UK guarantees remain, but must pay their way

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Irina Kendix

is a consultant in the London office of the Tillinghast business of Towers Perrin.

Abstract Guarantees were once an essential part of the life insurance market, but this has changed across much of Europe. In the UK, the move away from guarantees has been prompted by a combination of consumer, adviser and regulatory behaviour. Consumers tend to feel that guarantees come with high costs, insurers find that guarantees offer lower returns and regulators want to ensure that the true nature and cost of the guarantee is disclosed. Consequently, whereas the primary and unique role of insurers was once to pool and spread risks to provide individuals with guarantees, insurers must now compete directly with other asset gathering financial services institutions.

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The evolution of UK life insurance companies from risk takers to asset gatherers is nothing new. Their core business is long-term savings; meaning they must compete head-to-head with fund managers. Protection and annuities, however, are insurance specialities and most protection takes the form of guarantees made by the insurer to the policyholder. So what is the nature of guarantees offered by UK insurers and what lies behind their recent moves away from offering investment guarantees?

The provision of a guarantee has traditionally been an important reason for customers to buy from an insurer. But there has been a flight from guarantees in some product sectors, which has been driven by a mix of consumer, adviser and regulatory behaviour.

The main area where guarantees remain and where insurers are sole providers is annuities. Almost all annuities have yearly payout levels

defined at outset that will continue for the life of the annuitant. Insurers are guaranteeing to bear the two uncertainties of life expectancy and interest rates. As a transparent product, the pricing is very competitive. The failure to anticipate the rate of increase in life expectancy has caused some insurers great pain. But in aggregate, the insurance industry remains willing to meet annuity demand at reasonable cost (Figure 1).

The other sector reliant on guarantees is protection products, such as term assurance. Margins are generally attractive but premium amounts are relatively low. Again, although transparency makes term assurance competitive, there is no wish to stop offering these products.

In other product sectors, the offer of a guarantee to the policyholder is a product feature rather than the basis of the underlying contract. This feature must be suitably priced and reserved for by the insurer. The customer must also find the guarantee sufficiently attractive at the price charged. Meanwhile, the regulator is busy ensuring that the true nature and cost of the guarantee is disclosed in some form.

Correspondence: Irina Kendix, Towers Perrin, 71 High Holborn, London, WC1V 6TP, UK
Tel: +44 020 7120 2000;
Email: irina.kendix@towersperrin.com

Figure 1: The requirement to annuitise has led to predictable demographic flows of retirement funds
Source: ABI data

Figure 2: Decline in with-profits can be illustrated by the changing pattern in the sale of single premium bonds
Source: ABI data

The decline of with-profits single premium savings products (Figure 2) can be explained by a number of factors. Consumers lost confidence in the with-profits concept — or perhaps they never previously understood it. They saw that guarantees had high costs that were being reflected in their payouts and that the mechanism of setting bonuses was hard to understand. A quite separate factor that may be relevant is that, as people become more affluent, they become more willing to accept volatility in their long-term investments. Regulators have imposed capital adequacy models that have forced insurers to recognise the true cost of smoothing and also introduced increased regulation of business conduct. IFAs' response to

both of those pressures was a significant turn away from with-profits.

A particular example of the decline in with-profits business is the near extinction of endowments (Figure 3). Curiously, in the case of endowment mortgages, the product lost its credibility because of a guarantee that was never there. This product was designed to pay off a mortgage at maturity — but only if investment returns were adequate. Customers, sometimes misled by intermediaries, believed this to be a guarantee. It could be claimed that this was one historic case where insurers did fail to recognise a customer need for a guarantee and failed to design a suitable product. But the cost of

Figure 3: Sales of conventional and mortgage endowments have virtually disappeared. New annual premium endowments sales, with-profits and unit-linked (£m)

Source: ABI data

providing a guaranteed payout so far into the future would be prohibitive to the customer, and under the current capital adequacy regulations, virtually impossible for the insurer.

There are other types of guarantees that are attached to savings products. Some specify a minimum return on an equity investment by a given date. But these are not insurance-type guarantees. The futures and options markets provide contracts that hedge the insurers' positions.

The pensions market provides another interesting example of how insurers' provision of guarantees has further diminished. Many employers cannot afford to maintain defined benefit pension schemes. As schemes close, the trustees look to pass guarantees, such as paying annuities, on to insurers. But in defined contribution schemes, investment risk is retained by the individual. With buying an annuity no longer compulsory, some longevity risk (the risk of outliving one's resources) and investment risk will rest with the pensioner.

The final example of guarantees is attached to products for marketing and presentation purposes. Examples have been accidental death cover, minimum payouts on policy anniversaries and guaranteed annuity options. The failure to realise the true cost of the latter caused serious problems for several insurers. It is now unlikely that any UK insurer will allow such 'bells and whistles' to be attached without calculating properly the true costs. This in turn will make it less likely that

such features will be financially justified and included in future.

Conclusion

None of these signifies a flight from guarantees. It is simply an inability to offer products that are attractive enough for the customer, transparent enough for the regulator while still providing an adequate return for the insurer. Lower interest rates have contributed to this situation, since the cost of guarantees to the insurer and thus to the customer are now much higher relative to expected investment returns.

There are areas where customers want guarantees, but insurers do not meet that demand. A savings product that pays off a mortgage was mentioned earlier. Another example might be a product that meets long-term care costs. Guaranteed annuity options have been withdrawn, while investment guarantees on new types of products are more likely to be covered by futures contracts than by smoothing bonuses and managing an estate.

It was a foundation of insurance that pooling and spreading risks allowed insurers to provide guarantees to an individual. As this role diminishes, an insurer becomes more of an asset gathering financial services institution. The challenge for insurers is whether, in that capacity, they can offer their customers anything over and above what fund managers do.

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