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The Development of the Underwritten Annuity Market in the U.K. and Elsewhere

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An underwritten annuity is a life annuity for which medical history and lifestyle considerations are taken into consideration at the time of purchase. These policies target individuals with impairments that produce below-average life expectancies and to use the shortened life expectancy to offer a higher annuity payout.

This article first describes the development of the U.K. underwritten annuity market. It then considers the factors leading to the demand for these products and how insurers were able to provide them. Finally it considers the market potential for these products outside of the U.K.

The Development of the U.K. underwritten annuity market

In 1995, the first two "official" underwritten annuities were introduced in the U.K. Before 1995, some U.K. life insurers did offer annuities with enhanced terms to clients in poor health, but very much on an ad-hoc basis. The two insurers offering the product, Stalwart Assurance Company and Pension Annuity Friendly Society Ltd. (PAFS), focused on very different market sectors. Stalwart Assurance initially offered enhanced annuities for cigarette smokers only, before branching out into other lifestyle-related impairments such as obesity or raised blood pressure. PAFS focused on offering underwritten annuities to individuals with more severe medical impairments, such as cancer, cardiovascular disease and type 2 diabetes.

In the nearly two decades since, the U.K.'s underwritten annuity market has grown and evolved tremendously. Total sales for underwritten annuities have grown from approximately £30 million per annum in 1996 to nearly £4 billion[1] in 2013, comprising one-third of the entire U.K. annuity market by premium size.

The two original ends of the market have merged as well. Life insurers today offer policies that encompass a full range of medical and lifestyle impairments. More than 10 insurers now offer these products, with new entrants expected to enter the market in the next few years as well.

A separate, distinct market also exists for immediate needs annuities, which cover long-term care needs. These underwritten policies, also known as immediate care plans or care fees annuities, are usually bought at the point of need—typically, upon entry into care homes. The market for these products is considerably smaller than the underwritten annuity market; sales were £125m in 2012[2] and currently there are only three market participants. There are many similarities between these two markets but differences exist around the tax treatment of the products and also underwriting, where the questions focus more on activities of daily living, frailty and dementia.

Demand for underwritten annuities

The underwritten annuity market developed in the U.K. because of a range of factors which drive demand for annuity products. We examine the three main factors: the first two describe why an annuity market existed in the U.K., and the third explains why underwritten annuities could enter the market.

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[1] Source: ABI Quarterly New Business Statistics, published February 2014, accessed March 2014.

[2] Source: ABI, Quarterly New Business Statistics, published February 2013, accessed March 2013.

Existence of defined contribution pension funds

Defined benefit (DB) final salary pension schemes have long been the gold standard for occupational pension scheme provision in the U.K. However, by the late 1990s, membership of these schemes was in significant decline, as the combination of increasing longevity and legislative changes led companies to recognise the increasing cost of providing these pensions.

The reduction in DB pension scheme provision led to increased membership of defined contribution (DC) pension schemes. Several legal structures existed for DC schemes, but fundamentally, employees and employers contribute assets to a financial portfolio that would be used to fund the employees' retirement. As DB plan participation shrank, enrolment in DC plans continued to increase, and DC funds today are a significant part of retirement provision in the U.K.

High propensity to purchase an annuity

Until April 2011, a U.K. retiree was required to purchase an annuity with his or her pension fund before reaching age 75. The annuity purchase requirement was in place to ensure that pension funds accrued and invested in a tax-advantaged environment were then used to pay for retirement in a safe and secure manner.

The requirement to annuitise had created a large compulsory market, which underwritten annuities could enter. Today, three years after that requirement was removed, the purchase of an annuity still remains synonymous with retirement in many people's minds.

No restrictions on changing providers

Pension funds accrued with one provider can be freely moved, without penalty, to another, allowing retirees (should they choose) to seek the provider which offers the best annuity and the best rate in the market.

Significantly for the development of the underwritten annuity market, this also means new market entrants can compete for business as soon as they enter, without having to wait for pension funds to accrue with them.

Unfortunately, many U.K. retirees often end up purchasing their retirement annuity from the insurer with which their funds were accrued. The potential this has for consumer detriment, especially for those customers who would benefit from an underwritten annuity, has led to a range of initiatives to encourage more annuity shopping on the open market.

The Association of British Insurers' (ABI) compulsory code of conduct on retirement choices went into effect in March 2013. The code requires pension and annuity providers to ensure pre-retirees are educated about the "open market option" for annuities prior to retirement, and includes measures to encourage pre-retirees to investigate product options and shop around for comparative quotes before choosing a retirement annuity.

Supply of underwritten annuities

Three key factors are enabling a growing number of insurers to provide the product: sufficient data to price accurately, pricing and product design freedom, and availability of appropriate investments.

Data to price accurately

Pricing a conventional annuity requires a host of actuarial assumptions. Pricing an underwritten annuity requires the same range of assumptions, but with considerably more emphasis on mortality. A conventional life annuity requires current and future mortality rate assumptions for the pool of annuitants as a whole, whereas underwritten annuities require current and future mortality rate assumptions for each sub-pool of lives with the same health impairments.

When underwritten annuities were in their infancy, insurers held relatively few impairment-specific mortality tables. Generally, it was one for each significant group of impairments for which they offered enhanced terms—one for smokers and one for cancer sufferers, for example. As the market has developed and become more competitive and rating bases more granular, the number of rate tables used for pricing has increased. Some insurers now use an approach akin to conventional life assurance underwriting—that is, applying percentage extras (e.g. +50 per cent

mortality) and per-mille loadings (e.g. +5 per mille for five years) to an underlying mortality table that reflects a healthy cohort of lives.

These more granular rating bases now mean that underwritten annuity providers can offer differential enhancements. For example, a cancer sufferer's enhancement will vary depending on elements such as the site of the cancer, how long ago the cancer was diagnosed, the stage and the extent to which the cancer has spread.

In order to be able to price these products confidently considerable research must take place, blending together actuarial, medical and underwriting skill sets.

For the actuarial elements, the Continuous Mortality Investigation bureau (CMI) of the Institute and Faculty of Actuaries (U.K.) has a long history of analysing data from U.K. life assurance companies, producing a range of studies into annuitant mortality and providing tools to develop mortality improvement assumptions. This research provides a solid foundation for insurers to develop assumptions for underwritten annuities.

For underwriting, companies leverage years of medical and underwriting expertise gained developing research-based underwriting manuals for life assurance. Correctly estimating the impact of health conditions on mortality is fundamentally the same for underwritten annuities as for life assurance—just the emphasis is different. For life assurance contracts, the risk is in underestimating the impact of an impairment, whereas for underwritten annuities, overestimation is the risk.

Although the challenge of assessing the impact of health impairments is fundamentally similar whether for a life assurance contract or an annuity, several specific issues can make underwritten annuities particularly challenging. Most notably, the severity of illnesses for which ratings are needed (for life assurance, such cases would be declined) and also the substantial number of co-morbidities that are seen on older lives.

Design freedom

In comparison with some other markets, the U.K. is not constrained by many specific regulations in relation to product design and pricing. For example:

- Product pre-authorisation does not take place, nor do prices have to be approved before being launched in the market.
- U.K. insurance companies have relatively few restrictions around how to underwrite and the rating factors that can be used. The most notable restriction is that gender cannot be utilised as a rating factor.
- The actuarial bases for reserving are not set in legislation, and can reflect the health of the policyholder. Contrast this with countries where the bases for reserving for all annuity business are pre-defined. Companies in these countries would likely experience significant capital strain if they provided preferential terms to individuals with significantly shorter life expectancies.

These factors have permitted the development of pricing and underwriting approaches which can reflect, in a very granular way, the health of applicants.

Availability of Appropriate Investments

As with conventional life annuities, insurers require suitable long-term fixed or index-linked investment instruments to match their underwritten annuity liabilities. The U.K. benefits from government-issued long-dated fixed and index-linked bonds, as well as access to more complex instruments such as commercial and equity-release (reverse) mortgages.

Potential for underwritten annuities worldwide

Although underwritten annuities have been a substantial success story in the U.K., other markets have not yet embraced the concept. The U.K. underwritten annuity market has thus far benefited from a confluence of positive demand- and supply-side factors.

As we look around the world we see some (but not all) of these factors being replicated. For example:

- Germany, the Netherlands, Ireland and South Africa appear to be the countries most likely to investigate and offer underwritten annuities. Annuity markets already exist in these countries, and some have compulsory annuitisation requirements.
- The U.S. has substantial pension fund assets, but also greater flexibility than the U.K. over how those funds can be invested at retirement. Not surprisingly, annuity markets have not to date developed substantially. Underwritten annuities could be an interesting market entrant.
- In other countries, regulation is often a barrier to these products, with either restrictions on health assessments for annuities or regulation-mandated reserving bases.

Despite these barriers, the growing need for retirement solutions that provide good value to consumers is likely to see underwritten annuities become significant products in more countries in the years to come.