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# The *Pension Annuities (Amendment) Bill*

**Bill 12 of 2001-02**

David Curry MP came fifth in the ballot for Private Members' Bills on 28 June 2001. He introduced a Bill which would reform the compulsory annuity purchase rules for certain types of private pensions on 18 July 2001. It is due to receive its Second Reading on 11 January 2002.

The Bill would introduce provisions based on proposals published in March 2000 by the Retirement Income Working Party, a group made up of academics and industry representatives. These would limit the requirement to purchase an annuity to an amount which would give the annuitant a minimum retirement income. It would provide for greater flexibility over the application of any residual fund once the minimum retirement income had been met. The Bill would apply to the whole of the United Kingdom.

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# Summary of main points

Interest in the role of annuities in private pension provision has increased over the last few years. This is due to the fall in the rates offered by insurance companies which itself reflects factors such as low long-term interest rates and increased life expectancy. Opposition parties, and some people in the financial services industry, have called for either reform or abolition of the current compulsory annuity purchase rules relating to defined-contribution pension schemes.

David Curry's Private Member's Bill seeks to reform these rules in line with proposals put forward by the Retirement Income Reform Campaign (RIRC). The Bill would introduce two new concepts into private pensions:

- The **Minimum Retirement Income (MRI)**. The level of the MRI would be set annually by the Chancellor of the Exchequer and is intended to be at a level above Income Support. The intention is that those retiring in the future would be required to purchase an increasing annuity which would provide an income "sufficient to maintain an annuitant without recourse to state benefits".

- The **Retirement Income Fund (RIF)**. Individuals with pension fund assets in excess of those required to meet the MRI would be able to reinvest these savings in a RIF and there would be no restrictions on when and how much income could be withdrawn from it.

The Bill would also require annuities used to purchase the MRI to be provided without regard to the sex of the annuitant and would abolish the provisions relating to income drawdown which is the main alternative to annuity purchase under current legislation.

Mr Curry intends that the proposals in his Bill should be cost neutral to the Treasury. The government has agreed to examine proposals for annuity reform which would not result in costs to the Exchequer. It has also announced a consultation document early in 2002 on "how better to promote competition in this market and thereby improve the benefits to customers". The government has not indicated whether it intends to support the Bill but it seems unlikely that it will do so in the light of previous statements on the subject of annuity reform and the forthcoming consultation.

This paper describes how annuities work, their role in private pension provision and the rationale behind the current annuity purchase requirements. It also summarises the background to the campaign to reform the existing rules, the provisions in Mr Curry's Bill and the potential implications of his proposals including reaction from other interested bodies.

Pension law and administration has its own lengthy vocabulary which can be offputting to those who are not familiar with the terms. Although this paper tries to explain any jargon, readers may find the glossary in section VI, or that appended to the government's 1998 Green Paper on pensions (Cm 4179), useful points of reference.

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# I Background

## A. What is an annuity?

An annuity is a contract in which a person pays a premium to an insurance company, usually in one lump sum, and in return receives periodic payments for a specified period, most commonly the remaining life of the annuitant. As such, annuities have been described as the opposite of a life assurance policy: the policyholder pays the lump sum; the insurer makes regular payments until the policyholder's death.[1] A life annuitant is guaranteed to receive a constant income stream for the remainder of his/her life and is therefore insured against the risk of outliving his/her resources.

There is a long history to annuity provision and they were often provided by governments to replenish exhausted national exchequers, particularly at time of war.[2] Today life annuities are purchased from insurance companies which have traditionally covered their obligations by investing in long-term government bonds (gilts). The interest paid by the government on the bonds is one source of income; this is boosted by running down the capital, by selling the bond holdings gradually over time. The insurance company pools the mortality risk across individuals: it does not pay out to those who die earlier than the aggregate mortality experience would suggest and this allows a higher pay out for those who remain alive. In theory, the pooling of this risk enables insurance companies to offer each annuitant a higher income than if s/he invested his/her individual premium in the same long-term government bonds.

In the case of annuities purchased from a pension fund, the period of payment for the annuity will usually be for the rest of the investor's life and the amount paid is based on actuarial assumptions about the life expectancy and the expected yield from the investment. There are different types of annuities but the current Bill concerns those bought to provide an income in retirement under tax rules which make the purchase of an annuity from a pension fund compulsory.

## B. The role of annuities in private pension provision

Life annuities are an integral part of provision in defined-contribution pension schemes. Defined-contribution schemes are sometimes referred to as money purchase schemes and are schemes where the final pension payable depends on the size of the pension fund at retirement and the rate of the annuity purchased with it. The size of the pension fund will depend on factors such as the contributions to it, the returns from investments and the provider's charges. On retirement a proportion of the fund is usually converted into an

1 *Oxford Dictionary of Finance and Banking*, 1997 edition, p 14

2 For a comprehensive history of annuity provision, see Mike Wadsworth, Alec Findlater and Tom Boardman, *Reinventing Annuities*, Paper for the Staple Inn Actuarial Society, Appendix 1.1 available from http://www.sias.org.uk/papers/reinvann.pdf

on-going pension through the purchase of an annuity. The other main type of private pension scheme, defined-benefit occupational schemes or final salary schemes, pay benefits related to the final salary of the member. These do not require the purchase of an annuity on retirement.

All personal pensions, including group personal pension schemes, and about 20% of occupational schemes, offer main benefits calculated on a defined-contribution basis and therefore usually involve the purchase of an annuity.[3] Stakeholder pensions, available since April 2001, may be occupational or personal pensions but must offer benefits calculated on a defined-contribution basis. Occupational pension schemes are required to offer additional voluntary contribution (AVCs) facilities to enable scheme members to increase their benefits. Benefits from AVCs may also accrue on a defined-contribution basis and will therefore be given effect by an annuity. The rules for when and how these various types of annuity may be purchased are now similar but the different types of schemes can operate under different legislation and separate Inland Revenue rules.

Section 1 of the *Pension Schemes Act 1993* defines two types of private pension scheme: an occupational pension and a personal pension. Separate social security and tax legislation applies to each type of scheme though some provisions are common to both. Although the rules for tax relief on different types of pension differ, the underlying principles are that tax relief should be for the provision of a pension as opposed to other forms of savings and that the tax relief should not be unlimited.

## 1. Approved personal pensions

Approved personal pensions were established by the *Social Security Act 1986*, which came into force in April 1988. The Act and accompanying tax legislation provided for a new system of approved personal pensions that could be entirely portable and could benefit from the rules for contracting out of the State Earnings Related Pensions Scheme (SERPS) by using the rebate for contracted-out National Insurance Contributions to help fund the pension. All personal pension schemes are defined-contribution schemes and rely on the purchase of an annuity from an accrued lump sum to provide a regular income for life in retirement. Like occupational pensions, approved personal pensions qualify for certain tax reliefs and in order to qualify for this relief they have to comply with certain rules. These rules are set out in the *Income and Corporation Taxes Act 1988* (*ICTA 1988*), as amended, and in guidance notes issued by the Inland Revenue which has some discretion to make tax rules in addition to those in the legislation. The tax legislation therefore provides a framework within which approved personal pension plans must operate. Individual policies may be written with clauses which are more restrictive than the limits contained in the legislation.

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[3] The figure of 20% is based on information in the NAPF's *Annual Survey 2000* and does not include group personal pensions or hybrid schemes which apply both the defined-benefit and defined-contribution basis and often provide scheme members with whichever basis gives the higher benefits.

Section 634 of *ICTA 1988* provides for annuity purchases from personal pension plans. Policies can usually provide for benefits to come into payment at any age between 50 and 75. Once a member takes his or her benefits, a certain amount may be taken as a tax-free lump, broadly up to 25% of the accrued fund. The remainder of the fund must eventually be annuitised. Most people take their tax-free lump sum and, at the same time, purchase an annuity which will provide an on-going income in retirement. The *Finance Act 1995* added a section 634A to *ICTA 1988*, which allowed for the additional option of "income drawdown" and deferral of the purchase of an annuity until age 75.

### *a. Income drawdown*

Under the drawdown provisions a policyholder may take a tax-free lump sum from an accrued personal pension fund, draw income from that fund (subject to specified limits) and defer buying the annuity until the age of 75. Under current legislation, income drawdown from a pension fund is the only alternative to buying a life annuity on the date that benefits start to be taken and it may only defer the date at which the fund must be annuitised. An Inland Revenue press release announcing the new rules at the time of the November 1994 Budget said that the intention of the change was to give personal pension scheme members increased flexibility in the way they used their funds.[4]

The amount of income that can be drawn down is closely regulated and although the income drawdown rules provided an additional option, it may not be suitable for many people. The Inland Revenue rules (IR76) set out the minimum and maximum amount which an individual can draw down from their pension fund in each 12 month period commencing with the pension date. These amounts must be not less than 35 per cent (the minimum) and not more than 100 per cent (the maximum) of the annual amount of the annuity which could have been purchased at pension date.[5] The Government Actuary's Department (GAD) regularly compiles a set of tables for each age and sex on the basis of a level, single-life annuity and these provide the basis for the calculation.[6] The GAD makes a series of assumptions in compiling these tables and bases its figures on the gross redemption yield for gilts with a 15 year term. The initial minimum and maximum income withdrawal limits will apply for the first three years from pension date. A fresh calculation must be made as at the first day of each subsequent three year period, using the current GAD table and the amount of the member's fund remaining at that date.

Therefore the amount of income that may be taken from a pension fund under the drawdown provisions is dependant on the annuities market and the price of long-term gilts. Also drawdown policies involve a greater degree of risk and higher management charges. Unlike an annuity there is no long-term guarantee and income is dependent on

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4 Inland Revenue Budget Press Release, *Deferral of Personal Pension Annuity Purchase*, 29 November 1994

5 Inland Revenue, *Guidance notes on approval of personal pension schemes* (IR76), para 9.11 and section 634A(4) ICTA 1988

6 see section C below for a description of the different types of annuity.

the performance of the fund investments. Many commentators therefore suggest that they are usually only suitable for those with relatively large pension funds and with alternative sources of income.[7]

In practice, relatively few people use income drawdown policies as a means of deferring annuity purchase: around 16,000 per year in each of the last three years.[8] In 1999, the average fund used to purchase an annuity was £30,000; the average fund used for income drawdown was £130,000.[9]

## 2. Occupational pension schemes

The rules for money purchase occupational schemes, and Additional Voluntary Contributions, are generally contained in the trust deed and rules of the particular scheme. Those schemes which operate within limits set out by the Inland Revenue benefit from special tax reliefs and are known as exempt-approved schemes. The tax rules are set by the section of the Inland Revenue known as the IR SPSS (Inland Revenue Savings, Pensions, Share Schemes formerly the Pension Schemes' Office) under the broad discretionary powers granted by *ICTA 1988*. Section 590 of *ICTA 1988* sets out stringent conditions which entitle a scheme to be approved by the Inland Revenue. The vast majority of schemes do not meet these conditions, but are approved by way of the discretionary powers granted by section 591 of the Act. Inland Revenue practice in using these discretionary powers is described in *Occupational Pension Schemes Practice Notes IR12* (2001).[10]

Like approved personal pension plans, the Inland Revenue rules allow schemes to offer benefits made up of a tax-free lump sum on retirement and an on-going pension. Unlike with a personal pension, benefits from an occupational pension must be taken on retirement and under Inland Revenue rules, exempt-approved occupational pension schemes may allow members to retire on pension at any time between age 50 and 75. In most cases, a defined-contribution occupational pension scheme will give effect to pension benefits through an annuity purchased from a life insurance company though some large schemes may pay benefits directly from the fund and manage the associated risks themselves. Small self-administered schemes must comply with special Inland Revenue rules to gain exempt-approved status and this includes a requirement that pensions should normally be secured from the outset by the purchase of an annuity from a life office.[11]

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7 See, for example, "Revenue eases the rules on scope of income drawdown", *Times*, 24 July 1999

8 Association of British Insurers Statistical Bulletin, *New long-term insurance results*, Q3 2001

9 ABI statistics cited in Retirement Income Working Party *Improving security and flexibility in retirement: full technical report* March 2000 p 5

10 Available from http://www.inlandrevenue.gov.uk/pensionschemes/ir12.pdf

11 Part 20 of IR12

Until July 1999, an on-going pension from a defined-contribution occupational pension scheme had to be taken at the same time as the lump sum. If members of a scheme wanted to defer taking pension benefits they had to transfer their pension into an approved personal pension plan to take advantage of the income drawdown rules. In its 1998 pensions Green Paper, the government announced that it intended to change the tax rules for approved occupational schemes.[12] These changes may allow, among other things, members of an occupational money purchase scheme to take income drawdown from the age of 50 and postpone the purchase of an annuity up to the age of 75, thus aligning the rules with those which apply to personal pensions. In a press release on 6 July 1999, the Inland Revenue announced that it had introduced new arrangements to this effect.[13] This also applies to benefits from defined-contribution Additional Voluntary Contributions (AVCs) and Free-Standing Additional Voluntary Contributions (FSAVCs). These are policies bought by some members of occupational pension schemes to enhance their benefits on retirement.

This change did not need legislation and was given effect by an amendment to the Inland Revenue rules. Trustees of occupational schemes may decide to change the rules of the scheme to allow the new arrangements but the amendment did not require them to do so. Approximately 16% of defined-contribution occupational schemes have amended their rules to allow drawdown.[14] Scheme members may be given an open market option when buying an annuity or the scheme trustees may choose an insurance company.

## 3. Stakeholder pensions[15]

Provisions in Part 1 of the *Welfare Reform and Pensions Act 1999* provide for stakeholder pensions. The detailed rules and main features of stakeholder pensions are contained in the *Stakeholder Pensions Regulations 2000*.[16] They began to be sold from 6 April 2001.

Under the legislation, stakeholder pensions must provide benefits which accrue on a defined-contribution basis and therefore will involve the purchase of an annuity under current tax rules. They may be legally established as personal pensions or occupational pension schemes. However, for tax purposes, stakeholder pensions are classed as personal pensions under the new defined-contribution tax regime introduced from 6 April 2001 by the *Finance Act 2000*. The rules for annuity purchase and income drawdown are therefore those which apply to personal pensions described above.

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[12] DSS, *A new contract for welfare: partnership in pensions*, December 1998, Cm 4179, p 75
[13] Inland Revenue press release, *Improved flexibility for pension schemes*, 6 July 1999
[14] NAPF survey 2000, p 44
[15] Library Research Paper 01/69, *Stakeholder pensions* discusses these in more detail.
[16] SI 2000/1403

# C. The annuities market

## 1. Types of annuity

There are three main types of annuity.

- **Level annuities** are by far the most common. These are sold at fixed rates and produce the same income for each year they are in force. Over time, inflation erodes the value of the income from a level annuity. Insurers generally back this type of annuity through purchasing fixed interest securities such as government securities (gilts).
- **Increasing annuities** provide an income which increases each year. With an **escalating** annuity, income increases at a fixed rate (usually 3 or 5% each year). With an **RPI-linked** annuity, income increases in line with inflation as measured by the RPI.[17] Increasing annuities pay a lower starting income than level annuities and "catch up" over time; if annuity rates are actuarially fair and accurately estimate future inflation then the real income from level and increasing annuities will be broadly similar, although it will be paid in a different pattern. Escalating and RPI-linked annuities are generally backed by, respectively, fixed interest gilts and index-linked gilts.
- **Variable (investment-linked) annuities** provide a variable income depending on the underlying performance of a with-profits or unit-linked fund. Both types of fund invest in a portfolio of equities, gilts and property, offering the prospect of higher returns than either a level or increasing annuity but also the risk of declining income. With-profits funds incorporate an element of smoothing to protect annuitants from fluctuations in the stock market and can incorporate a guaranteed minimum income. The presence of fund management charges means that variable annuities are relatively expensive to administer, and they generally produce a lower initial income than a level annuity.

Each type of annuity can be offered with or without a **guarantee** that the annuity will continue in payment for up to ten years after the death of the annuity purchaser. Annuities can also be bought on either a **single life** or **joint life** basis, the latter providing for payment to a surviving spouse (usually 50% of previous income).[18] Some insurers also offer **impaired life** annuities, offering a higher income to people – such as smokers, those with specified medical conditions and those from certain occupations - with a lower life expectancy.

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[17] The 'protected rights' element of a fund – the part deriving from DSS minimum contributions – must be used to buy a limited price indexation annuity where income increases in line with RPI or 5% whichever is lower.

[18] Again, annuities bought to give effect to protected rights must provide for a pension for a spouse on the death of the annuitant.

There are around 240 UK insurers authorised to provide annuities, although the Retirement Income Working Party suggest that some 20 firms supply almost the entire market with the top five accounting for over 50% of the market.[19] Others are satisfied with the level of competition in annuity provision, noting that the market is very competitive with the leading companies providing significantly better rates than others.[20] Individuals are generally free to use any annuity provider, regardless of the provider of their pension plan – the so-called open market option. In practice, it is believed that only between 20-45% of annuitants exercise the open market option.[21]

## 2. Determinants of annuity rates

Annuity rates are determined by two main factors: life expectancy and the expected returns on the investments backing the annuity over the period in which it is in payment. Recent trends in both factors have combined to push annuity rates to a historic low.

Continued improvements in life expectancy are a long-term factor depressing annuity rates. Insurers set their annuity rates on the basis of actuarial assumptions about the length of time the annuity is likely to be in payment; the longer the expectation of life, the lower the annual income offered. The growth in life expectancy among the general population is well-documented (see table 1). Actuaries in the insurance industry use more specific measures based on the mortality experience of particular types of insurance customer (such as annuitants). Life expectancy among insured groups – who are generally wealthier - is higher than among the general population although patterns of change over time are similar to those shown in table 1. Concern over the rapid growth in life expectancy among the insured population led the actuarial industry to review the basis of its mortality statistics in 1999. The Chairman of the Faculty and Institute of Actuaries' continuous mortality investigation bureau commented:

**Table 1**

**Expectation of life at age 60**
**United Kingdom**
***years of remaining life***

| | Males | Females |
|---|---|---|
| 1911 | 13.7 | 15.3 |
| 1931 | 14.5 | 16.4 |
| 1951 | 14.8 | 17.8 |
| 1971 | 15.3 | 19.8 |
| 1991 | 17.7 | 21.9 |
| 1998 | 19.0 | 22.6 |
| 2011 *projected* | 21.0 | 24.1 |
| 2021 *projected* | 22.0 | 25.1 |

Source: Government Actuary's Department (via National Statistics statbase dataset ST30704)

> we decided that improvements in UK mortality were taking place so fast that we needed to produce an entirely new set of tables. The reason insured people are now living so much longer is not entirely clear. However we believe it is due to a combination of better long term care available for the elderly, recent medical

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19 RIWP, *Improving security and flexibility in retirement: full technical report*, March 2000 p 9

20 The Retirement Choices Working Party, The Pensions Board and The Faculty and Institute of Actuaries, *Extending retirement choices: retirement income options for modern needs*, June 2001, p 8

21 Julie Stark and Chris Curry, "Is there an 'annuity problem'", in ABI, *Insurance Trends*, April 2001, p 7

> advances and a reduction in smoking. It is clear that the trend of improving mortality will continue.[22]

Annuity rates also reflect the yields which insurers can expect to secure from the investments they use to back annuities. As discussed above, traditional annuities have historically been backed by long-dated government securities, or gilts.[23] Gilt yields have fallen sharply over the past decade, with nominal yields on ten-year gilts falling from over 10% throughout 1990 to an average of 7.5% in 1996 and of 4.5% in 2000.[24] Falling yields reflect a coalescence of three factors which enable the government to issue gilts with low interest rates:

- low expectations of future real interest rates;
- increased demand, partly through insurers needing to back more and larger annuity contracts, partly through managers of occupational pension funds transferring assets from equities to gilts;
- reduced supply, as the government seeks to reduce its borrowing.

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[22] Faculty and Institute of Actuaries press release, *Male mortality continues to improve faster than female, say actuaries*, 22 July 1999

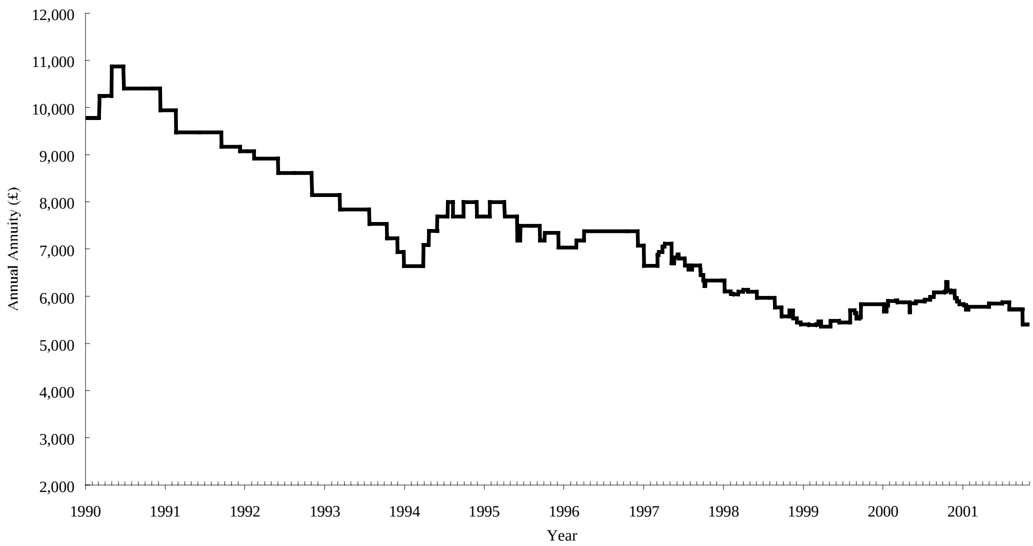
[23] Gilts are issued by the Treasury as a means of borrowing from the private sector. They are purchased at a fixed price which will be repaid to the investor at a fixed date in the future, and produce periodic interest payments – or 'coupons' – at a fixed or index-linked rate.

[24] National Statistics, *Financial Statistics*

## 3. Annuity rates

There is no official series of annuity rates. The Annuity Bureau, however, produce monthly figures on the range of annuities available to hypothetical individuals. Data from the bureau are reproduced below: they show the annual income for a man aged 65 with a wife aged 62 purchasing a 3% escalating annuity with a fund of £100,000. The annuity is guaranteed for five years and pays a 50% spouse's pension. Their data, reproduced in figure 1, indicate the decline in annuity rates over the past decade.

**Figure 1: Annuity Rate Movements (01 Jan 1990 - 31 October 2001)**




Source: The Annuity Bureau

A fund of £100,000 would have bought an annuity producing annual income of around £10,000 in 1990. Today it would produce less than £5,500.

Some commentators argue that such falls in annuity income are less significant than they may appear. To some extent, it is argued, they represent a "money illusion" whereby nominal and real levels of annuity income are confused. Today's pensioners are faced with much lower nominal annuity rates than earlier pensioners, but the expectation of low and stable inflation in the future (incorporated in the bond yields underlying annuity rates) means that they face less inflationary risk in future and that their income will maintain its purchasing power much better than has been the case in the past. Nevertheless, the perception remains that it is unfair for current annuitants to be retiring with annuity income based on rates half those prevalent ten years ago.

Research from the ABI stresses the extent to which the determination of income in retirement is a two-stage process, encompassing both annuity rates and pre-retirement investment growth. While someone retiring today faces historically low annuity rates their pension fund will have benefited from historically high growth in equities in the period before retirement. The net effect of these two countervailing forces is that – for a given level of contributions relative to average earnings - an individual retiring at the end of the 1990s has a higher income in retirement than someone who retired at the start of the decade.[25]

Of course this coincidence of high pre-retirement growth with low post-retirement returns may not continue into the future. Low levels of equity growth in the future would mean that future annuitants would be faced with low annuity rates coupled with pension fund growth at much lower levels than has been the case in the recent past. The Institute of Actuaries estimate, for example, that if the real rate of return on equities falls to 4.5% per year (compared with an average of around 7% since 1969) than a man aged 30 contributing 10% of his earnings retiring in 30 year's time would receive a pension equivalent to around 24% of his final salary; a similar individual retiring now would receive around 66%.[26]

## 4. Innovation in annuities

The government takes the view that many of the perceived problems of annuities can be addressed through product innovation within the existing legal framework and:

> welcomes recent moves by annuity providers to develop more flexible annuity products that will enable those pensioners for whom it is desirable to remain invested in equities. As the annuity market grows, it should aim to meet the demand for greater investment choice and higher returns**.** The Inland Revenue will continue to work with the industry to ensure that the tax rules do not unnecessarily restrict the development of these products and this market.[27]

The variable or investment-linked annuities described above go some way to increasing the investment choice of annuitants. Recent growth in this market has been rapid, with investment-linked annuities' share of the overall pension annuity market rising from 5% in 1998 to nearly 20% in 2000.[28] However, they remain based on a single decision at the point of annuitisation and do not enable annuitants to adapt their annuity income to meet changing income requirements or to respond to changes in investment conditions.

More recent innovation has focused on schemes which enable annuitants to purchase an annuity consisting of a series of temporary and deferred annuities. The deferred annuity guarantees income throughout retirement – a key Inland Revenue requirement for annuities purchased from approved pension schemes – while the series of temporary annuities enables annuitants to choose from a range of investment strategies appropriate to their personal circumstances and stage of retirement. Outlining a product of this nature, Watson Wyatt consultants suggest that it bridges the gap between current variable annuity products and income drawdown, while remaining within the scope of current Inland

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[25] Julie Stark and Chris Curry, "Is there an 'annuity problem'", in ABI, *Insurance Trends,* April 2001, p.7
[26] "Age of discontent", *Financial Times*, 11 August 2000
[27] HM Treasury, *Economic and Fiscal Strategy Report 2001*, para. 5.68
[28] Julie Stark and Chris Curry, "Is there an 'annuity problem'", in ABI, *Insurance Trends April 2001*, p.6

Revenue rules, and would over time become the prevalent product in the UK annuity market.[29] The aims of such products, they suggest, would be, from the annuitant's viewpoint:

- to increase potential lifetime income through greater freedom to choose optimally performing assets, and to vary this choice during retirement to reflect any change of attitude to risk and reward, and in financial circumstances;
- to provide insurance against longevity, but with flexibility as to the extent of such cover chosen;
- to generate stable income but to allow flexibility as to the level of income generation
- in a 'stakeholder' culture, to be transparent.[30]

An annuity launched by the insurer London & Colonial has been welcomed by financial advisers as a still more revolutionary form of annuity provision. The "Open Annuity", available only to those with pension funds in excess of £250,000, offers a range of investment options and manages an annuitant's fund in isolation, rather than pooling funds together as with traditional annuity products. The product has been been structured in such a way that any capital remaining on death can form part of the investor's estate. Financial advisers see the Inland Revenue's approval of the annuity as indicative of a new flexibility and of the government's desire to find a market-based solution to the perceived problems of annuities. A director of the advisers Annuity Direct commented "this would not have been allowed ten years ago [although it] should not be seen as a substitute for full-scale annuity reform".[31]

A report commissioned by the Institute and Faculty of Actuaries reached the, not surprising, conclusion that the greater choice offered by annuity packages such as those described above means less security.[32] Clearly, while such products improve on the flexibility and investment efficiency offered by traditional annuity products they also produce less security of income and may entail greater costs in administration and financial advice.

As with income drawdown policies, products with lower security are unlikely to be suitable for those with relatively small pension funds to annuitise and/or those who are dependent on annuity income for a large part of their retirement income. Indeed, investment-linked annuities in general are unlikely to be a suitable solution for poorer annuitants; in general, those with lower incomes die earlier and are less likely to benefit from the increasing income offered by investment-linked annuities.

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29 Mike Wadsworth, Alec Findlater and Tom Boardman, *Reinventing annuities*, paper presented to the Staple Inn Actuarial Society, 16 January 2001

30 *ibid*. p.16

31 Cited in "Cascade from the Rock will ease constraints", *Financial Times*, 1 December 2001

32 The Retirement Choices Working Party, The Pensions Board and The Faculty and Institute of Actuaries, *Extending retirement choices: retirement income options for modern needs*, June 2001, p.24

# II Campaign for reform

## A. The arguments for and against annuities

The fall in annuity rates, particularly over the last decade, has led to increased pressure for reform in recent years from those who argue that the requirement to buy an annuity should be abandoned or the age restrictions relaxed. There were also some people who questioned this requirement even before the fall in rates, particularly after the introduction of tax reliefs for other forms of saving, such as Personal Equity Plans (PEPs). Supporters of reform argue that current annuity rates offer poor value, or at least are perceived by potential annuitants to offer poor value, and there is little prospect of annuity rates increasing.

Other points made by the opponents of the annuity requirement are that the person buying the annuity is locked into the rate that applies at the time that the annuity is bought and that any remaining fund cannot be passed on to the policyholder's dependants on his/her death. It is argued that individuals should have greater flexibility about how they access any part of their pension fund which is in excess of that required to take their income above state benefit levels. This would ensure that individuals would not outlive their resources while providing people with greater freedom over how they access their savings and potentially encouraging more people to save for their retirement in private pensions. Opponents of the present system often particularly object to the rule which requires an annuity to be purchased by the age of 75 and argue that this is an arbitrary cut off point. Some have also argued that the annuities market is a relatively closed one and that insurers exploit the mandatory provisions to make excess profits.

The rationale for the compulsory annuity purchase requirement for private pensions is that the relatively generous tax reliefs given to private pensions should be for the provision of a pension as opposed to other forms of savings. As the government gives tax relief on private pension contributions specifically to encourage saving for retirement, it has a legitimate interest in requiring those savings to be used for that purpose. For example, some may question whether it is appropriate for tax advantaged savings, which are intended for use in retirement, to be passed on to future generations in the form of a bequest.[33] Furthermore, arguably some of the recent financial products which have been approved by the Inland Revenue mean that some of the criticisms about the lack of flexibility in the market are less justified.

A second point made in support of annuities is that no other product provides a regular, guaranteed income for life; ultimately what a pension is intended to provide. Other arrangements carry the risk that an individual will outlive his/her resources. For example, it has long been argued that the payment of a lump sum without compulsion to purchase

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[33] see, for example, "Is there an annuity problem?", *Insurance Trends*, April 2001, p 7

an annuity on retirement may lead people to spend unwisely and ultimately rely on support from the state. The 1888 Ridley Commission on the Civil Service concluded:

> The payment ...of a lump sum is open to the obvious objection that in the event of improvidence or misfortune in the use of it, the retired public servant may be reduced to circumstances which might lead to his being an applicant for public or private charity.[34]

Also, increased flexibility in the way individuals take money from their pension fund will have tax implications and these may result in costs to the Exchequer. The extent of any costs incurred as a result of annuity reform is difficult to quantify. Supporters of reform argue that there is scope for a new system which increases flexibility but which is also tax neutral and this is the principle which underlies the Bill. This issue is discussed in more detail in section III of this paper on the Bill's provisions.

The competing arguments around the compulsory annuity purchase requirements have been explored in more detail in recent years as the government has come under pressure from inside and outside parliament to reform the rules.

## B. Previous attempts to amend the legislation

In March 1999, during the Committee Stage debates on the *Welfare Reform and Pensions Bill*, Quentin Davies MP moved an amendment for the Opposition to abolish the requirement that an annuity be bought by the age of 75, with the intention that people could choose to continue with income drawdown indefinitely.[35] The amendment was not supported by the government and was defeated. At an earlier stage in the Committee proceedings when the issue was debated at greater length, Stephen Timms, then Minister at the Department of Social Security, outlined the government position. He said that he recognised the problems caused by falling annuity rates but said that "it does not seem that any fundamentally different approach is available as an alternative".[36] In response to a Parliamentary Question a few days earlier, he also said that:

> Life offices providing annuities have a good record of reliability, which is an important point in favour of the existing system.[37]

Later that year, the Opposition again argued for the removal of the requirement to purchase an annuity under approved personal pension schemes during the Committee Stage of the *Finance Bill 1998/99*. In proposing a new clause to the Bill removing the obligation, Nick Gibb MP argued that the current age limit of 75 was arbitrary given

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[34] Quoted in Leslie Hannah *Inventing retirement: the development of occupational pensions in Britain,* Cambridge University Press, 1986, p 115

[35] SC D Deb 16 March 1999 c 294-6

[36] SC D Deb 11 March 1999 c 149

[37] HC Deb 8 March 1999 c 19

increases in life expectancy. He also argued that compulsory annuity purchase means that the capital is lost and pensioners are unable to take a smaller income in order to retain capital to leave to their children if they wish. In conclusion he said:

> Pensioners are finding that they can achieve a better return by leaving their capital in the pension fund than by taking it out and purchasing an annuity … There are circumstances, with which other members of the Committee will be more familiar than I am, in which annuity rates have risen (sic) not only because of low interest rates but because of an attempt by the annuity industry to recover margins following past mistakes, and because the annuity industry is probably under-supplied in relation to the level of demand. There are also worries about 20-year gilt rates in the marketplace, because of excess demand by the annuity industry for annuities for 20-year gilts …
>
> If the stock market were not delivering sufficient returns to the pension fund, no doubt many of the constituents who have written to me would be happy to take out an annuity. However, it should be up to them to make that decision, at the right time, taking into account prevailing conditions on the stock market and the level of interest rates. The point at which they take out an annuity should not be dictated by legislation.
>
> The new clause would not prevent them from taking out an annuity; it would simply give them flexibility. I can see no argument against that, as I believe that the case is unassailable. It is wrong to presume that pensioners are profligate and irresponsible, and that they should not take responsibility for those decisions. The current law is carefully drafted to ensure that there is no profligacy. The income draw-down rules are specific and do not allow pensioners to withdraw vast sums from their pension fund and squander them on a world cruise, so that they would then be forced to claim income support from the state. The government's response to my constituents' concerns has been measured and sympathetic, but firm in their support for annuities.[38]

The government opposed the new clause and the amendment was defeated. In her response on behalf of the government, Patricia Hewitt MP, then Economic Secretary to the Treasury, said that the Treasury was reviewing the rules:

> The move from an era of boom and bust … to an era of macroeconomic stability and low inflation creates problems of adjustment. This country has not been used to a period of sustained low inflation and low interest rates--with all the benefits that that brings for business investment--for a very long time. Neither were elderly people used to it, therefore they had not planned for their retirement on that assumption. Although low inflation brings real benefits to elderly people--directly, because their income and capital is not eaten away by inflation, and indirectly, because of the greater economic benefits that it brings--low inflation

[38] SC B Deb 22 June 1999 c 739

> and low interest rates bring with them the problem of low annuity rates, which the hon. Member for Guildford mentioned.
>
> My hon. Friend the Paymaster General and I have said that we want to consider whether the current arrangements for income withdrawal from personal pension funds can be improved, and the Inland Revenue has begun a review of the issue. I expect that review to conclude in the autumn, when we shall be in a position to decide sensibly whether changes can be made to improve pensioners' access and choice, while still protecting the security of benefits and their income in older age.
>
> I have asked the Inland Revenue specifically to consider whether the age limit of 75 is still appropriate. I have also said that we shall be happy to consider any innovative products that the financial services sector might develop, as long as they retain the guarantee of a secure income for life. A combination of capital fund and income draw-down, together with the purchase at some point of a forward annuity, as the hon. Member for Guildford suggested, might provide an adequate alternative to the present arrangements. I do not know, but I would certainly urge financial services providers and others who have an interest in the matter to provide evidence to that review, so that we can carry out a thorough analysis.[39]

This review did not result in any radical changes to the compulsory purchase rules though the government did introduce some limited amendments. Following a short consultation, the government introduced a new clause into the *Child Support, Pensions and Social Security Bill 1999-2000*. This is now contained in section 51 of the 2000 Act which amends the *Pensions Act 1995* and relaxes the rules on buying an index-linked annuity on retirement for members of occupational money purchase schemes, enabling people to buy an investment linked annuity as an alternative. This relaxation of the rules was described as "going almost nowhere to meeting the increasingly vociferous demands to do away with annuity purchase altogether on any kind of money purchase scheme".[40] During the debate on the new clause, Jacqui Lait, then Conservative spokesperson on pensions, welcomed the measure but reiterated the arguments about whether annuities should be compulsory.[41]

## C. Recent developments

Following months of speculation that the government would introduce further changes, the March 2001 Budget Report reiterated the view that annuities remain the only financial product that can guarantee a secure income throughout retirement.[42] It stated that many

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[39] SC B Deb 22 June 1999 c 745

[40] *Pensions Today*, March 2000

[41] HC Deb 3 April 2000 c 747-8

[42] HM Treasury, *Budget 2001 – investing for the long term: building opportunity and prosperity for all*, HC 279 2000/01, March 2001, paras. 5.65-5.69

suggested alternatives to the present system involved substantial costs to the Exchequer and argued that, within the existing legislative framework, there was further scope for the current annuities market to be developed through more flexible annuity products. The Inland Revenue would "continue to work with the industry to ensure that the tax rules do not unnecessarily restrict the development of these products and this market". The issue would remain under review. The government was also concerned that some of those retiring were not exercising their open market option when they bought an annuity. The Budget Report said that the government would work with the regulators to consider whether more needed to be done to encourage people to shop around. On 21 August 2001, the Financial Services Authority announced proposals for the disclosure of information in relation to open market options.[43] These would require firms to inform policyholders within four months of their planned retirement date that they have the right to shop around for the best pension annuity. The consultation date for these proposals ended on 31 October 2001.

The range of views on compulsory annuity purchase was reflected in the manifestos of the main parties for the 2001 General Election. The Labour Party Manifesto stated: "we will continue discussions on annuity reform to ensure tax rules do not unnecessarily restrict the development of annuity products and markets".[44] The Conservative Party's Manifesto repeated the party's earlier commitment to abolish the current requirement to purchase an annuity at 75 and said that "people with personal pensions will only need to ensure that they have sufficient income to keep free of means-tested benefits. The remaining capital will be theirs to keep and – if they wish – to pass on to their children".[45] The Liberal Democrat Manifesto stated that the party would "relax" the current rules.[46] Steve Webb, Social Security Spokesperson for the Liberal Democrats, had introduced an adjournment debate on pension annuity reform in 1999 in which he argued for greater flexibility for pensioners at age 75 and tighter regulation of the sale of income drawdown policies.[47]

In statements since the General Election, ministers have reiterated the government position and argued that while it is open to suggestions for reform, these must be workable and cost effective. For example, in a reply to a question from John Greenway MP on proposals by the Retirement Income Working Party, discussed in more detail below, Ruth Kelly, Economic Secretary to the Treasury, said:

> I certainly understand the concerns that the hon. Gentleman has raised although I repeat that, at the moment, annuities are the only way of providing a secure income flow in retirement. Of course, we have to consider other proposals, and in the next six months, I hope that people will make serious proposals for reform.

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[43] FSA CP106, *Disclosure: trading an endowment policy and buying an annuity,* August 2001
[44] Labour's Manifesto 2001, *Ambitions for Britain*, p 28
[45] Conservative Manifesto 2001, *Time for Common Sense*, p 24
[46] Liberal Democrat Manifesto 2001, *Freedom, Justice, Honesty*, p 10
[47] HC Deb 30 June 1999 cc 259-280

> The hon. Gentleman proposed that we consider Dr. McDonald's suggestions, which are interesting but have cost implications. If annuities and savings funds became more flexible, it is of course possible that people would start to use them not only as savings vehicles for their future pension but also as inheritance vehicles. There is that risk, in which case the cost implications could be severe. However, as I said, I am interested in hearing sensible, efficient and workable proposals. If I can be shown that they are not costly, of course the Treasury will take them extremely seriously.[48]

Iain McCartney, Pensions Minister at the Department for Work and Pensions, has also been reported as opposing some proposals for annuity reform on the grounds that it would mainly benefit the very wealthy who will already have benefited from significant tax concessions with their private pension savings.[49]

At the time of the Pre-Budget Report in November 2001 some press reports suggested that the government was about to consult on wide reforms of the annuity rules.[50] In fact, the report itself simply reiterates the government's view that an annuity is the only financial product that guards against the risk of an individual outliving their resources. It states that the government has plans to publish a consultation document on "how better to promote competition in this market and thereby improve the benefits to customers".[51] This consultation will take place in the first quarter of 2002.[52] Some submissions to this consultation are likely to call for more radical reforms than the market-based proposals which the document seems likely to propose.

# III The Retirement Income Reform Campaign and the Bill

The Retirement Income Working Party (RIWP) chaired by Dr Oonagh Macdonald published proposals for annuity reform on 1 March 2000 in a document called *Choices*.[53] The preface to the report stated that its purpose was "to make a contribution to the public policy debate about how best to provide retirement income and to set out practical alternatives to the current regime". The working party was established after Dr Macdonald argued for reform of the system of compulsory annuities in a 1999 paper for the Association of Unit Trusts and Investment Funds.[54] After the March 2000 document was published, the group, which is made up of academics and industry representatives,

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48 HC Deb 19 July 2001 c 424

49 *Money Marketing*, September 2001

50 "Annuity rules review could bring change in policy", *Financial Times*, 1 December 2001

51 HM Treasury, *Pre-budget report 2001: building a stronger, fairer Britain in an uncertain world*, Cm 5318, November 2001, p 94

52 HC Deb 4 December 2001 c 205W

53 Retirement Income Working Party, *Choices – an independent report to encourage the debate on retirement income*, March 2000, available from http://www.bbk.ac.uk/res/pi/reports/Mar00.pdf

54 Dr Oonagh Macdonald, *Income in retirement - are annuities the answer*, AUTIF, April 1999. Dr Macdonald was Labour MP for Thurrock between 1976 and 1987 and was a spokesperson on Treasury issues from 1983 to 1987.

formed the Retirement Income Reform Campaign (RIRC). The RIRC is funded by several financial services groups and trade associations and continues to press for reform. After the 2001 election the RIRC lobbied MPs who were successful in the private members' ballot to bring forward a Bill on pension annuity reform and David Curry, who came fifth in the ballot, decided to take up the issue. The RIRC's Internet site contains a copy of the *Choices* report, information about the campaign and background material on the Bill.[55]

The *Choices* report presented four main proposals which are central to the Bill currently before parliament:

1. An individual would continue to be free to take a tax-free lump sum from his or her pension fund subject to the current limits.

2. When someone retires, they must purchase an index-linked annuity to meet a Minimum Retirement Income.

3. There should be much greater freedom over the application of any residual fund, to be known as the Retirement Income Fund, after the Minimum Retirement Income is achieved.

4. The current shortcomings of existing annuities should be addressed by government and the financial services industry.

Therefore, the Bill would provide for two new concepts: the Minimum Retirement Income (MRI) and the Retirement Income Fund (RIF). Clauses 1 and 2 of the Bill would amend sections 630 to 637 of the *Income and Corporation Taxes Act 1988 [ICTA 1988]* to this effect and would also repeal the current provisions relating to income drawdown. Unless otherwise stated, all references below to existing legislation are to *ICTA 1988*.

Section 630 currently defines a personal pension scheme as a scheme "whose sole purpose is the provision of annuities, income withdrawals or lump sums under arrangements made by individuals in accordance with the scheme". **Clause 1(2)** would extend this definition to include the provision of sums for investment in a RIF. Section 633(1) currently states that the Inland Revenue shall not approve a personal pension scheme which makes provision for any benefit that is not covered by subsections (a) to (e), thus limiting approval to schemes which provide some or all of these benefits. These are:

- an annuity or income withdrawals payable to a member (subsection (a))

- a lump sum payment to the member (subsection (b))

[55] http://www.rirc.org.uk

- an annuity or income withdrawals payable to a member's widow, widower, or dependants following the death of the member (subsection (c))

- a lump sum payment to a dependant which is payable, on the death of the member before the age of 75, from any life cover offered with the policy, subject to limits (subsection (d))

- on the death of a member when no annuity has been, or is to be, purchased, a lump sum not exceeding a return of the contributions, subject to certain conditions. This usually applies where the policyholder dies with no dependants or on the death of the member during income withdrawal (subsection (e)).

**Clause 1(3)(c)** would add a new subsection 633(f) to the list of approved benefits allowing payments to the policyholder from the RIF. **Clause 1(3)** would remove the reference to income withdrawals in section 633(1)(a) and 633(1)(c) and **clause 1(5)** would repeal sections 634A and 636A. Therefore, income drawdown would no longer be permitted under the provisions in the Bill. Clause 1(5) states that this would not apply to schemes executed before the date the Bill came into force which is proposed to be 6 April 2004. It appears that the intention is that income drawdown would be retained in respect of drawdown policies purchased before this date. A guide to the Bill produced by the RIRC states the under the Bill's proposals, policyholders would have greater control over their pension funds and therefore "there is no purpose for maintaining the drawdown provision".[56]

## A. Minimum Retirement Income (MRI)

**Clause 1(4)** would amend section 634 which currently provides the rules for annuity purchase from an approved personal pension plan. An annuity must be purchased from an authorised insurance company and must be payable for at least the lifetime of the annuitant under sections 634(1) and 643(4). These provisions would remain under the Bill. It would introduce a new subsection 634(1A) which states that the annuity must provide the member with an annual income not less than the MRI which is defined in clause 2 of the Bill. **Clause 2** states that the MRI shall be set annually by the Chancellor of the Exchequer. The RIRC press release states that "it is expected that this level would be sufficient to maintain an annuitant without recourse to state benefits". The Bill would also provide that the MRI annuity may be bought no earlier than 50 but by the age of 65 with an exemption until 75 for those with drawdown policies in place on 6 April 2004 **(clause 1(4)(b))**.

The Bill contains little detail on how the MRI would actually operate, besides requiring the Chancellor to set its level annually. The intention, however, is that the Chancellor would both set a level for the MRI and define the sources of income which can count

[56] RIRC press release, *David Curry launches Bill on annuities reform*, 17 December 2001

towards it (although the Bill, as currently drafted, does not provide powers for such a definition). Income which would count towards the MRI would be likely to include all sources which are uprated annually by at least the rate of inflation: broadly, basic state pension, SERPS and/or, in some cases, income from a defined-benefit pension scheme.[57] As proposed in the *Choices* report, annuity income would have to make up the difference, if any, between the total income from these sources and the MRI. The requirement would be for income from the annuity to meet this "residual income requirement", not to meet the MRI itself.

There are numerous issues to be considered in establishing the level of the MRI. These are centred on the trade-off between flexibility and certainty. The policy intention of maximising flexibility in the use of pension fund assets points to setting the MRI at a low level. The secondary intention of ensuring that pensioners are not reliant on means-tested provision suggests, however, a floor below which the MRI cannot be set. The RIWP considered three broad options for setting the MRI level:

- at the level of the Minimum Income Guarantee (MIG) for a single pensioner (then £75 per week, now £92.15, expected to be around £100 in 2003). This option was rejected as it would not provide certainty that the annuitant would remain off means-tested benefits throughout retirement. After retirement, the components of an individual's MRI would rise in line with inflation while – for this parliament at least – the government is committed to increasing the MIG in line with earnings. A MRI set at the level of the MIG at the date of an individual's retirement would quickly fall below it during retirement.
- at a level representing the average income from basic state pension and membership of an occupational scheme (then £220 per week). This option was rejected as too high to secure the required flexibility.
- at a level representing the income produced by the basic state pension and SERPS for someone formerly on national average earnings (then £140 per week, from next year around £160 per week). This option was recommended on the grounds that it struck a suitable balance between flexibility and certainty, and because it marked a link between the income produced from contracting-out of SERPS and the income which would have been produced by staying contracted in.

By providing the freedom to set the MRI annually, the Bill seeks to ensure that the MRI would not be tied to any of the options discussed above. Annual adjustments means that it can be set to maintain its value relative to means-tested benefits levels. However, there remains a need to set the MRI sufficiently above the MIG to ensure that, over the course of his/her retirement, an individual's income does not fall back below MIG levels. The proposed introduction of the State Pension Credit from 2003 complicates the situation further, by splitting means-tested provision for pensioners into two parts. The guarantee credit would be broadly equivalent to the MIG, and is expected to be £100 for a single

[57] Retirement Income Reform Campaign, personal communication

pensioner in 2003; the savings credit would top-up the incomes of pensioners with modest incomes other than the basic state pension, and is expected to be payable to single pensioners with incomes of up to £135 in 2003.[58] It is not clear whether the policy intention of ensuring that the MRI provides an income above means-tested levels refers to the level of the guarantee credit or to the level at which entitlement to the savings credit would run out.

The treatment of pensioner couples is a further complicating issue. The MRI proposals – like the income sources which would constitute any MRI – are based on the individual. However, the means-tested benefits system which the MRI seeks to maintain pensioners above is based on the family. The interaction between individual income and family assessment of benefit entitlement raises the issue of the MRI over-providing for couples where both have pension entitlements from a defined-contribution pension scheme. This is illustrated in box 1, which assumes an illustrative MRI of £140 per week. Both partners would be required to purchase an annuity sufficient to provide them with individual income of £140 per week, producing a joint income of £280 per week. Given that to avoid dependence on the MIG they only require a joint income of £140.55 per week, their flexibility in annuitising their pension fund may be seen as somewhat less than is intended.

**Box 1**: Based on illustrative MRI of £140 per week

| | Man's Income | Wife's Income |
|---|---|---|
| Basic State Pension | £72.50 | £72.50 |
| Occupational Pension | £50.00 | £25.00 |
| *sub-total* | *£122.50* | *£97.50* |
| Required annuity income | £17.50 | £42.50 |
| **Total income** | **£140.00** | **£140.00** |

The level at which the MRI might be set is not yet known, although £140 continues to be discussed as a likely figure, and there is debate as to how many people will have sufficient funds to benefit from the flexibility above the MRI. At current annuity rates, an annuity producing an income equivalent to the £67.50 difference between the basic state pension and the MRI would require a fund of around £55,000 for a man aged 65 and of around £60,000 for a woman.[59] Given that the average annuitised fund in 2000 was just £23,000 it appears that many annuitants would not be able to meet the MRI, let alone stand to benefit from flexibility in the use of their remaining fund. This fact perhaps underlies reported Ministerial comments that the proposed changes would affect only the

[58] Further information on the State Pension Credit will be contained in a forthcoming Library Research Paper on the *State Pension Credit Bill*.

[59] Based on the income produced from a RPI-indexed annuity with the highest-paying provider in the Annuity Bureau's survey of 1 December 2001.

very wealthiest pensioners.[60] Similarly, a spokesperson for the ABI suggested that "most people will have insufficient savings to take advantage of [the reform]".[61]

However, many annuitants will have second-tier provision other than that from an annuity and their annuity will not have to meet the whole gap between the basic rate of retirement pension and the MRI. Since defined-contribution schemes could only be used to contract out of SERPS from 1988, anyone who was an employee with earnings above the lower earnings limit before this date, and after April 1978, will have accrued other second-tier pension rights either through SERPS or through a defined-benefit occupational scheme. Among those in their 60s who have annuity income it provides only around 18% of their total income.[62] Oonagh McDonald suggests that the Government consistently underestimates the size of peoples' funds because it does not aggregate amounts held with different providers.[63] The RIWP's own research suggests that around 25% of current annuitants and those approaching retirement would be affected by the proposals.[64] Whatever the current level, it is likely to grow, as the emergence of stakeholder pensions and the spread of defined-contribution occupational schemes mean that annuity income is likely to be a more significant source of retirement income in the future.

## B. Unisex annuities

**Clause 1(4)(c)** would make two further changes to the current annuity requirements both of which would extend the requirements relating to annuities used to provide protected rights benefits, to all annuities purchased from a personal pension plan. The term protected rights refers to the conditions which defined-contribution pension schemes must fulfil in order to be contracted out of SERPS. Broadly, they represent the benefits that may be bought with the National Insurance rebate paid by the state in respect of individuals who have contracted out of SERPS. Protected rights benefits are usually given effect by the purchase of an annuity which must be provided without reference to the member's sex.[65] Also, the annuity must increase each year in line with inflation though this may be limited to 5% or 3% depending on whether the contributions which gave effect to these rights were made before or after 6 April 1997. These provisions aim to reflect the benefits they are intended to replace, that is a SERPS pension.[66] The Bill aims to provide

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60 See, for example, "McCartney rules out 'change for the rich'", *Money Marketing*, 20 September 2001; "Tory MP launches Bill to alter law on annuity purchase at age 75", *Sunday Telegraph*, 16 December 2001.

61 Cited in "Insurers welcome pensions Bill", *This is Money*, 17 December 2001 (www.thisismoney.com)

62 James Banks and Carl Emmerson, *UK Annuitants*, IFS Briefing Note No.5, December 1999 (figures based on data from 1996-97 and 1997-98).

63 "Truce called for consultation", *Financial Times*, 1 December 2001

64 Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000

65 regulation 4(2), *Personal and Occupational Pension Schemes (Protected Rights) Regulations* SI 1996/1537

66 SERPS is currently uprated in line with the RPI in the previous September to September period and is not limited to 5%

that annuities purchased to provide the proposed MRI should also be provided on a unisex basis and should be uprated by the lower of the RPI or 5%.

Currently, annuities from a pension fund in excess of any protected rights do not have to be unisex annuities and may be based on different actuarial factors. They are generally quoted at a lower rate for women to take into account the fact that women, on average, live longer than men. Different actuarial factors in relation to an annuity are currently specifically exempt from the general provisions of the *Sex Discrimination Act 1975* by section 45 of that Act. Also, judgments in the European Court of Justice (ECJ) on cases relating to equal treatment have confirmed that the use of different actuarial factors according to sex in occupational pension schemes does not fall within the scope of Article 119 of the Treaty of Rome (now Article 141 of the European Treaty) which requires equal pay for equal work.[67] This exemption has been incorporated into domestic occupational pensions legislation[68] and these provisions are generally read as applying to personal pension schemes by analogy though there is a suggestion that this may be open to challenge.[69]

David Curry stated that he had:

> decided, having looked at changing life expectancy statistics, and looking at the trend in European employment and human rights law, that the annuity used to provide this Minimum Retirement Income should not discriminate against women in the rate at which it is sold.[70]

Rates of life expectancy are certainly converging and are projected to continue to do so (see table 1 in Section IC2). At age 60, male life expectancy was 77% of female life expectancy in 1971, it is currently 84% and is projected to increase to 87% by 2021. However, a difference remains and this difference is reflected in current annuity rates, which are typically 10-20% lower for women. The requirement to annuitise a relatively large part of a pension fund on the basis of unisex annuity rates raises the prospects of cross-subsidisation from men to women. On average, men would not live long enough to receive annuity income actuarially equivalent to their total capital. The unused portion of their capital would be used to subsidise female annuitants who, on average, would live beyond the point at which their annuity income exhausted their own capital.

Non-protected rights annuities are not required to be increasing annuities and most annuitants currently purchase level annuities which start at a lower rate (see section IC1 above). This raises the possibility that the proposals as drafted could actually increase the

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67 *Coloroll Pension Trustees Ltd v Russell and others*, (Case C-200/91) [1995]

68 s 64(3) of the *Pensions Act 1995* and regulation 15 of the *Occupational Pension Schemes (Equal Treatment) Regulations* SI 1995/3183

69 *Tolley's Pensions Handbook*, second edition, para. 21.19. The RIRC is supporting test cases to challenge the use of non-unisex annuities.

70 RIRC, op cit

annuity requirement on those with smaller pension funds who are currently only required to buy a level annuity.

## C. Retirement Investment Fund (RIF) and "fiscal neutrality"

**Clause 1(7)** would introduce a new section 637B into ICTA 1988 which would provide for the proposed RIF. According to the RIRC's guidance on the Bill, the intention is that the parameters for the RIF would be that:

- Funds in an RIF must be invested in an approved institution, such as a bank, building society, or financial services company.
- A person may withdraw money from their RIF as and when they wish.
- Before someone may invest in an RIF they must have first purchased the MRI annuity.
- The RIF and its income may not be assigned or surrendered by its owner.
- Withdrawals from the RIF are treated as income and will be subject to income tax.

The Bill does not provide for the tax treatment of the RIF. This is significant because the government has previously pointed to the potential cost implications of proposals for annuity reform.[71] The RIRC has therefore published a working paper on the tax implications of its proposals and some draft clauses which Mr Curry intends to introduce as amendments to his Bill during its Committee Stage.[72] These provisions would mean:

> - That if any money remains in an RIF on the death of a person, it may be transferred to a spouse, partner or dependent child free of charge.
> - Other transfers to be charged at 35%, by way of 'exit charge' to compensate the state for past tax relief on pension contributions to retirement savings now, due to death, no longer being used for retirement income.
> - That following the 'exit charge', the Fund is included in the member's estate for Inheritance Tax purposes (noting that spousal transfers are already Inheritance Tax exempt).[73]

The principle behind these proposals is that they achieve "fiscal neutrality".[74] The RIRC's working paper argues that its proposals contain " a limited danger of increased tax leakage".[75] However, the extent to which fiscal neutrality is achieved will largely depend on behavioural factors which are difficult to predict. Some commentators argue that the balance between increased flexibility and tax neutrality may be difficult to achieve and any reforms are likely to involve some compromise between these

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71 HC Deb 19 July 2001 c 424

72 see RIRC, *Annuities and taxation*, available from www.rirc.org.uk and RIRC press release, *David Curry MP launches Bill on annuities reform*, 17 December 2001

73 RIRC press release, *David Curry MP launches Bill on annuities reform*, 17 December 2001

74 Ibid

75 p 2

principles.[76] The tax regime for private pensions is currently based on the broad principle that contributions to a fund and growth within it are tax-free and pensions-in-payment are taxable.[77] Therefore, the payment of tax on earnings used to make contributions is effectively deferred until the individual reaches retirement. In addition to the savings from deferring the payment of tax, this is also tax-efficient because pensioners pay tax on a smaller proportion of their income than non-pensioners and are more likely to pay a lower rate of tax than when they were in work.

There are a number of areas where reform of the rules could result in either short-term or long-term costs to the Exchequer. For example, any proposals which extend the circumstances in which savings remain in a pension fund may have cost implications, at least in the short-term. Currently, individuals are required to take a regular sum from their pension funds either through the drawdown arrangements or through annuity purchase. This regular income is taxable at the individual's marginal rate of income tax. The Bill's provisions for the RIF state that income may be withdrawn "by the member as and when he elects" **(clause 1(7))** and this may increase the deferral period before tax is eventually paid on some pension savings. Also, the government has suggested that relaxing the annuity requirement may encourage people to use private pensions vehicles as a tax-efficient way of accumulating capital for inheritance purposes.[78] Another concern is that higher rate taxpayers would take advantage of any increased flexibility and make increased contributions to approved personal pensions which would attract tax relief.

The RIRC working paper argues that its proposals for the tax treatment of the RIF, for example, the proposed 35% exit charge, would offset any other costs incurred as a result of the relaxation of the rules. Furthermore, it argues that there is little evidence that tax incentives result in a net increase in savings, as opposed to a "reshuffling" of existing assets, and that the essentially long-term nature of pension savings would still provide a significant disincentive to transfers from more liquid savings vehicles. The RIRC also argues that concerns about the savings behaviour of higher earners should not, in itself, be an argument for retaining what it perceives as flaws in the current annuity system. The Treasury is in a position to review other areas of the tax treatment of private pensions, such as the tax rebate on contributions, if it has concerns about the behavioural effects on higher earners of a relaxation of the annuity rules.

## D. The scope of the Bill

The long title states that the Bill is to:

76 "Pension progress", *Financial Times*, 3 December 2001
77 The main exemption to this principle is the tax-free lump sum which may be paid on retirement.
78 HC Deb 19 July 2001 c 424

> amend the law relating to the purchase of annuities in respect of private and personal pensions, defined-contribution and additional voluntary contribution pension schemes.

Despite this, the Bill as currently drafted would not alter the current arrangements for annuity purchase from defined-contribution occupational pension schemes, including AVC policies. This is because any requirements are currently contained in practice notes issued by the Inland Revenue under its discretionary powers to approve schemes under section 591 of ICTA 1988. Presumably, the intention is that the Inland Revenue would make analogous amendments to the present rules should the Bill be passed.

The tax legislation covering private pensions is extremely complicated and it is likely that aspects of the Bill would need to be redrafted, and additions and consequential amendments made, in order to give effect to the proposals outlined by the RIRC. For example, the Bill as currently drafted would require personal pension policyholders to buy an annuity which would provide the member with an annual income not less than the MRI. However, it does not provide for those whose funds would be insufficient to provide an increasing annuity at the rate proposed. Nevertheless, the broad aim of the Bill is clearly set out in the papers produced by the RIRC which are available from its Internet site.

# IV Reaction

The RIRC campaign and David Curry's announcement that he intended to make the annuity rules the subject of his Private Member's Bill were welcomed in some parts of the press which have been running their own campaigns on this issue. For example, the *Sunday Times* ran a campaign earlier this year which highlighted the fall in annuity rates over the last decade and called on the government to give pensioners greater flexibility over the use of their pension funds.[79] According to press reports, the Bill also has support from MPs of all parties including Frank Field MP, former minister for Welfare Reform.[80] Howard Flight MP, Shadow Paymaster General, supports the RIRC campaign and provides case advice on its Internet site. Both main Opposition parties have voted for annuity reform in previous parliamentary debates.[81]

The Faculty and Institute of Actuaries set up its own working party on retirement income and in a recent paper it argued for a wider range of investment options to be available to those retiring. The paper suggests that there is a need for a range of products which would reflect individuals' different priorities in retirement and points to the fact that the present annuity and drawdown options have remained unaltered for a number of years. It goes on to state that the RIRC proposals would be a "welcome extension to retirement

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[79] "Scrap annuities to end pensions misery", *Sunday Times*, 21 January 2001
[80] "MPs call for overhaul of annuities", *Sunday Times*, 22 July 2001
[81] see, for example, SC B Deb 22 June 1999 c747

options but we feel it will not suit everyone". It examines the range of retirement options based on seven criteria to which, it argues, individuals approaching retirement attach different degrees of importance: choice, security, the potential to pass on pension savings to relatives on death, flexibility, self-reliance, investment efficiency and cost effectiveness. The paper concludes that wider choice can be made available by using annuity products which already exist but which the tax legislation does not currently allow to be used with private pensions. It also suggests that changes in the current legislation would open up product development opportunities where none currently exist.

The Faculty and Institute of Actuaries is one of a number of organisation which has examined the current pension annuity market and proposed new products within existing legislation or argued for reform of it. The wide range of organisations which have contributed to the debate on annuity reform reflects the importance attached to the issue by many in the industry and those with an interest in pensions. However, among those who oppose the current annuity rules, there are different ideas about how they should be reformed and the RIRC's proposals have been criticised by some who wish to see greater flexibility for members of private pension schemes. For example, in a paper published by the Staple Inn Actuarial Society, the authors suggest that large numbers of people would be affected by the RIRC's MRI requirement and would be subject to greater restrictions as a result of the requirement to buy an index-linked annuity. It argues that the main effects of the proposals would be:

- to increase demand for index-linked annuities which the bond market may not be able to support satisfactorily, and
- to give more options after retirement but only to the relatively affluent.[82]

The paper goes on to argue for a new annuity model called an annuitised fund which could operate within the existing legislative framework and would allow fund holders to tailor asset allocation or income to changing economic or personal circumstances.

Some opponents of the compulsory annuity purchase rules argue that the RIRC proposals do not go far enough. In a paper for the Social Market Foundation, Donald McCarthy argues for complete abolition of the requirement to purchase an annuity at the age of 75. He argues that people who have been sufficiently prudent to save for retirement are unlikely to run down their savings to the point that they will rely on state support in the future. Complete abolition is also the preferred option of the Compulsory Annuity Purchase Protest Alliance (CAPPA), a pressure group established by members of private pension schemes.[83]

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[82] Mike Wadsworth Alec Findlater and Tom Boardman, *Reinventing annuities*, January 2001, para 5.37, available from http://www.sias.org.uk/papers/reinvann.pdf

[83] www.cappa.org.uk

It also seems likely that the existing legislation will be the subject of a legal challenge. Lawyers acting for a pensioner, Joseph Singer, are arguing that the obligation to buy an annuity is a contravention of the *Human Rights Act 1998*. In September 2001, the Judge, Mr Justice Collins, gave leave for a judicial hearing though the case has not been heard to date. Cherie Booth QC is reported to be representing Mr Singer.[84] The RIRC is also supporting a potential class action on the question of sex based annuity rates.

The government has not made an official announcement on the Bill to date. The Pre-Budget Report, and the apparent remit of the consultation process which will start in early 2002, suggest that the government remains committed to increasing flexibility within the existing legislative framework. It seems unlikely therefore that the Bill would attract government support and if the government is persuaded that changes to the legislation are necessary, these would probably be given effect by a future Finance Bill.

Opponents of the current system and those who defend it appear to agree that annuity rates are unlikely to increase significantly in the near future. The extent to which this makes annuities a 'poor deal' is a matter of some debate but as long as they continue to be perceived as such, pressure for reform of the current rules is unlikely to end. Furthermore, an important plank of the government's pension policy is to encourage more people to save in private pensions for their retirement. Stakeholder pensions are central to this policy and, as defined-contribution pensions which under current rules require the purchase of an annuity in retirement, some argue that public perception of annuities may influence take-up. The issue of annuity reform is therefore one which is likely to continue to attract attention inside and outside parliament even if Mr Curry's Bill is not enacted.

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[84] "Retirement victory in human rights case could set precedent", *Financial Times*, 5 September 2001

# V Further Reading

Retirement Income Working Party, *Choices – an independent report to encourage the debate on retirement income*, March 2000, available from www.rirc.org.uk. The full technical report is available from http://www.bbk.ac.uk/res/pi/reports/Mar00.pdf

Retirement Income Reform Campaign, *Annuities and taxation*, November 2001 available from www.rirc.org.uk

The Retirement Income Reform Campaign Internet site contains further information about the campaign and the Bill.

Dr Oonagh Macdonald, *Income in retirement - are annuities the answer*, AUTIF, April 1999

Mike Wadsworth, Alec Findlater and Tom Boardman, *Reinventing Annuities*, Paper for the Staple Inn Actuarial Society, available from
http://www.sias.org.uk/papers/reinvann.pdf

The Retirement Choices Working Party, The Pensions Board and The Faculty and Institute of Actuaries, *Extending retirement choices: retirement income options for modern needs*, June 2001 available from http://www.actuaries.org.uk/index2.html

Julie Stark and Chris Curry, "Is there an 'annuity problem'", in ABI, *Insurance Trends*, April 2001

# VI Glossary

**Annuity** – this is purchased, usually from an insurance company, to provide a regular income from a lump sum. It is the method by which the fund from a money purchase scheme is converted into a pension.

**Basic State Pension –** this is the part of the state scheme into which all those earning above the lower earnings limit currently contribute. It is paid at a flat rate and is administered by the Benefits Agency. The full weekly rates in 2001/02 are £75 for a single pensioner and £115.90 for a couple.

**COMPS - contracted out money purchase scheme –** this is an occupational scheme where members have contracted out of the state scheme. The benefits payable on retirement depend on the fund that has built up from contributions from the member and the employer.

**Contracting out –** this is the process in which people opt out of the state scheme into a private scheme. This may be an occupational, approved personal or from 2001 a stakeholder pension. The person contracting out and the employer may pay reduced NICs and the rebate must be used to fund the pension.

**Defined-contribution schemes** - these are private pension schemes that pay benefits according to the level of the pension fund on retirement. The fund builds up from contributions from members, and in some cases employers, and returns from the fund's investments. Part of the pension fund that has been built up must be converted to a regular income, usually through the purchase of an annuity.

**Defined-benefit schemes** – an occupational pension scheme that pays benefits according to the member's earnings while they were in the scheme. They do not require the purchase of an annuity on retirement.

**Final salary schemes –**this is another name for defined-benefit schemes.

**Income Support –** this is the means-tested social security benefit which may be paid to certain pensioners, and other groups, who have low incomes.

**LEL - Lower Earnings Limit –** this is the minimum amount someone must earn before they pay NICs. It is currently £72 per week.

**Minimum Income Guarantee** – the Government's name for Income Support paid to people aged 60 and over. Current rates are £92.15 for a single person and £140.55 for a couple.

**Money purchase scheme –** this is another name for defined-contributions schemes.

**NICs - National Insurance Contributions** – the contributions which are paid into the National Insurance fund by employees and employers. The amount paid is used to calculate entitlement to certain benefits and these are paid from the fund. Employees pay Class 1 contributions and self-employed people pay Class 2 and 4 contributions. These contributions provide different entitlements to different benefits.

**Occupational Pension Scheme** – this is a private pension scheme provided by an employer.

**Personal Pension –** a private pension that belongs to an individual. It may be approved by the Inland Revenue and can be contracted out of the state scheme.

**SERPS - State Earnings Related Pension Scheme** – the current state second tier pension. Entitlement is based on earnings between the lower and upper earnings limit and the pension is paid in addition to the basic Retirement Pension.

**Stakeholder pensions –** these may be either a personal pension or occupational pensions and have been available since April 2001 under provisions in the *Welfare Reform and Pensions Act 1999*.

**State Pension Credit –** the government intends to bring this in from April 2003 and the *State Pension Credit Bill [HL]* is currently before parliament. It will replace the MIG with a new guarantee credit and will introduce a new savings credit designed to help those with modest incomes who currently gain little or nothing from any small amounts of pension income because of the way the MIG rules operate.