



An Interview with... Prudential

Prudential's head of business development for retirement income Vince Smith-Hughes is grilled by Burrows & Cummins Partner Billy Burrows with a little help from financial journalist John Lappin.

Words by John Lappin

Prudential's Vince Smith-Hughes believes the firm's range of annuity and retirement products allows it to "talk about the retirement income space impartially."

Prudential offers a conventional annuity, an enhanced annuity, an income choice annuity, a flexible lifetime annuity, a purchased life annuity and income drawdown.

However it is the income choice annuity that has seen the biggest move of the last 12 months. Launched in March last year this has now replaced the with-profits annuity which was withdrawn at the end of 2009.

The key, says Smith-Hughes, is that the annuity is asset backed by the with-profits fund, offers more flexible income options and believes it is less complex than other with-profits annuities.

"We wanted something that was flexible, gave people the opportunity to change their income but also something that was easy to understand. There are an awful lot of third way products in the market that even advisers can't understand. The challenge we gave ourselves was that, it would be understood by the end user."

Smith-Hughes says there has been a spread of clients taking maximum income, minimum income and in between. "People are using it in a variety of circumstances." He adds that it is also being used by investors coming out of drawdown who wish to scale back their risk.

Burrows asks: "How do you explain the difference between the income choice and the with-profits annuity?"

Smith-Hughes: "Income choice was designed to allow people to change their income. We were getting a lot of feedback that people wanted that. Although the with-profits annuity had a guarantee it wasn't widely understood. The income choice annuity has a guarantee that is very simple from the outset. People can understand how it increases. It is evolution not revolution. We are keeping the same fund to back the annuity, so people keep what they liked about the with-profits annuity, but with additional flexibility."

Burrows: "Could you explain how the guarantee works?"

Smith-Hughes: "From the outset of the contract people are given a range of incomes to choose from. Regardless of the income selected the guarantee on the contract is always the minimum amount of income that the member

can select from the outset. But it has the potential to grow as well so every time we declare a return and the income increases we will actually increase the guarantee by 50 per cent of the increase in income. For example, if your income rises by £500 on the first anniversary, we will increase the guarantee by £250. The guaranteed income will never fall below that figure, whatever happens in the market."

Smith-Hughes adds that alongside the flexibility available to clients, remuneration is flexible too, including the ability to take a recurring income which means the structure is compatible with adviser charging.

"Have advisers been taking advantage of this flexibility?"

"We have looked at the commission profile. There is no particular pattern to it.

Some people are taking what looks like the level on the old with-profits annuity, some people are taking less, others are taking more, some are taking annual remuneration, others aren't. I think that says we have got it right by allowing a flexible commission menu."

Smith-Hughes says that advisers have not complained about the withdrawal of the with-profits product. "We spent a long time explaining the rationale and people seem very happy to move across to income choice."

Burrows: "Do you see any other providers entering that space?"

Smith-Hughes: "I do think people offering with-profits are developing their contracts. You may see some providers make their products more like income choice. You will see more providers come into the asset backed space though not necessarily with-profits annuities."

Burrows: "Do you think customers understand the rationale behind asset backed annuities?"

Smith-Hughes: "Certainly we have made it very clear to them, with improved, clearer key features of what they are buying. They are purchasing a contract with a level of investment risk. I think people are starting to realise that risk isn't just about investment risk. You've got to look at the risk of inflation, the risk of looking after your dependants. These are the sort of risks asset backed annuities can help with."

Burrows asks: "Are you noticing IFAs recommending their clients buy more than one type of annuity?"

"That is becoming increasingly popular. A simple example is combining a conventional annuity with an asset backed annuity which gives the member a high level of guarantee but with the potential for growth in income going forward. That can be very powerful," Smith-Hughes says.

He also argues that such combinations provide an outcome like a variable annuity but more cheaply.

"With a variable annuity, in its simplest form it gives people guaranteed income with the potential for growth in that income. By combining an asset backed annuity and a conventional annuity you can provide similar guarantees with the potential for growth much less expensively."

Burrows then makes a bit of a challenge: "You keep using the word asset backed. Are you trying to get away from with-profits?"

Smith-Hughes: "Not really. It is not just with-profits. We have the flexible life-time annuity which is the unit linked

version. We use the term asset backed or investment linked to say it is an annuity but there is some level of investment risk. It is more the genre of the product rather than trying to avoid talking about with-profits annuities. Interestingly though I have noticed recently that people are talking about 'income choice annuities' to describe flexible annuities. I think therefore the phrase is being used in the same way as people talk about Hoovers to describe vacuum cleaners."

Indeed, he says, the Pru's with-profits record is something to be proud of.

"The attitude to with-profits is softening generally. In the retirement income space with-profits is a really good vehicle to use. Taking a simple example, fund values fluctuating prior to retirement is a number on a piece of paper and people are often comfortable with that.

"If they are in retirement, that fluctuation may lead to a change in income which obviously has a direct impact. Therefore if you can smooth out those fluctuations it is a major advantage. That is what with-profits does and why it works very well in the retirement income space."

Burrows: "Do you see a role for asset backed annuities in the DC corporate money purchase arena?"

Smith-Hughes: "It is very easy for large corporations who control the DC and employee benefit market to say we are going to find the best open market option rate in the market. But it isn't just about finding the best conventional rate. IFAs ought to see this as a market they should look at. Particularly with DC schemes people may have got used to the investment risk so it may be an ideal choice for many."

"So there is no reason why members of DC shouldn't consider with-profits.

Do the supermarkets drive people down that route?" asks Burrows.

"I think the annuity supermarkets need to consider a broader selection of products. Instead of being annuity specialists, they need to become retirement income specialists. If you are

in a DC scheme you may be in high risk funds, you then buy a fixed stream of income with absolutely no risk or upside potential at all. That doesn't make a lot of sense to me," says Smith-Hughes.

Burrows observes: "One of the things I find interesting is that you have people with a small DC pot but they may have a final salary scheme. So they can take risk with their small pot."

Smith-Hughes says: "We took the minimum down to £10,000 for the Income Choice Annuity in the main for people who are already in other types of schemes. So that £10,000 is a relatively small part of their retirement fund, with which people are happy to take a level of investment risk."

Is part of the problem the fact that recommending these products is more of an advice heavy process than simply finding a good rate?

Smith-Hughes says he was recently with an adviser who showed him a network questionnaire where clients were asked if they wanted to take any risk in retirement and 90 per cent said no and were defaulted to a conventional annuity.

"We come back to the level of risk of those 90 per cent who will end up in a level annuity. Have they gone through the process of explaining to the client that a level annuity will pretty much guarantee a drop in their level of income? Should those people be looking at different forms of income which has the potential to keep pace with inflation?" he says.

He adds that the impact of inflation on a level annuity should be explained, given life expectancy of the average 65 year old can easily be 25 years which means the erosion of income by inflation is much more significant.

Burrows asks: "Do you think you might be missing a trick because one of the problems in the corporate market is that while advisers may be happy to talk about with profits, the trustees are reluctant to have asset backed annuities introduced to their members?"

Smith-Hughes suggests an awareness campaign could be in the offing. "We need to raise the awareness. We are quite keen on getting product providers and advisers together to help raise awareness in general. There are some good solutions to clients here which don't yet have the profile they deserve."

Does he think there is an oversimplification of the divide among old style providers and new ones?

Smith-Hughes says: "I think a lot of advisers still think in terms of annuity or drawdown. We had a with-profits annuity in 1991. We think it was pretty much the first third way product. It sits between a conventional annuity and drawdown."

"Does Pru see advisers mixing and matching retirement products solely using Pru or Pru and those of others?"

"You might see an adviser getting the best rate for a conventional annuity and then come to us for the income choice. It depends on the benefit. If it is negligible it may all come to us. If there is a substantial benefit, they may split it in two," he says.

Burrows asks his view of post-code annuities?

"I think they will come in more and more. I think Solvency II also has some really significant challenges. Maybe alternative arrangements will look more attractive by comparison to conventional annuities. Investment linked annuities for example may see a seismic shift," says Smith-Hughes.

Burrows presses the point. "Do you think the middle Britain cohort have missed the boat in the context that post-coding is discriminating against middle Britain and Solvency II may affect value for money?"

"I hope that advisers are making it clear. It is difficult for us to see at the point of sale. If you go into a contract that is an annuity deferral vehicle like income drawdown or a fixed term annuity, there is always a risk that annuity rates will move against you. I feel that risk is pronounced at the moment," he says.

Burrows: "So there could be an argument for revisiting critical yield on drawdown?"

"There could be an argument for revisiting drawdown in the light of Solvency II, GAD rates and of course a lot of drawdown funds are not where they were in terms of value," says Smith-Hughes.

Burrows makes another challenge: "One of my favourite quotes is 'with-profits annuities good, with-profits drawdown bad'. What are the advantages of a with-profits drawdown?"

Smith-Hughes says: "If you take income at the wrong time say from unitised funds you face the risk of negative pound cost averaging. This can significantly damage your drawdown strategy.

"If you look at with-profits in drawdown, you haven't got that problem. If you take an income when markets are low we don't apply an MVR. If markets are high and we are applying a terminal bonus, we take that into account when working out the income. This means you haven't got the potential for negative pound cost averaging. You have all the benefits of a mixed asset fund, plus no MVR, and a guarantee on death and at 75 as well.

"You've got people in drawdown who want a nice simple approach, this can suit them well. In 2008 we looked at our with-profits fund in drawdown and reviewed it against several sector averages for example the balanced managed sector and the UK all companies sector. In the with-profits fund you would have done better in the last ten years than the average fund in the other sectors, and even would have fared well against the best fund in these sectors."

"Are Pru making headway in the with-profits drawdown market?" asks Burrows.

Smith-Hughes says: "Advisers' attitudes are softening. If you have advisers who are looking for a nice simple solution for funds say around £250,000 then this could be the answer. If you look at with-profits drawdown compared with the variable annuity market usually with-profits is the cheaper option."

However the provider is not planning a variable annuity any time soon.

"We couldn't bring a contract to market with high guarantees that wouldn't have a high reduction in yield. We are keeping a watching brief. It seems to me unless the cost of the guarantee comes down, it will not be that easy," he adds.

Burrows asks: "Do you think the variable annuity market will recover?"

"It depends on the cost of those guarantees reducing to make it more palatable. I don't believe you can knock it as a potential contract shape but the cost means they won't gain a significant foothold in the market yet," says Smith-Hughes.

Burrows asks: "Do you think other insurers are pricing their annuities in a profitable way?"

"All I can say is what we do. We have a number of people monitoring the markets, we have a number of people monitoring longevity. We look at all the things that can impact on annuity rates. We are comfortable with what we offer. Sometimes it looks like we are out of line particularly with pricing but we have a lot of people looking at this and we have great confidence in our ability in this area," he says.

Will Pru stay around?

"I think one of the problems the market suffered from was people chasing market share at the exclusion of everything else. That is something we have never done. With other companies who have, the chickens have often come home to roost," says Smith-Hughes.

Burrows' final big topic is the FLA. Is it seeing increasing interest?

"We are seeing people looking for a solution at 75. They are not attracted to ASP because of the tax and the income limits. We have income choice in that space. But if you have clients who want to manage that choice of funds, then you also have flexible lifetime annuity. We have an exit strategy for people who have those characteristics," says Smith-Hughes.

Burrows adds: "What is the main advantage of FLA over other annuities?"

Smith-Hughes: "I think the main advantage is the ability to select your own funds and the really attractive death benefits. At 75 they are looking at their fund values. It is not so much their income. They are looking at it to see how they can make sure their beneficiaries get the maximum benefit.

Ring fencing with FLA is a great way of ensuring you or your dependents receive a good amount of the value," he says.

Burrows: "What is the maximum?"

Smith-Hughes: "Eighty per cent. So you have 80 per cent guaranteed back, obviously subject to tax against potentially an 82 per cent tax charge on ASP. So for people coming out of drawdown FLA looks like a really attractive option."

Burrows: "How does that compare with a guarantee?"

"Normally it would work out more. It depends on the fund performance.

Let's say you are in a ringfenced FLA fund and say you die in year nine, it would normally work out much more than a guaranteed period on an annuity," he says.

Burrows: "Are you disappointed that FLA hasn't gained more traction?"

Smith-Hughes: "Its place is for those with larger funds, with the main market being those coming out of drawdown or approaching 75. The income choice annuity is a more mass market product."

Burrows makes his parting shot: "It is very difficult to see too many chinks in the Prudential armour. If I was a challenging IFA – one of the observations would be it does seem the Pru are more interested in Asia and the Far East?"

"The UK business provides very valuable capital to the rest of the group. I think the retirement income side of Prudential is particularly important to that," adds Smith-Hughes.

