



Pensions Reform Strategic Opportunities

The new simplified pensions regime

Thursday 6 April 2006 heralds a day of significant change in the pensions world. On that day, commonly referred to as A day, the Pensions Bill published in January 2004, and the tax simplification measures proposed by the Inland Revenue in December 2003, will be implemented. These reforms will create a single set of rules to replace the current eight regimes and the changes will, albeit to varying levels, affect everyone, as the new legislation is retrospective. Below is a brief summary of some of the key changes:

Lifetime Allowance – this sets a maximum on pension savings that can benefit from tax relief. It has initially been set at £1.5 million rising to £1.8 million in 2010. The Lifetime Allowance will then be reviewed quinquennially.

Annual Allowance – this relates to contributions to DC schemes or increases in accrued benefits in DB schemes. It has initially been set at £215,000, with annual rises specified through to £255,000 in 2010. Thereafter, the annual allowance will also be reviewed quinquennially.

Contributions – no longer limited to a fraction of capped earnings. Individuals can make unlimited contributions and tax relief will be given on the higher of 100 per cent of relevant earnings (subject, where relevant, to the Annual Allowance) or £3,600 where the individual has no earnings.

Tax free lump sums – all schemes can pay tax-free lump sums of up to 25 per cent of the value of the pension rights. The maximum tax-free lump sum rises to 25 per cent of the Lifetime Allowance.

Minimum pension age – This rises from 50 to 55 by 2010. Those with certain existing rights to draw a pension earlier may have that right protected.

Access to occupational pension – it is not necessary for a member to leave employment. Members of occupational pension schemes may, where the scheme rules allow it, continue working for the same employer whilst drawing retirement benefits.

'In retirement income' – it is a continuing requirement that pensions are secured by age 75. The traditional annuity route remains and some new annuity variants are introduced, the limited period annuity and the value protected annuity. Pension income may also be delivered after age 75 through Alternative Secured Income (ASI), a type of drawdown arrangement with a minimum income of only £1 per annum.

In the rest of this edition of *Strategy Matters*, two of our senior strategy consultants, Mark Joannes and Andy Sanders, consider how these changes offer strategic opportunities for providers to develop their business.

Extending the potential customer

Mark Joannes



+44 (0) 207 598 2847
mark.joannes@eu.watsonwyatt.com

Background

Historically, the pensions market has focused heavily on optimising the accumulation of pensions benefits up to retirement.

Consistent with this approach, a lot of the focus regarding the imminent changes in pensions rules has been directed to the restructuring of existing pensions assets and the impact of the pensions cap.

Very often, in the past, advice for vesting pensions has been limited to the sourcing of an annuity or, if the fund is large enough, an income drawdown policy. After A Day, though, the new rules will allow considerably more freedom providing opportunities for continued post-retirement activity including active management of retirement assets, designing and providing innovative products, and asset allocation.

What's going to change to make this possible?

The following changes in rules, in particular, will impact on how retirement assets can be managed.

- Higher annual contribution limits that can be used immediately prior to retirement to boost the pension fund.
- Greater flexibility in the design of retirement products.
- No requirement to fully annuitise, even at, or after, age 75.
- The introduction of the Alternative Secured Income (ASI) option after age 75.

What do we mean by retirement?

In the past, there has been a fairly distinct entry into retirement, with simultaneous retirement from work, stopping saving for pensions, and starting to receive retirement benefits. Although this will, in general, continue to be the case, the transition could be much less clear in the future.

Nevertheless, it is still helpful to consider a pension as being in two phases: accumulation (where the primary concern is saving and building funds) and decumulation (where the primary concern is an efficient management of the utilisation of assets over the remaining lifetime), which is generally referred to as retirement. Efficient management of the decumulation stage is, arguably, even more important than the accumulation stage as there is little or no opportunity to make up any shortfalls.

Even within the decumulation phase, and notwithstanding that these may overlap, there are three distinct stages, each with its own opportunities. These

relationship

are pre retirement, at retirement and in retirement.

Stage 1 – pre retirement

It is important to have advice, products and planning tools that look ahead, as some actions can only usefully be taken before retirement. For this reason, the decumulation stage really starts a few years before retirement.

At this time, the customer needs to understand all the options available to him and start planning for actions to take at retirement. Providing good, well communicated support for financial advisers is essential to achieve this.

Amongst the issues that could be considered at this point are optimising existing pensions holdings to best take advantage of the rules at retirement, considering the impact of inheritance tax, and perhaps considering the use of equity release to generate funds for an immediate vesting pension (an option that has always been possible but with higher contribution limits there will be greater scope).

Stage 2 – at retirement

The exact timing and method of moving from saving to taking retirement income can be used to optimise retirement benefits. This is aided by the new rules that allow greater flexibility for phased retirement and the option to continue to grow the pension fund at a gross rate until required.

It is also a time to consider the best way to use any other assets, such as other savings, investments and property. Taking these other assets into account (for example,

considering the value of a property in an equity release context) means that the full picture is understood.

Stage 3 – in retirement

Under the new rules, there will be opportunities to design new and innovative retirement products and to continue to give advice and provide products well into retirement.

Possible new types of retirement products include value protected annuities, term annuities and alternative secured income (ASI) policies. These new products may, as well as benefiting the customer, also reduce the longevity risk for the provider relative to providing a fixed annuity. Impaired life annuities may also have a greater role, if term annuities are initially purchased and then an individual's health subsequently deteriorates.

There is also more opportunity for giving investment advice in retirement, as there is a greater likelihood of active funds being held. This could lead to a

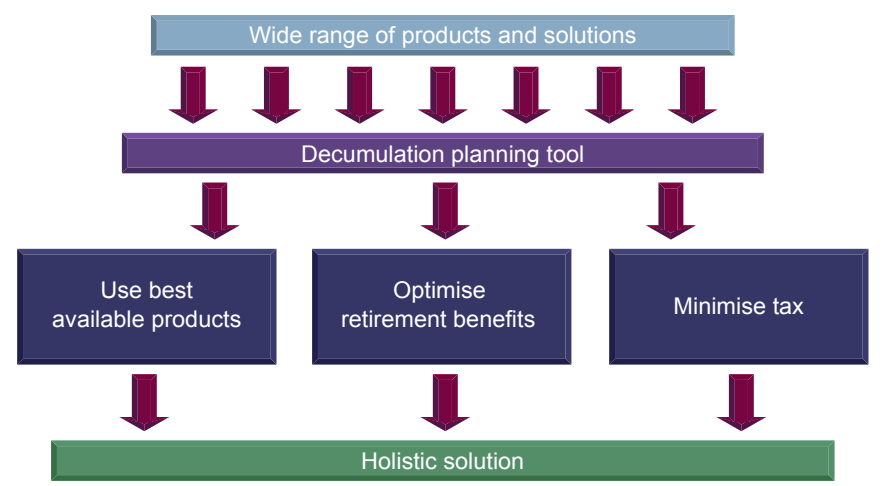
demand for 'retirement-friendly' funds and for asset allocation software that is tailored to the in-retirement market.

How can the customer benefit?

It is very important, in the light of 'Treating Customers Fairly' and the principle of giving good advice, that customers are given guidance to optimise their benefits in retirement. The two key issues here are being able to determine the optimal decumulation strategy and communicating this to the customer.

The decumulation market is large and growing and, in time, all the pension funds accumulated must be managed down. Under the new rules there will be many opportunities for providers in this new market. With a wide range of innovative products and solutions, and associated decumulation planning tools that take account of non-pensions assets and property, companies could provide a truly holistic service that would benefit customers throughout their life and not just up to retirement.

Figure 1: How to take a holistic approach to retirement benefits



A catalyst for change in the protection markets?

Andy Sanders



+44 (0) 1737 284744
andy.sanders@eu.watsonwyatt.com

The April 2006 pensions reforms, intended to encourage pensions savings amongst the UK population, could also force significant developments in the protection markets, with much at stake in both defending in-force portfolios and securing future new business.

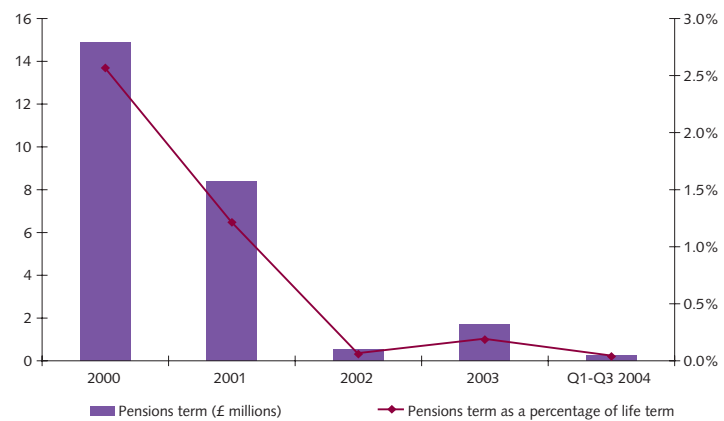
Current position in the protection markets

Despite around a 10 per cent fall in new business premiums in 2004, the life protection market has grown significantly in recent years. According to ABI data, new business premiums were around £600 million in 2000 and grew steadily to over £900 million in 2003.

Individual pensions term assurances are nothing new. It has been possible for some time to write life cover (subject to restrictions) within a pensions wrapper and gain the associated tax relief on contributions.

As Figure 2 shows, sales were significantly higher in 2000 and 2001, although still only a small fraction of the life protection sales. The impact of more restrictive rules introduced in April 2001 had a noticeable effect on pensions term assurance sales.

Figure 2: Pensions term assurance new business



Source: ABI, Watson Wyatt analysis
Note: Life term premiums include mortgage term, non-mortgage term and whole of life business (with/without CI)

Prevailing restrictions may be a significant factor explaining why the market has not developed. For example, it is not possible to have joint life policies or attaching riders; and policies are limited to the period of asset accumulation specified by the retirement age. There are also limits on what can be contributed to pensions products and what benefits can be taken.

Much, although not all, of this changes with effect from April 2006 providing a far more compelling case for pensions, as opposed to life, protection. For many people accessing tax relief on their protection contributions will simply be easier under the new regime as multiple pensions vehicles become more readily achievable and contribution limits are significantly extended. In addition, the Lifetime Allowance for benefits will be relatively generous for all but the highest earners and transition into retirement will become a less rigid process.

What could be at stake?

Accurately estimating the UK 'in-force' protection business is a difficult exercise. However, considering ABI new business statistics since 1994, in excess of 19 million life term or whole of life policies (with and without critical illness) have been written. Simplistically allowing for a 20 per cent per annum termination rate from all causes would imply around eight million in force policies.

A significant number of accelerated critical illness policies would be included in this total which, as is currently the case,

could not be written as pensions business. An interesting issue could be whether consumer demand for tax relief on their life cover is a stronger pull on purchasing behaviour than accessing the current critical illness propositions available.

Even without critical illness though, Swiss Re's Term & Health Watch reports indicate that over 900,000 pure life cover policies have been sold each year since 2000 (1.2 million in 2003).

The ease of demonstrating the scope for lower costs to the consumer could,

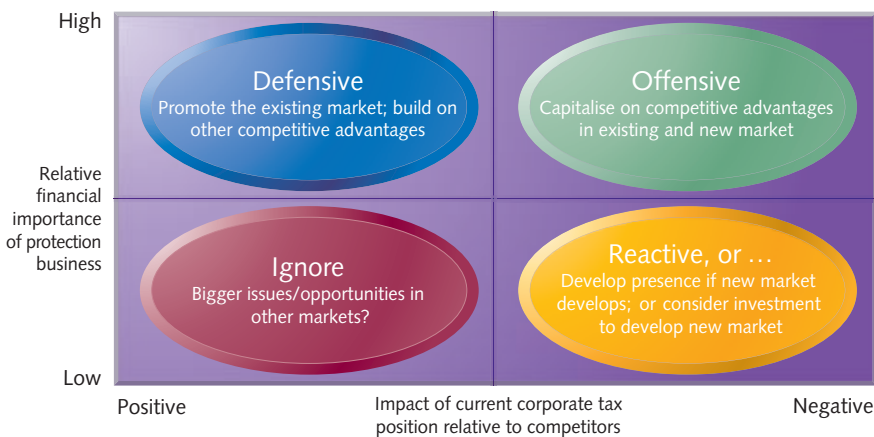
therefore, mean we see a rerun of the experience of the late 1990's and early 2000's where 'lapse and entry' made complete financial sense as mortality improvements fed through into lower premium rates.

And finally, there may even be a regulatory driver through the FSA's 'Treating Customers Fairly' initiative. This is still in its infancy, with the principles not yet defined, but the onus could be placed on providers to make customers aware of potentially better value policies.

Strategic considerations

Figure 3 illustrates our view that different corporate strategies are likely to apply based on two key considerations, the relative financial importance of protection business and the existing corporate tax position.

Figure 3: Strategies for responding to the pensions reform opportunity



Financial importance, whether in terms of existing and future sales, or profitability helps to identify the need for proactive or reactive responses to the opportunity.

The relative corporate tax position identifies whether a company's competitive position will benefit from a stronger pensions protection market. Currently some companies enjoy a tax advantage through writing protection business in their Basic Life Assurance and General Annuity Fund. For pensions term assurance business, no tax relief is available to any company, so a 'level playing field' results from a corporate tax perspective. Competitive advantage must then be generated from other means.

How to address this opportunity

The tax implications are the starting point for considering how to respond to the April 2006 opportunity. A successful strategy will ultimately require the alignment of the corporate and policyholder perspectives on tax. A detailed understanding of the tax issues to achieve this alignment is therefore required.

Identification of customer groups to be targeted or defended will be needed. Some will be more attractive or vulnerable than others. Analysis is required to determine the nature and value of the key segments for your company.

And finally, a robust strategy will only emerge through understanding the attitudes of your key competitors to the opportunity and their scope to capitalise upon it. There will be some natural winners and losers amongst the established protection providers and the prospect of new entrants to the market should not be discounted.

About Watson Wyatt

Strategy Matters is brought to you by Watson Wyatt's Insurance & Financial Services strategy group.

In today's intensely competitive environment, staying ahead of the competition is vital. Understanding and exploiting sources of competitive advantage, from the overall positioning and direction of the organisation to the detail of operations and distribution, is a challenge for any company in today's rapidly changing environment.

Focusing exclusively in the fast-moving and challenging financial services world, the Watson Wyatt strategy group is comprised of industry-experienced specialists, who combine hands-on 'client-side' experience with professional consulting skills. We work with clients across the financial services spectrum, bringing an external perspective, expertise, experience and, above all, the dedicated resource necessary to solve problems and realise opportunities quickly.

Watson Wyatt's global Insurance & Financial Services practice provides wide-ranging consulting advice on strategic matters, management issues, the sources of value and all aspects of financial condition and risk management within insurance and financial services businesses.

Combining broad practical experience with leading-edge technical and actuarial expertise, the practice advises a wide range of clients including major financial institutions, life, non-life and health insurance companies, reinsurers, fund managers, banks, bancassurers and companies involved in the purchase or distribution of insurance and financial services.

The Insurance & Financial Services practice is part of Watson Wyatt Worldwide, a global consulting firm focused on human capital and financial management, with more than 6,000 associates in 88 offices around the world.

For more information, visit www.watsonwyatt.com

Authorised and regulated by the Financial Services Authority.

The articles in *Strategy Matters* are for general interest. No action should be taken on the basis of any article without seeking specific advice.

To unsubscribe, email unsubscribe@eu.watsonwyatt.com with the publication name as the subject and include your name, title and company address. You can manage your Watson Wyatt subscriptions at www.watsonwyatt.com/membership

This publication is printed on paper produced using a chlorine-free process and wood pulp originating from managed sustainable plantations.