

# Pensions: Annuities in perpetuity

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The pension annuity is a staple product. Two recent changes seem to spell the end of UK annuities. BRAVE Partners analyses these trends and examines the implications.

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## UK Annuities

Payout annuities have been a staple product of the UK life insurance industry. The product is simple. The client pays over a lump sum in return for a, usually monthly, regular payment until they die. Product enhancements include some form of increase – either a fixed percentage, or inflation linked and a spouses' pension which will pay a proportion of the regular payments to a surviving spouse after the policyholder dies.

## Annuity reserves

A JP Morgan presentation from 2007 estimates the annuity reserves in UK life insurers at £135bn.

## Shifting sands of the UK annuity market

There are two significant factors at play that will shift the UK annuity market – in fact, in the opinion of BRAVE Partners, it is likely that payout annuities will soon cease to be a viable product in the UK. These two factors are:

- Solvency II driving increased capital requirements for annuity business.
- A change to the UK tax law which means that pensions savings that are not used to buy an annuity before the age of 75 will no longer be subject to punitive tax from April 2011.

Examining each issue in turn:

### Solvency II

The impact of Solvency II on UK annuity business has been generating headlines for a while. Some time ago, major newspapers were speculating that Legal & General would need to raise a significant amount of capital – mainly to support their large annuity books.

BRAVE Partners believes that payout annuity business will soon become obsolete in the UK. This will create £135bn of insurance reserves in run-off.

### Change in UK tax laws on annuities

Like many countries, pensions savings in the UK are, up to a point, tax deductible. In order to protect against misuse of this tax advantage, there are punitive tax charges on

pensions savings that are later withdrawn to be used for other purposes. In order to ensure that pension savings are used to support retirement, the UK has a law that stipulates that all tax-advantaged pension savings must be used to purchase a pay-out annuity before the age of 75, or these savings will become subject to the punitive tax rates. Most pension savings are therefore used to buy annuities.

### Unpopular

There has been resistance to the requirement to annuitise pension savings for some time. Many argue that annuity rates were too low – driven by the expense, profit requirements and lack of investment expertise of the insurers. Certainly some of the BRAVE Partners have had revealing conversations around investments with one reasonably large UK annuity provider (who ultimately reinsured most of their annuities in payment). The recently announced changes are not a surprise – there has been pressure for this for some time.

### Annuities in 2011

Annuities are not regarded as a value product. The product has really been supported by the tax legislation. In the insurance sector, many companies have also regarded the product as capital intensive and low return. Many companies have withdrawn from the market, leaving a few large-scale players. Solvency II will increase the capital requirements for the product – although not by as much as initially feared.

### Assessing the impact

BRAVE Partners believes that the combination of Solvency II and the UK tax changes will render annuity products obsolete. Insurers will then be left with large blocks of reserves and increased capital allocated to a run-off business. This will create a significant opportunity to manage the extremely long-tailed run-off of these blocks.

There will be a significant business opportunity to run-off the UK annuity reserves.

BRAVE Partners believes that this opportunity will not be taken by the classic pension buy-out market. That business model has proved tough.

### The pension buy-out market

The specialised pension buy out insurers, such as Pensions Corporation, would appear to be the likely buyers of the run-off portfolios. However, BRAVE Partners is more skeptical of this. The firm has already commented, in [Bye buy](#), that it believes that the monoline pension buy-out business model is flawed. Pensions Corporation continues in business with some success, but Paternoster has all but failed and Synsersis failed to even get into business. These companies ultimately suffer from the same capital

rules that Solvency II will bring to the current owners. Most importantly, insurers cannot realistically extract the value of the illiquidity of the pension liabilities.

### Natural buyers

The natural buyers of annuity books will be those that are able to capitalise on the value of the illiquidity of the reserves. By nature these will be asset intensive businesses with a combination of liquid assets, that can be used to meet any immediate fluctuations in the market value of the reserves and to make

immediate annuity payments, and illiquid assets that can take advantage of sticky, long-term financing. Banks would appear to be the clear candidate.

### Working with the (re)insurers

Whilst banks are keen on the illiquid cash pools, most are not willing or able to take insurance risk and annuities include a component of longevity risk. Therefore should banks be seeking to accumulate run-off annuity business, this will stimulate significant demand for longevity hedges.

### BRAVE Partners' services

BRAVE Partners has significant expertise in the life insurance and pensions market. The firm and Partners have established a number of life insurance and reinsurance businesses in a range of jurisdictions. BRAVE Partners can assist banks, hedge funds and management teams that are seeking to capitalise on the likely run-off of large blocks of annuities in the UK.

### Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on [commentary@bravepartners.com](mailto:commentary@bravepartners.com)

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- BRAVE Partners LLP believes that there is to be an imminent fundamental shift in the UK annuity market.
- Two factors: Solvency II and changes to the tax laws will render the payout annuity product obsolete.
- BRAVE Partners believes that these changes will put around £135bn of annuity reserves in the UK into run-off.
- It is likely that the current owners of run-off annuity books will seek to transfer them to specialist players, creating a significant opportunity.
- BRAVE Partners LLP can assist banks, hedge funds and management teams that are seeking to capitalise on the likely run-off of large blocks of annuities in the UK.

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