

12<sup>th</sup> June 2015

Dear Sirs

**SL Investment Management response to the UK government consultation  
CM9046: Creating a Secondary Annuity Market**

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.

SL Investment Management (SL) is fundamentally supportive of this government initiative. 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.

We are providing a full and detailed response to the questions raised in your consultation paper. We also include some general observations regarding considerations we believe to be of vital importance in the creation of a successful new market in secondary annuities.

SL has extensive experience in similar markets - UK Traded Endowments and US Life settlements - and we are interested in working further with the UK government to help plan and develop an efficient market in UK annuities. We enclose a summary of our past experience and particular interest in this potential market.

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 myself direct and I would be very happy to support.

Yours sincerely,

## **Creating a fair and efficient UK annuity re-sale market**

### **Background**

SL Investment Management was founded in 1990 and has 25 years' experience dealing directly with UK consumers and UK Life Assurance companies in the evaluation and trading of UK endowment policies. We also have considerable experience in the market for trading Insurance policies on the lives of US seniors and the structured settlement of Annuity streams on US lives.

SL is interested in entering the Secondary Annuity Market as an advisor to investors who may seek to purchase annuity streams as an investment asset.

### **Experience**

SL Investment Management (trading in the UK as Surrenda-link) has evaluated over 600,000 UK endowment policies for purchase, and provided actuarial, valuation and investment management advice to more than 30 corporate entities holding investments in traded policies. We were founder members of both the UK Association of Policy Market Makers (APMM) and the European Life Settlement Association (ELSA). SL has been active in the UK market since 1990 and the US market since 2003. In both markets we have championed the evolution of best practice, codes of conduct and seen the regulatory regimes gradually evolve to meet the needs of the market and to protect consumers.

### **General Observations**

A market comprises both buyers and sellers. Whilst bringing forward legislation that will enable annuitants to sell, it is equally important to ensure that conditions are right to bring forward buyers into the market.

The UK Traded Endowment market is an interesting comparable. The legislation that allowed the trading of Life Assurance policies was passed in the 19<sup>th</sup> Century. However, large scale trading of policies did not commence until 1992. Large numbers of policies were in force during the 1970s and 1980s (circa 36million policies at its peak); however, a significant resale market did not occur until investors could be found to invest in large volumes.

Traded Annuities will be similar.

We believe that the obstacles/challenges in attracting investors to buy annuities will be as follows:

1. Access - there needs to be cost effective access to policies. Transactional costs are likely to have a significant impact on the price which can be paid (particularly in the case of policies of below around GBP 30,000 in value). Thus restraining annuity provider fees is important to ensure that smaller annuities can be successfully traded.
2. Expertise/Analyses. Information flow and the skills to analyse.
3. Information - details of the annuitants state of health, including access to medical records.
4. Scale - creation of a portfolio of sufficient size to justify set-up and running costs and to spread the mortality risk.
5. Liquidity - the ability to re-sell the asset (if the asset cannot be resold, then a higher return/lower purchase price will be demanded by the investor).
6. Price - there needs to sufficient potential return to justify the risk.
7. Risk Management - especially the risk of anti-selection.

Given the above challenges, it is inevitable that investors in annuities will demand a higher return than, for example a corporate bond, or indeed the GRY equivalent of the Annuity at issue. On balance we consider it unlikely that many annuities could be resold at much above 80% of their original issue price

on average, although figures might be somewhat lower for smaller annuities and slightly higher for larger annuities.

### **Establishing a Viable market**

Given that the Government considers this to be a niche market and given that this is a diverse and complex investment area with significant barriers to entry in terms of scale and expertise, we consider that under normal market conditions it might be expected that in many cases annuitants might receive either zero quotes or only one or two quotes in the market. This is consistent with experience in the Traded Endowment and Life Settlement markets in which a significant proportion of policies are untradeable or barely tradable. It may therefore be unworkable to require annuitants to demonstrate that they have received multiple quotes prior to trading. We also feel that the proposed monitoring of annuity providers fees is too weak and more should be controlled in advance to ensure fees are set at reasonable levels.

We would fully support the proposal that annuities should be re-tradable, indeed this may be essential in order to attract investors into the market as it would be their only route to liquidity.

We disagree with the proposal in 2.23 that states that Annuity providers should be under no-obligation to consent to the assignment of annuity payments. We see no commercial reason for this. The right to assign to a buyer of choice should be guaranteed to all annuitants, in order to ensure they all receive fair treatment. However Annuity providers should be entitled to fair and reasonable costs to cover the assignment processes/paperwork.

We agree with your suggestion in 2.27 that the consent of all beneficiaries should be obtained, this is in line with US practice and is considered an essential legal safeguard, and in any case will almost certainly be demanded by any investor prior to purchasing the policy.

### **Minimum Size and Maximum Age**

For practical reasons, there will inevitably be a minimum size below which it is impractical to trade an annuity (due to costs), and impractical for a new owner to own it e.g. because of on-going fixed costs of ownership/valuation. Likewise there is likely to be a maximum age beyond which it is unlikely that any investor will bid (due to the increasingly high risks of mortality creating much greater volatility in their portfolio). Furthermore, with increasing age, there will be increasing challenges in decision making for the annuitant and for the advisers/regulators in ensuring that the annuitant is taking a well informed decision. It would be important that guideline criteria on minimum size/maximum age are available in order to ensure annuitants do not unnecessarily spend money appointing advisers to advise them on transactions that may have little or no chance of happening.

This is an example of a 'market dynamic' issue which may be best handled through a trade association. The UK Association of Policy Market Makers (APMM) for the Traded Endowment market would for example, issue similar guidelines from time to time indicating which types of policies are currently tradable. In the US, Life Settlement Market Makers were initially unlicensed, but after years of 'bad practice' cases they must all now be licensed at state level. It is important that the UK system of licensing or regulation is clear from the outset and that there is a trade body to quickly establish best practice and disseminate market information.

### **Compensation scheme**

In 2.14 it states that there 'may be scope' for the purchasers of existing annuities to benefit from the compensation scheme in the event of default of the annuity provider. In our view it is important that this protection is formalised so that the purchaser continues to benefit from the protection. Otherwise, if the annuities are effectively stripped of this underlying guarantee then it greatly increases the likelihood that a Secondary Market in annuities will fail to develop.

## **SL Investment Management response to specific questions raised in consultation CM9046**

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

Assigning one's rights to annuity income should be an option that is as widely available as possible. Applying restrictions that curtail the freedom of one set of annuitants over another would need to be considered very carefully, and have solid grounds for having restrictions in place.

For policies with a secondary beneficiary (e.g. wife, husband), consent for an annuity sale should be provided by both beneficiaries. This would be consistent with our experience in the UK Traded Endowment Market, where a good proportion of sales are triggered by financial restructuring during divorce settlement. (Straightforward and reliable procedures can be established to administer such consents). Without such consent, this could lead to future problems within the market.

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. Again, this is consistent with the approach adopted in the UK Traded Endowment Policy market.

We strongly disagree that Annuity providers should have the ability to apply discretion over whether an annuitant can make a sale or not. This would give annuity providers an effective veto over the market and an ability to 'ration' re-sale volumes in a potentially unfair way. Policyholders need to be able to plan and have certainty and it would be problematic if for example an annuity provider indicates consent to sale, and then at a later date decides that they will no longer allow it. By providing Annuity providers with discretion over whether an annuitant can make a sale or not, this may inadvertently lead to an increase in the risk premium applied in the secondary market as a result of reduced liquidity, reducing prices to every policy holder across the 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?**

Yes, we agree that a wide range of corporate entities should be permitted to invest in annuities. In terms of retail investment in annuities, we also agree that investment should be restricted.

Whilst the mechanics of an annuity itself are relatively simple, we agree that pricing is a complex process as it fundamentally depends upon an assessment of the longevity of the life assured. Diversification from a secondary investor perspective is of paramount importance in managing the volatility of secondary returns.

In the event that retail investors are allowed to buy individual policies on a secondary market, there would likely be a strong concentration of risk around a small number of annuities. It is inevitable that in some cases retail investors would suffer large losses in the event of the early death of annuitants. This would quickly become a public relations disaster for the newly created market.

However, we believe that indirect retail investment should be permitted in a newly created market, through the use of appropriate Collective Investment Scheme structures such as London Listed

Investment Trusts which are strongly regulated and enjoyed by corporate and individual investors alike. Such products would ensure that retail investors achieve greater diversification, hence protection from volatility, and can access longevity expertise to deal with valuation complexities in a cost effective manner.

Many commentators have compared potential secondary annuity investments to US Life Settlements, citing the fact that they are both a longevity based investment. Many of them go on to draw a parallel with the FCA stance on retail investment into US Life Settlements. We agree with the FCA that retail investment in US Life Settlements is generally unsuitable because of the significant liquidity risks resulting from large and increasing annual premium payments to maintain each policy in force. We are, however, of the view that secondary annuity investments are fundamentally different in that there is positive, rather than negative, cost of carry. As such, we believe that secondary annuity investments will not be subject to the same liquidity risks as US Life Settlements, and should therefore not be completely restricted to retail investment.

In terms of the corporate entities that should be permitted to participate in the market, this should be as broad as possible. However, corporate entities should be able to demonstrate a good level of capitalisation to protect against smaller retail investors circumventing the rules prohibiting them from accessing the market.

**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?**

We are of the view that Annuity providers should not be permitted to buy annuities they have issued themselves. The reasons being (i) that they have an existing direct relationship with the annuitant, allowing them to have unique and practically unhindered access to policies (ii) that as insiders, they have privileged information, leading to unfair competition (iii) the market is relying on the issuers to provide fair and efficient administration to annuity buyers and (iv) there would be serious conflict of interest issues if the Provider is aware of an improvement of health and yet fails to enhance the price offered to buy back the annuity.

If Annuity providers are permitted to buy policies themselves then this would be to the detriment of the open market philosophy, and would most likely have a negative impact on the value achieved in the secondary market by annuitants. Our experience within the UK Traded Endowment Policy market, where contracts can be cancelled with the provider ("surrendering"), has shown that the value achieved by policy holders via this route has been generally poor.

The providers (UK Life Companies in the instance of TEPs) have a captive audience, and hence no reason to offer best value to policy holders other than broad commitments outlined within their Principals and Practices of Financial Management (PPFM). The former regulator, the FSA, recognised this weakness in the market, instigating a consultation process (CP106) to review the situation in 2002. This resulted in the introduction of COBs16.5 in the regulatory handbook shortly afterwards, obliging Life Companies to inform policy holders looking to surrender their policies of the existence of a secondary market.

Although the intention of this initiative was well founded and did result in the number of referrals to the secondary market increasing, it is our view that it did not achieve its full potential.

Why? The actual method and extent to which Life Companies have to inform policy holders of the secondary market is not stipulated in the regulation, and there is no requirement for Life Companies to actively co-operate with the market, for example, by the adoption of comprehensive and efficient referral procedures.

As such, Life Companies have largely been unwilling to invest time and resource into developing positive working relationships with the TEP market. In fact, there is little benefit in them doing so as this simply incurs cost. Consequently, there is evidence that secondary market referral rates remain low, despite adherence to the letter (rather than perhaps the spirit) of the legislation by Life Companies.

For example, one major UK Life Company has shared with us that they processed 37 policy surrenders within their with-profit fund during November 2014. This was against a backdrop of just 2 policy referrals from the Life Company to the secondary market.

Chapter 2 of the consultation also highlights the risk of annuity provider "buy backs" causing a potential run on the annuity fund. Whilst this is a real and material risk, we believe that annuity providers will simply mitigate this by offering to buy back annuity policies at larger discounts. Other costs, such as a possible health assessment on each annuitant requesting a buy back quotation, will also be borne by the smaller number of policy holders who actually cancel their contract.

Our experience in the UK TEP market shows that only a small proportion of policy holders requesting surrender values actually action a surrender with the life company. Hence, Life Company overall fixed costs in providing a "buy back" service will be felt disproportionately amongst the smaller number of annuitants actually proceeding with the cancellation of their contract.

**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, we do agree that the solution to the death notification issue is best resolved by market participants. Annuity providers will already have existing systems and procedures in place to identify deaths, and arrangements for seeking the refund of any over-payments. There is no reason why these arrangements should not continue.

However, it is appreciated that in the current market, an important "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. This payment could be made by either the annuity provider, or by the third party purchaser (who would then have an obligation to inform the annuity provider of a death). By annualising this payment transactional costs could be minimised, whilst still providing a reasonably timely notification of death.

A government solution to the issue will, in our opinion, be very difficult to implement successfully. 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.

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

Yes, we generally do agree with the proposal that the government should work with the FCA on the fees and charges that can be imposed by annuity providers.

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. As such, we would recommend that the annuity providers' charges applied in a secondary annuity market should be very similar to those currently levied by Life Companies within the UK TEP market.

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 by us upon request.

From our provisional analysis, we estimate that although the average secondary market value of a UK annuity is similar to that of a TEP, the distribution of annuity policy value is skewed towards smaller policies. In addition, we are anticipating that a greater proportion of those policy holders with smaller annuities will look to access a secondary market than those with larger policies.

Consequently, we would recommend that from the outset the government and FCA implement an additional cap on the annuity provider fee that will be applied on an individual policy basis. For example, we suggest that a cap equal to the monthly annuity payment would be the most appropriate and easily implemented limit. This will ensure that smaller annuities do not become untradeable as a result of high administration fees.

**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?**

In implementing pension freedoms the Government is introducing welcome opportunities that should be available to all individuals approaching retirement and all existing annuitants. Nevertheless, we agree that initial scope should be on the development of a secondary market for annuities in the name of the annuity holder. Further consideration can and should be given to develop similar opportunities for group and scheme annuitants.

In any event, the mechanics to aid the development of a tertiary market (allowing secondary buyers of annuities to sell them on again) should be implemented alongside the requirements for a developing secondary market. This is a very important market requirement, as secondary investors will value the liquidity of being able to re-sell these assets.

For joint annuities or cases that have dependent benefits, all beneficiaries should be party to the assignment. A standard deed of assignment should be used and accepted by the annuity providers.

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

The reforms as presented would only seem applicable to pension annuities, however, other annuity structures that could be considered to enhance the potential market development may be: Purchased Life Annuity; Deferred Annuity; Structured settlements (i.e. accident / compensation payments).

**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. The system outlined in chapter 3 seems reasonable and fair to both those who access their pension flexibly and those able to access their annuity flexibly.

The Government should avoid introducing too many tax measures that may hinder or stifle the development of an effective secondary market.

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

There is not an obvious link between tax avoidance and the participation of annuitants selling and investors buying policies. Hence, the Government should avoid introducing too many tax measures immediately as this may hinder or stifle the development of an effective secondary market.

Market participants should be FCA regulated or approved corporate entities.

**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?**

The Government should recommend that individuals take advice, however this should not be at a cost level which stifles the market or makes it impossible for small annuitants to participate. Therefore, in some instances guidance may be sufficient and individuals should not be compelled to take advice. Existing regulation for transfer from a defined benefit scheme to a defined contribution scheme requires that anyone with a transfer value of over £30,000 is required to obtain advice and this would be an acceptable level to implement similar advice requirements for trading annuities. In any event, advisors should be appropriately authorised and regulated.

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

The safeguards can be implemented through a combination of regulation and guidance, including update or expansion to Pension Wise. A difficulty in implementing a threshold test is how to determine if the valuation of an annuity is above or below this threshold, prior to obtaining a market valuation. Hence, the requirement to obtain advice may become necessary during the process of a market submission and valuation.

**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 cost of any financial advice or guidance should be borne by the annuity holder. Individual annuitants should be free to pay for the appropriate level of advice depending on their particular circumstances.

**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?**

The Government should promote the concept of obtaining multiple quotes as a recommended course of action. However, only obtaining one quote should not prevent an individual from selling their annuity, especially in the case that multiple quotes have been requested and only one buyer has offered a price. We are not aware of any other markets that operate with strict requirements on quote numbers.

That said the Government should ensure that an appropriate trade association is set up for annuity policy investors. This function is fulfilled in the TEP market by the Association of Policy Market Makers (APMM) and has been extremely effective. The APMM was founded in 1992 to offer policy owners and financial advisers a central location to access the leading market makers in the industry.

Individual annuity holders would submit their policy details to an Association, which would be responsible for disseminating the details to its members, thereby achieving the best price for the annuitant. The Association would also help create efficiencies in the market in terms of developing processes with life companies, standardising transfer documentation etc. In addition, the Association would be responsible for promoting awareness and understanding of the annuity market, which would supplement (and could eventually supersede) the Government's involvement in this role.

Multiple quotes from members of a trade association, together with a more efficient sales process, will ensure that consumers obtain a competitive price.

**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?

We support the concept of a 'beneficiary waiver form' – whereby anyone entitled to receive any payments following the death of the principal holder (eg spouse of the annuitant) must sign a legal document giving up any future entitlement following reassignment. This would ensure that no annuity could be sold without the express agreement of all dependents.

This would also protect both investors and life companies - enabling them to transfer ownership with no risk of legal repercussions. This is crucial to ensure an effective market.

Clearly, any approach needs to bear in mind the legal terms of the original annuity contracts. However, it is standard practice to sell joint-life policies in both the UK TEP and US life settlement markets, so this is a well established concept.

Furthermore, we do not think it is practical for someone to sell their annuity and yet retain payments to a secondary beneficiary upon death of the principal annuitant.

**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?**

Covered in our response to question 14 – we do not think the principal annuity holders income should be assigned whilst retaining the income stream for a secondary beneficiary.

The separating out of dependent's rights from a legal standpoint would be complicated and expensive. The costs associated with this would erode the financial benefits of the transaction to both the annuity seller and the third-party investor, which could hinder the success of the market.

**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?**

The government will need to offer clear guidance on how people receiving means tested benefits will be affected by selling an annuity. This understanding should be promoted via a combination of law, written guidance widely available in brochure form and online, Pension Wise and the IFA community.

It is not clear from the details published to date how - for the purposes of benefit calculations - the Government will differentiate between a (large) one-off capital receipt versus (smaller) long-term annuity income. It is critical that this is clarified in advance of a secondary market, to avoid individual's inadvertently affecting their current or future level of means-tested benefit.

Conversely, the state must be protected against paying higher benefits in the future as a direct result of individual's future annual income reducing due to cashing in their annuity in one particular year.

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

Reportedly, around 13% of annuitants currently receive means tested benefits. Therefore this is a relatively small proportion of the overall market. However, the underlying principles of a secondary annuity market are freedom, choice and fairness. In keeping with these principles, we believe that those on means-tested benefits should be allowed to assign their annuity income should they wish to.

Naturally it is important that these individuals understand the implications of doing so. The impact of selling an annuity on an individual's means-tested benefits should be clearly understood via access to the channels referenced in our response to question 16.

From an investor perspective, these policies will be (by definition) smaller than average size. Therefore their inclusion in the market will offer valuable diversification benefits to investors seeking exposure to as many lives as possible. These policies will therefore be important in attracting investors, which in turn will create a competitive market, which in turn will benefit annuity sellers.

**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.**

In general, women live longer than men. For example, the latest projections from the Office for National Statistics assume that women aged 70 in 2015 will on average live to 89.7, compared with 87.3 for men. All else being equal, a 70 year-old woman's annuity should be worth more than a 70 year-old man's. Since 2012, insurers selling annuities have no longer been allowed to reflect mortality differences between men and women in the prices they quote, following a European Court of Justice ruling 11.

Therefore there may be an arbitrage opportunity for annuity investors if they were to purchase annuities originally sold to women following the 2012 basis change. This could lead to a higher proportion of annuities held by women being assigned than those held by men.

