Gordon Midgley Memorial Debate:

'Drawdown Will Eventually Replace Annuities', April 16, 2008

Against the Motion: Tom Boardman

Slide 1

Good evening

I'm pleased to be here and to be debating an important topic in honour of Gordon.

Gordon and I had a number of good discussions … about where the decumulation market in the UK should be heading … in particular … around the encouragement of greater asset diversification … to optimise pensioners investment returns during their early retirement.

I am speaking on behalf of annuities … which I confess to being passionate about … but I also believe that there is a role for income drawdown and Variable Annuities … for the right consumers at the right time.

My comments this evening are personal … and do not necessarily reflect … those of my employer Prudential.

I think it is important for me to define up-front what I mean by annuitisation … because I **don't** use the term … as you might expect … to simply mean buying an annuity!

Slide 2

I use annuitisation … to indicate the process which puts capital at risk … in exchange for receiving a mortality cross-subsidy allowance.

Annuitisation does not have to take place at the time an annuity is bought … since provision of a death benefit can delay the timing of when capital is put at risk.

I will shortly show … how annuitisation works within a conventional annuity to provide guaranteed lifetime income.

However annuitisation can also operate within an annuity which is invested in unitised funds … and where … like income drawdown … the income is dependent on investment performance.

In our reinventing annuities paper for the Staple Inn Actuarial Society in 2001 … Mike Wadsworth, Alex Findlater and I showed … how mortality cross-subsidy could work within annuities invested in unitised funds … thereby enabling a higher lifetime income … than available under drawdown … in exchange for a giving up capital on death.

I therefore don't agree with any suggestion … that drawdown will replace annuities … simply because drawdown can invest in equities … and annuities have to invest in gilts.
As a result I'm **not** going to focus on investment strategies this evening.

I am going to concentrate instead … on demonstrating why annuitisation remains the most effective and efficient means of maximising retirement income.

In my view … the critical difference between annuities and drawdown … is the impact that annuitisation has on the trade off between income and death benefits.

Higher death benefits result in lower income and vice versa … you can't magic something out of nothing or magic the risk away.

Slide 3

Lets quickly remind ourselves of the challenge laid down by the motion.

Despite the income drawdown revival over the past couple of years … it's interesting to note that income drawdown still has a similar market share … at around a quarter of the market by value … as it had in 2001.

Slide 4

And … if we look at the number of cases sold in 2007 … I have to point out that the motion looks even more far fetched!

Less than 10% … of the half million annuity and drawdown cases… ended up in income drawdown.

And perhaps … as many as a half of these … are taking drawdown to release tax free cash … whilst taking no immediate income.

There is therefore a long way to go before annuities will be replaced by drawdown.

Slide 5

One major reason for this … is the size of pension funds.

Over ¾ of funds are less than £30,000 … after the 25% tax free cash has been taken.

Fund sizes are such that most people do not have scope for drawdown.

… Or perhaps those supporting the motion … see a way of charging the extra costs needed for ongoing advice and extra administration … in a way that is acceptable and gives value to consumers … and complies with TCF?

Of course … I accept and hope that fund sizes … as Billy argues … will increase significantly in the future … and this may lead to higher drawdown take up … but regrettably … I suspect that there are always going to be a lot of pensioners … with insufficient funds to be able to afford drawdown … and who will get better value from buying a new generation annuity product … rather than one of Billy's new generation drawdown products.

The PPI work on the impact of current pension reforms … published last December … indicates that the proportion of pensioner benefit units … eligible for pension credit … is only likely to fall from 45% today to 40% by 2050 … despite the introduction of personal accounts and the other improvements to state pensions.

Too many people … including many of Billy's middle England … are not saving enough for their retirement.

A lot of people are going to need a retirement income product that maximises their income in a cost effective and low risk way … in other words … an annuity.

Slide 6

I believe it would be useful to look under the bonnet and see how annuities work … as I believe this will help to demonstrate … in a balanced way … a number of key points … some of which Billy has already alluded to.

This chart is for an annuity on a male life aged 65 … payable yearly in arrear … with no death benefit … so a fully annuitised fund.

The insurance company guarantees annuity payments however long each pensioner lives.

The chart shows the expected composition of each annuity payment … that the insurance company expects to make to a pensioner … who is still alive at each age.

The investment growth is in blue … the use of the annuitant's capital is in purple … and the cross-subsidy from capital expected to be released from other annuitants dying is shown in yellow.

I hope this chart helps to dispel the myth that insurance companies don't simply pocket the money on early deaths … in reality they use it to generate guaranteed lifetime income.

Slide 7

For a 65 year old annuitant the investment growth makes up a significant proportion of the annuity payment in the early years.

As you can see the benefit of annuitisation at age 65 is relatively small. The chance of dying at age 65 is less than 1% … so an annuitant receives a mortality cross subsidy of less than £1,000 in that first year for putting £100,000 capital at risk.

This is not really very attractive and does not lead to a significant increase in lifetime income.

Most pensioners would rather retain control of their capital and … if they are one of the very few pensioners unlucky enough to die early … feel that their family will receive some benefit from their pension fund.

It does explain why a number of people with larger pension funds decide to use income drawdown in the early years of their retirement. By investing in a mixed asset portfolio they hope to earn a higher investment return … to compensate for the lack of mortality cross-subsidy and ensuring that if they die early the fund is not forfeited.

Of course as many have found this strategy is not without risk. By delaying annuitisation … pensioners run the risk that the investments may not perform as well as they hoped … and when they come to annuitise find that annuity rates are lower than expected … as yields have fallen … and longevity assumptions have changed.

You only have to look at the relative incomes of 1995 annuitants with those who took out income drawdown to see how easy it is to underestimate the value of annuities.

Slide 8

As people get older … so the benefits of fully annuitising grow exponentially.

This is best illustrated by looking at the size of the cross-subsidy compared to the amount of capital at stake … because the capital outstanding reduces over time as shown by the purple bars.

Slide 9

This chart shows the effective mortality cross subsidy that people annuitizing and surviving for each year notionally receive . . . as a percentage of their residual fund.

Some will recognise this as a mortality drag chart … although the cut off is usually at age 75 when explaining the risks of income drawdown.

Cutting the scale off at age 75 has tended to obscure the importance of annuitisation.

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

Slide 10

Lets just suppose that a pensioner were allowed to delay annuitisation beyond age 75.

For a male aged 85 deciding to annuitise today … with no death benefit … the cross subsidy provides over half of the guaranteed income … and would allow a guaranteed income of around 20% of the capital.

The mortality cross subsidy overshadows any investment return once pensioners are over 85 … so fixed annuities with their bond investments increasing become the optimal solution.

Slide 11

So what does this all mean … it is not a question of IF but WHEN pensioners should fully annuitise …remembering that this is not necessarily when the annuity is first purchased.

The conclusion is that pensioners need a retirement annuity account which limits the fund at risk in early years … but retains mortality cross subsidy in later years … to provide the essential longevity insurance.

This can be achieved by providing some death benefit in the early years of an annuity … when the impact of the cross subsidy is small … while ensuring that by the time that annuitants are into their 80s … their fund is annuitised … and receiving the benefit of the mortality cross subsidy.

This approach is consistent with the conclusions reached by David Blake, Andrew Cairns and Kevin Dowd in their PensionMetrics 2 paper.

How can we change the rules to reflect this analysis … and better meet pensioners' needs?

As explained … I think the motion fails … by virtue of the fact that … there will be lots of small funds which will annuitise … but in the spirit of the debate … I will try to challenge Billy's assertion … that new style drawdown products will become the product of choice.

I believe its logical to argue that any change in the rules … with respect to income levels, investment strategy or death benefits … should apply consistently to Annuities and drawdown.

Slide 12

A number of us have promoted capital protected pension annuities … or as I like to call them Money back Annuities … for some time.

Research has demonstrated that the idea of a ‘live or die’ guarantee of at least getting your premium back … is readily understood and valued.

Following the industry’s lobbying … Value Protected annuities were introduced as part of the A Day reforms in April 2006.

The inability to pay any benefit under value protection after age 75 … means that the simple money back concept cannot be provided … and introduces significant complexity … into retirement income product design and advice.

In addition there is a real issue with the tax rate … there should be a tiered tax charge on the lump sums … so that mass market consumers do not pay a tax rate of 35% on modest death benefits.

Allowing the money-back promise to extend beyond 75 would provide a clear message to savers and annuitants that they can get full value from their pension savings … no matter when they die.

Slide 13

As well as providing a guaranteed return of at least the original purchase price … the Money-back annuitiy enables phasing into annuitisation.

The chart on the left shows the decreasing death benefit in yellow which is paid on death to supplement the accumulated income paid to the original purchase price.

The chart on the right shows how the contract results in phasing into full annuitisation by age 78.

Phasing into full annuitisation can overcome pensioners’ fears over loss of capital.

Slide 14

Billy and many commentators … suggest that the charging structures used by Variable Annuities are superior to annuitisation.

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

US style variable annuities provide a minimum lifetime guarantee … as an alternative to a lifetime annuity … but are not a panacea for all.
Although they provide higher death benefits this comes at the expense of a lower income than available under an annuity … particularly if the same investments are held.

Lets look at the two charging options for securing a guaranteed lifetime income.

Slide 15

As we've seen the annuity charging approach relies on a cross-subsidy to those living longer from those dying earlier.

Those dying earlier lose out significantly.

Those living longest benefit the most … and the approach achieves highest lifetime guaranteed income ... because there is no residual fund at date of death.

Slide 16

Under the Variable annuity charging approach … extra Fund charges are made for guarantees.

The result is that those dying early provide only a modest cross-subsidy to those living longest.

This gives high initial death benefits however … all things being equal …the associated lower cross-subsidy from those dying early … results in a lower guaranteed lifetime income.

Note that the methodology also imposes financial constraints on flexibility. If you surrender your contract … or to take income above the guaranteed level … or move into a lifetime annuity … then the value of the charges paid to date is likely to be lost.

This approach is best for asset wealthy pensioners who need a modest percentage guaranteed income throughout retirement and are looking to preserve a death benefit.

A move to providing higher guaranteed incomes closer to the levels provided by annuities will require high charges which will exhaust the fund much faster and therefore reduce death benefits.

We reach the same conclusion as before. Higher death benefits result in lower income and vice versa … you can't magic something out of nothing or magic the investment and longevity risks away.

Slide 17

This is a chart from the paper published in the U.S. Journal of Risk and Insurance following a Speech I made in Chicago in 2006.

It compares possible benefits from a US variable annuity contract and a hypothetical money back flexible lifetime annuity contract using consistent assumptions other than for the longevity charging structures.

The flexible lifetime annuity provides significantly higher income . . . . but of course … as expected ... this is at the expense of lower death benefits.

The flexible annuity could of course provide death benefits for longer … even return of fund for an initial period … but at the expense of a lower income.

Hopefully this gives food for thought if retirement income is the pensioner's biggest concern and need … and challenges Billy's assertion that it is impossible to make an annuity look like drawdown.

Slide 18

I've spoken a lot about annuities …and pointed out their strengths and weaknesses. So I should make some specific comments on drawdown.

Pensioners using Income drawdown are exposed to the random longevity risk around their life expectancy. They risk outliving their capital … or more likely having to reduce their income as they get older.

If lump sum death benefits are allowed … they could end up leaving more or less than they wanted to … depending on when they die.

Pensioners also take on significant Investment risks. In particular the risk that their investments under perform.

Drawing down income when markets are depressed can have a very significant impact on overall income levels.

They are also exposed to the spot risk should they decide to annuitise.

The issue of Mortality drag is generally understood … but pensioners using drawdown also expose themselves to the risk that Mortality improvement assumptions will be strengthened … by the time they come to switch to an annuity.

And finally there are … the extra Advice and Servicing costs … of using drawdown that I mentioned earlier.

Of course these risks can work in your favour … but you will excuse me if I don't emphasise this!

The key point is that … only those who can afford to take these risks … should do so…

Given the lack of adequate pension savings … this is unlikely to be a majority … let alone the dominant majority to support the motion!

Slide 19

Let me summarise my key points.

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.

I accept there may be a role for more drawdown as a prelude to annuitisation.

However I believe that many people may be better off … with the certainty of locking into annuity rates … via a money-back annuity … perhaps together with … some limited phasing over 2 to 3 years to smooth out the spot risk … rather than using income drawdown.

I do **not** believe that drawdown will eventually replace annuities.

The motion should be defeated.

Thank you.