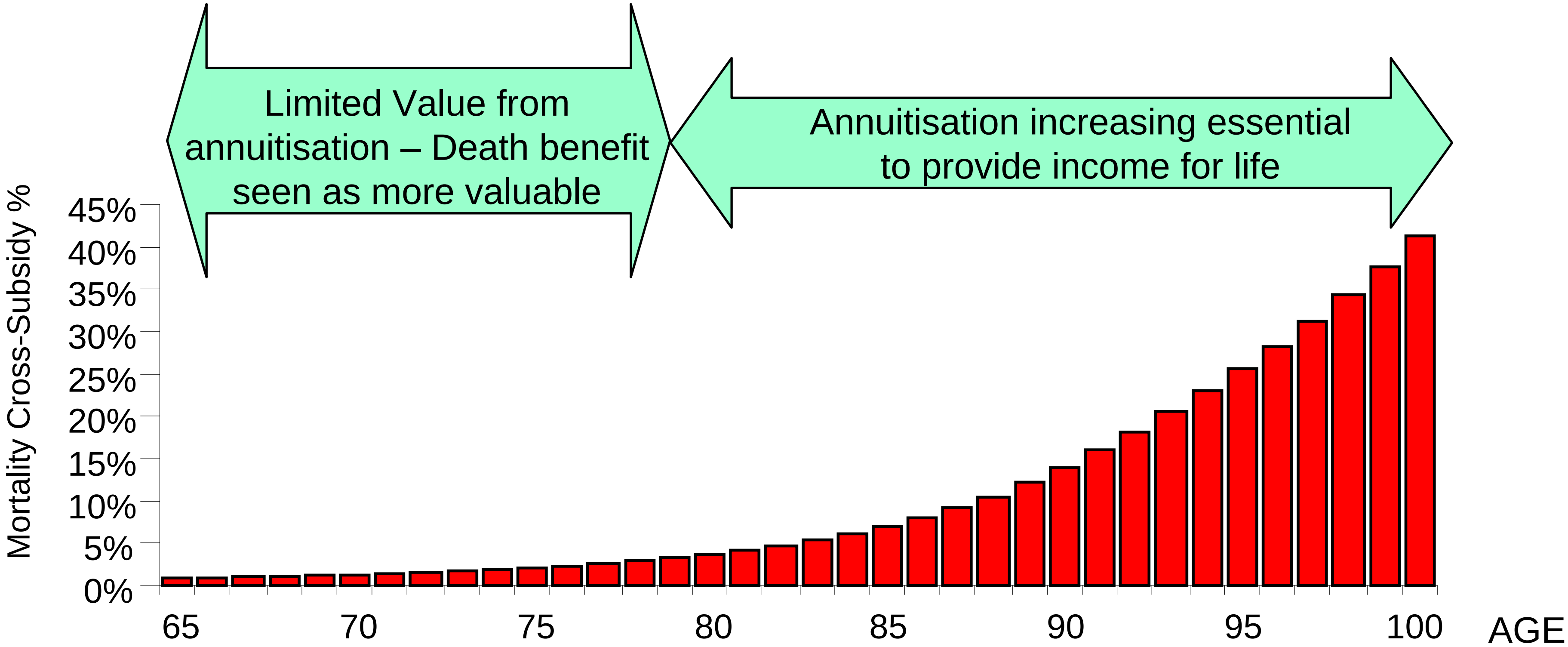
The scale of the mortality cross subsidy at older ages makes annuitisation essential for anyone without extensive alternative wealth.

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 …



Source: PNMA00 100% medium cohort 2007 Mortality cross-subsidy = qx / (1-qx)

How can we change the rules to better meet pensioners' needs?

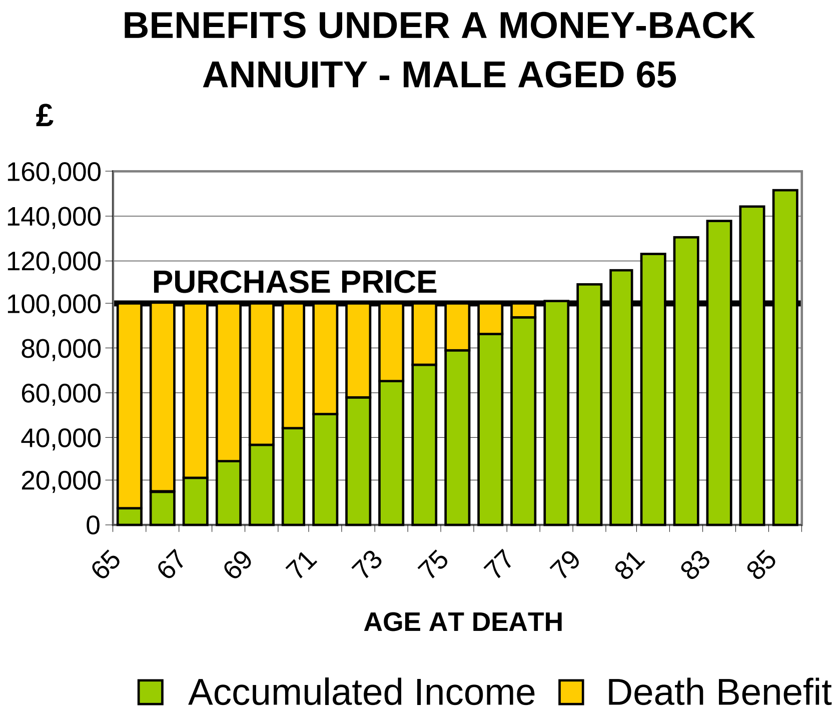
Money Back Guarantee – The Consumers' Perspective …

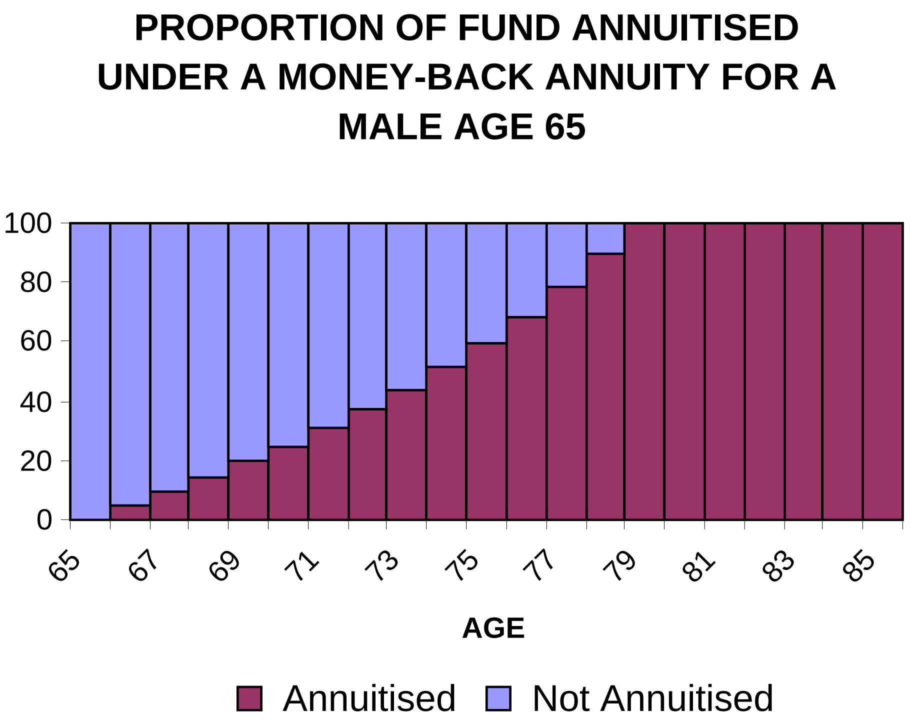
On death any excess of the original purchase price over the gross annuity payments already received is returned to the annuitant's estate.

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

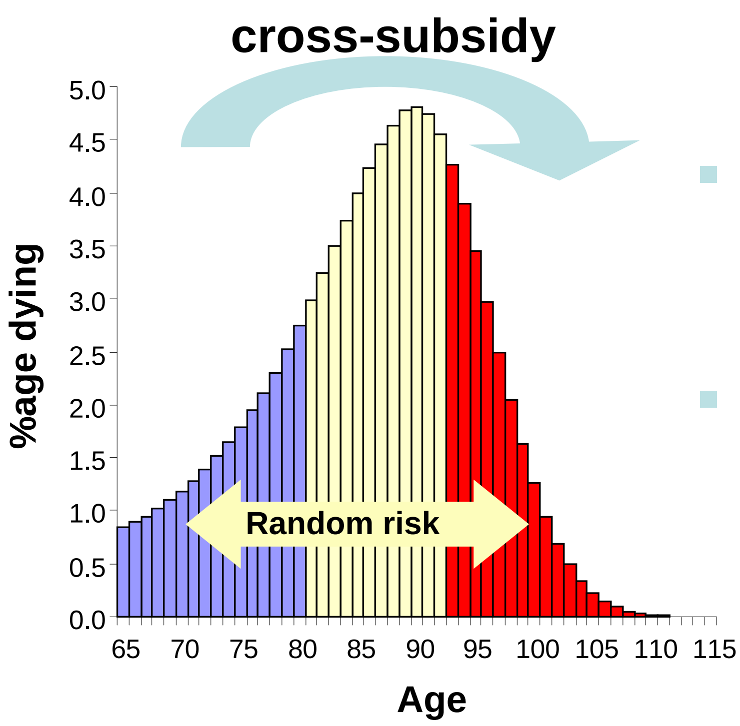
Money-back annuities provide a guaranteed return of capital and allow full phasing into annuitisation …





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

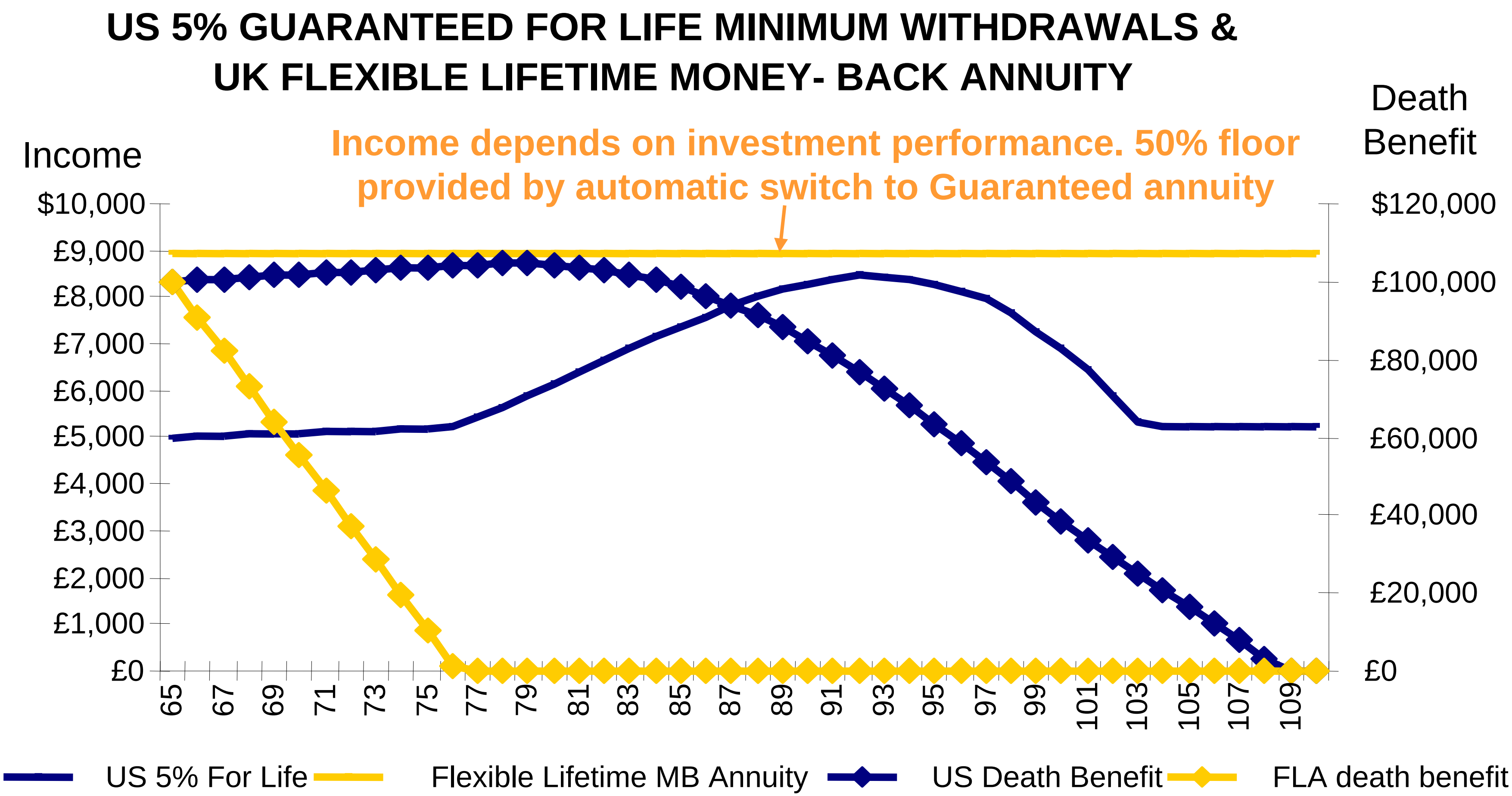
Annuity charging approach …

- 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



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

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