European Life Settlement Association Response to the UK Government Consultation CM9046: Creating a Secondary Annuity Market

June 2015

Dear Sirs,

We are writing to you in response to consultation CM9046, seeking views on the government's proposal to remove the barriers which currently deter annuity holders from accessing the value of their annuity.

The European Life Settlement Association (ELSA) was founded in 2009 to set standards for the European involvement in the US Life Settlement industry. We represent European funding sources, service providers and intermediaries in the US Life Settlement market who are looking to promote transparency by providing accurate, authoritative information to investors, regulators and the media.

As such, we believe that our experiences within the US Life Settlement market are highly relevant to the creation a new UK secondary annuity market, and will be useful in providing insight into how the major challenges and risks can be effectively addressed.

ELSA is fundamentally supportive of the government initiative to create a secondary UK annuity market. We believe that with careful and considered implementation it will lead to the creation of an effective, fair and efficient new market for the benefit of policy holders and secondary investors alike.

Please find enclosed a full and detailed response from ELSA to the questions raised in the consultation paper.

We trust that you find this feedback both useful and insightful, and would welcome the opportunity to engage with you further in the consultation process. If you have any further questions or points of clarification, please do not hesitate to contact me direct and I would be very happy to support.

Yours faithfully,

Simon Erritt, Chair

1. In what circumstances do you think it would be appropriate to assign one's rights to their annuity income?

It is generally appropriate for an annuity holder to have the right to assign their annuity to a third-party buyer. In 1911, the US Supreme Court established that a life insurance policy is private property which may be assigned at the will of the owner, and the same principle should apply to an annuity.

It should not be the case that an annuity holder requires the consent of the annuity provider to assign their annuity to a third-party buyer. Other than an administrative burden, the annuity provider should not be impacted economically by the assignment, and should therefore not have a basis for objection to it. If such a basis were to be identified and the annuity provider were to be able to select which of its annuities could be assigned and which could not, it may do so in its own interests and potentially to the detriment of a free and fair market. Insurance carriers in the US Life Settlement market have no such consent rights, and are arguably impacted by the sale of their life insurance policies to a far greater extent than annuity providers would be by the re-assignment of their annuities. For reference, the "adverse selection" impact present in the US Life Settlement market arises as the insured has access to information about its health which the insurance company does not and is therefore able to assess whether it is more likely for the traded value of the policy to exceed the surrender value of the policy.

If consent is a necessary part of the structure of this market for whatever reason, it should either be (i) granted to all assignments automatically or (ii) granted on a case-by-case basis with reference to fixed criteria established and monitored by the government or the PRA.

At present, it is unlikely that existing annuities are used by annuitants as security for loans. However, if such an annuity loan market were to develop, secondary buyers would need to ensure that any outstanding debts and charges over the annuity are released prior to sale. This is consistent with the approach adopted in the UK Traded Endowment Policy ("TEP") market.

2. Do you agree with the government's proposed approach of allowing a wide range of corporate entities to purchase annuity income in order to allow a wide market to develop, whilst restricting retail investment due to the complexity of the product? What entities should be permitted and not permitted to purchase annuity income and why?

The government should consider the extent to which it draws parallels to the US Life Settlements market which the former Financial Services Authority stated is not suitable for retail investment.

Based on experiences in the US Life Settlements market, it is unlikely that investments in annuity income will be suitable for retail investors. Retail investors find the risks present in life insurance contracts (in this case, mortality risk) very difficult to understand and certainly very difficult to quantify. Further, without predicting the form of the vehicles through which retail investors could participate, it is likely that further risks, such as liquidity and leverage could be present within vehicles which are exacerbated by insurance risks.

However, the government may wish to consider whether it is appropriate for retail customers to invest in a fund which has annuity streams within the asset portfolio provided the fund provides extensive details of the risks to investors. In practice, this may require that funds are "pre-approved" for retail investment by a regulator or industry body. For example, funds which complied with the principles of ELSA's code of practice (suitably modified for an annuity market) are much more likely to provide the level of disclosure of risks required for such investments.

We further agree that the tradable annuity market should be open to as many investors as possible to improve competition and accelerate maturity of the market which would ultimately benefit policyholders. This should include as a minimum, pension funds, asset management companies, and banks, whether based in the UK or overseas, as well as insurance companies themselves.

However, annuity providers should not be permitted to purchase the income from their own annuities, either directly or through affiliated companies or vehicles. This is to ensure a free and fair market: The annuity provider can be expected to have at least as much information about the annuity holder and their annuity as any potential third-party buyer, and most likely more, and should be prevented from trading on the back of this unique advantaged position. Further, insurers could choose to selectively purchase the income back from the annuitants based on their likely longevity. This could present further challenges such as the impact on gender equality rules (if the annuity provider purchased only female annuities rather than male annuities).

Note that although the net economic position may be the same, an annuity provider purchasing income from its own annuity is not the same thing as "buy back". In the former situation, the annuity continues in force until the death of the annuity holder. In the latter, it is terminated.

3. Do you agree that the government should not allow annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their existing annuity provider ('buy back')? If you think 'buy back' should be permitted, how should the risks set out in Chapter 2 be managed?

Yes. "Buy back" should not be permitted.

The key reason for this is the first argument put forward in the consultation: Annuity providers wouldn't want to provide annuity holders with this option for fear of losing the matching adjustment and creating uncertainty in respect of the duration of their liabilities. They would have little incentive to encourage such a transaction, and would be unlikely to offer the annuity holder a competitive price for it as a result. With appropriate guidance, it really shouldn't be the case that the second argument put forward in the consultation – that it "could result in some customers falsely believing that they can only use these new freedoms through their existing annuity provider" – is a serious cause for concern, but any steps that can be taken to avoid annuity holders being presented with anything other than market value for their annuities should be avoided.

A second reason, as described above, is a product of some of the other points raised in the consultation, including that (i) annuity providers would be able to select which annuities they "buy back" and which they do not, (ii) they may have access to key information that any third-party buyer does not and (iii) they would not incur the costs that a third-party buyer would incur to obtain this key information. If, for some reason, annuity providers were incentivised to "buy back" their annuities, they would have a significant and unique advantage over the rest of the market, such that the very existence of a free and fair market would be called into question.

4. Do you agree that the solution to the death notification issue is best resolved by market participants? Is there more the government should be doing to help address this issue?

Yes. The death notification issue is best resolved by market participants.

The establishment of central "death register" is a worthy idea but, as noted in the consultation, is likely to be complex and expensive. It would be hard to justify it unless it were part of a wider-ranging and longer-term "identity card"-style initiative. Any register of its type would also need to be complete in order to be useful: The US Life Settlement market no longer relies on the SSA's "Death Master File" after changes made to it in November 2011 on the grounds of data protection meant it became incomplete, and therefore unreliable. A government solution to the issue will, in our opinion, be very difficult to successfully implement. Our experience in the UK TEP market has shown that access to UK mortality data has become increasingly restricted in recent years as data protection concerns have escalated. It is difficult to envisage a situation in which this trend is reversed.

Instead, the third-party buyer of the income from an annuity should have a contractual obligation to notify the annuity provider of the death of the annuity holder. In order to meet this obligation, the third-party buyer would require the annuity holder to put in place arrangements to instruct the executor of their estate to notify the third-party buyer upon their death. To supplement this requirement, the third-party buyer would also have the contractual right to "track" the annuity holder, as that term is generally understood in the US Life Settlement market.

The third-party buyer should be obliged to notify the annuity provider of the death of the annuity holder on a timely basis, for example, within 30 days of notification of the death. Any annuity payments made to the third-party buyer after the date of death would be refunded to the annuity provider.

The annuity provider could continue to operate its fail-safe checks, including accessing the register of births, marriages and deaths. Should the annuity provider become aware of the death of the annuity holder itself, prior to receiving notification from the third-party buyer, it would cease making payments and request that any annuity payments made to the third-party buyer after the date of death of the annuity holder be refunded. If the annuity provider had reason to believe that the third-party buyer was notified of the death more than, for example, 30 days ago, the annuity holder would be able to pursue a contractual claim against the third-party buyer.

However, it is appreciated that the most likely “back stop” for an annuity provider finding out about the death of a life assured is when their bank account is closed by the executor of the estate, and payments by the annuity provider to the account fail.

It has been suggested that a “pepper corn” annuity payment to the original annuitant’s bank account is maintained as part of the sale process to ensure this “back stop” remains in place. One possible solution for the annuitant to receive a settlement amount that is based on their annual annuity less, say, £0.12 per annum where the annuity provider continues paying 1p to the annuitant per month. This would mean the annuity provider would have the same safeguards as it currently has to identify when the annuity payments should cease. This solution would lead to two ongoing relationships rather than the one shown in Figure 2.A – (1) original provider pays materially all of the annuity payments to the third party buyer; and (2) original provider pays the balance of the annuity to the customer. Such a solution is clearly more administratively significant for the annuity provider which may lead to higher fees from it; but that would appear to be outweighed by the administration fee savings that third party investor would be able to realise (and hence pass on to the customer).

This solution may be considered the most appropriate because:

- The annuity provider is the party that is subject to the risk from the annuitant living longer and so would be most diligent in identifying.
- It would not require any change to the probate processes – for this reason, the government could consider compelling this solution.

Given the construction above, the “alternative approaches” outlined in section 2.21 of the consultation may prove unnecessary.

5. Do you agree with the proposed approach of the government working with the FCA regarding the fees and charges imposed by annuity providers?

There are pros and cons to this argument. It could be argued that insurance companies should bear the cost of the changes within the large profits shown to be made through annuity sales vesting through their own pension products and that the costs (the administration of redirecting payments and the implementation of consumer protection measures). In the US Life Settlement market, insurance carriers are obliged to undertake these same tasks without passing on the cost of them to either the policy holder or the third-party buyer.

On the other hand, the administration process of assigning legal ownership of an annuity and transferring the income stream to the third party buyer should be very similar to the processes involved in a Traded Endowment Policy (TEP) transfer. Around half of the current policies transacted in the UK TEP market are from Life Companies that make no administration charge. These Life Companies include Legal & General, Prudential and Standard Life. For the balance of transactions, the Life Companies typically charge a fixed fee of £50-£100 per policy transaction. A more detailed summary of current UK Life Company charges can be provided upon request. As such, we would recommend that annuity

provider charges applied in a secondary market should be no more than those currently levied by Life Companies within the UK TEP market. The government and FCA may also look to implement a percentage limit to the annuity provider fee that can be applied on an individual policy basis, given that many annuities will be very small.

6. Do you agree that the scope of this measure should be annuities in the name of the annuity holder and held outside an occupational pension scheme?

It should be possible for joint annuity holders to assign their annuity, assuming both holders consent to the assignment. If one or other holder does not consent, it should not be assigned. It should not be for the annuity provider to decide whether and what confirmation is needed, but rather simply to create and maintain a clear consent form. This is a common type of transaction in the US Life Settlement market, with joint policies accounting for approximately 10% of all policies sold.

We agree that the scope of this measure should exclude annuities held inside an occupational pension scheme for the reasons set out in the consultation paper.

7. Are there any other types of products to which it would it be appropriate for the government to extend these reforms?

Not directly. Conversely, there may be features of the existing markets in other types of products that the government could consider “borrowing” for this one. These markets include not only the US Life Settlement market, but the US Structured Settlement market and the UK TEP market.

8. Do you agree that the design of the system outlined in Chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the government would need to apply to individuals who had assigned their annuity income?

Yes.

Steps should be taken to ensure that third-party buyers who also offer flexi-access drawdown funds and flexible annuities do not take advantage of their position in the market by offering special terms to, or imposing specific restrictions on, either the sellers of annuity income or the buyers of their products. Annuity holders should be able to choose to sell their annuity income to these buyers as a matter of convenience but should not be encouraged to do so, or effectively be given no option but to do so, on either economic or legal grounds.

9. How should the government strike an appropriate balance between countering tax avoidance and allowing a market to develop?

The provisions given as examples in section 3.11 of the consultation are both valid approaches to this potential issue.

10. What consumer safeguards are appropriate – is guidance sufficient or is a requirement to seek advice necessary? Should the safeguards vary depending on the value of the annuity?

Annuity holders should be required to confirm that they have sought and received advice from an Independent Financial Advisor if the likely market value of their annuity is above a specific threshold, say, £30,000. At this threshold, approximately one-third of all annuity holders would be required to take advice. In any event, advisors should be appropriately authorised and regulated.

Annuity providers should not be required to offer a benchmark "selling price". Given that the annuity provider would not be able to purchase the income from the annuity at this or any other price, and may have reasons to want to either encourage or discourage its assignment, this "selling price" would be akin to an estate agent's guide price on a house: While potentially useful, it really shouldn't be seen as a reliable indicator of market value.

Instead, the government or FCA should publish and maintain a simple table that could be used not only by the annuity holder to establish a benchmark value for their annuity, but also by the government to establish whether the annuity holder is required to seek and receive independent advice. The table would be based on age, sex, health and annual annuity payments. To establish a benchmark value, all four characteristics would be used, with health categorised as standard, "enhanced" or impaired. To establish whether independent advice is required, health – as the only subjective element in the calculation – should be assumed to be standard.

The other safeguards considered in the consultation – an offer of guidance and regulatory interventions such as risk warnings – are both valid approaches to this potential issue. The publication of risk warnings should always be balanced by a discussion of the potential benefits of entering into the transaction.

A lesson learnt in the US Life Settlement market is that, somewhat counter-intuitively, one can also generally rely on third-party buyers to offer elements of protection to policy holders. In order to protect their and/or their underlying investors' interests, and to minimise any potential legal challenge to their "title", third-party buyers generally ask policy holders to confirm that they have sought independent advice (or decided not to seek such advice) and that both they and the insured understand the transaction and the benefits they are foregoing as a result of entering into it. This is done via a combination of disclosure statements in written agreements and telephone "closing interviews" with both the policy holder and the insured.

Another consumer protection in the US Life Settlement market is the rescission period – a "cooling off" period immediately following the sale of a policy, often 15 days in length after the seller's receipt of the proceeds of the sale, within which the policy holder can reverse the sale at no (or minimal) cost beyond repayment by the policy holder of the sale proceeds.

11. What is the best way to implement these safeguards? Should the safeguards include expansion of the remit of Pension Wise?

These safeguards can be implemented through a combination of law, written guidance widely available in brochure form and online, Pension Wise and the Independent Financial Advisor community. Whichever precise combination of these resources is chosen, it should be ensured that there is no gap in the market for unregulated "advisors" of the type currently focused on PPI and personal injury claims.

12. Should the costs of any advice or guidance be borne by the annuity holder (mirroring the arrangements for conversion from a defined benefit scheme)? If not, what arrangements are appropriate?

Yes, the costs of taking independent financial advice should be borne by the annuity holder. Given the threshold suggested above, the cost of this advice would probably be less than 10% of the annuity assignment proceeds and would be factored into the decision by the annuity holder to consider an assignment.

13. Do you agree that the government should introduce a requirement on individuals to obtain a number of quotes? How else should the government best promote effective competition to ensure consumers obtain a competitive price?

No.

The government should implement the safeguards suggested above to ensure that annuity holders are properly informed, but then leave the annuity holders themselves to determine how best to engage with the market.

The government's guidance could certainly include the potential benefits of obtaining a number of quotes, along with those of using an advisor, but neither should be made compulsory.

Another way that the government can ensure that annuity holders obtain a competitive price is to maintain FSCS protection following assignment. There would be no change in the government's obligations by doing so, and no risk that the government is viewed as seeking to "profit" – by reducing its risk – from the introduction of the market. If the market proves to be relatively efficient, the bulk of the value of this protection will be passed on to annuity holders in the form of additional assignment proceeds. Such potential additional value could be quantified through the analysis of long-dated annuity

provider credit default swaps. Further, if the government were to increase the protection from 90% to 100% of losses, such that credit risk is essentially eliminated from third-party buyers' considerations, this may give rise to a disproportionately-high incremental benefit to annuity holders.

14. Does the government's approach sufficiently protect the rights of dependants upon assignment? If not, what further steps should the government take?

- Should the government or FCA issue guidance to annuity providers about protection for dependants?
- Are there particular classes of beneficiary which require special consideration, for example minors or following a divorce or dissolution of a civil partnership?
- Are there specific equality impacts that should be considered in this context?

As suggested above, it is third-party buyers rather than annuity providers that bear the ultimate risk of legal challenge to the assignment of an annuity from an original beneficiary. Because of this, one could generally rely on third-party buyers to ensure that the written consent of any dependents is obtained before rights under an annuity can be assigned. This is everyday practice in the US Life Settlement market: The policy holder and the policy's beneficiaries are typically different parties, and the third-party buyer ensures that the beneficiaries consent to the policy holder's sale of the policy prior to it taking place.

Of course, as noted in the consultation, annuity providers will also want to ensure that the rights of dependents are appropriately protected: The interests of the annuity provider and the third-party buyer are aligned in this regard.

We would note that the equity release market in the UK operates under the Equity Release Council guidance to require explicit consent from beneficiaries of the home owner. Similar consent would be appropriate in this case.

15. Should the government permit the principal annuity holder's income to be assigned while dependants retain their own income stream? Should the decision on whether to do so be left to the discretion of the parties to the transaction?

No. The rights of dependents should be assigned along with those of the principal annuity holder.

In addition to the expense and contractual difficulties associated with separating out dependents' rights, doing so would materially limit the value of the annuity to third-party buyers and may even weaken the alignment of "insurable interest" between the dependents and the annuity holder.

16. How can the proposed consumer protections for the assignment of annuities ensure that any impact on means-tested entitlement is understood by those deciding whether to assign their annuity income?

This understanding can be promoted through the same channels as above: A combination of law, written guidance widely available in brochure form and online, Pension Wise and the Independent Financial Advisor community.

17. Should those on means-tested benefits be able to assign their annuity income?

Yes. The ability to assign their annuity income should be available to everyone, regardless of means.

However, the economic impact of doing so for those on means-tested benefits will be wholly dependent on the relative contributions made to those means tests by (i) the annuity income itself and (ii) the capital generated by its assignment. If those two things are treated relatively equally in the tests, then this segment of the market should function normally. If one significantly outweighs the other, however, then market activity in this segment will either be significantly increased or reduced.

18. What are the likely impacts of the government's proposals on groups with protected characteristics? Please provide any examples, case studies, research or other types of evidence to support your views.

As noted above, the value of an annuity is a function of the holder's age, sex, health and the annuity payments themselves. Two of these factors – age and sex – are protected characteristics and a third – health – may be related to the protected characteristic of disability.

Third-party buyers can be expected to take each of these factors into account when establishing a price for the annuity income. To the extent that the original annuity provider could not – in respect of age, specifically – this can be expected to lead to an arbitrage opportunity for the third-party buyer and disproportionately more annuities held by women than by men being assigned.