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Retirement Income Reform Bill

Bill 18 of 2002-03

Edward Garnier MP came fourth in the ballot for Private Members' Bills on 21 November 2002. He introduced a Bill which would reform the compulsory annuity purchase rules for certain types of private pensions on 11 December 2002. It is due to receive its Second Reading debate on 7 March 2003.

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. David Curry MP unsuccessfully introduced a Private Member's Bill during the last Parliamentary session based on the same proposals.

The Bill would apply to the whole of the United Kingdom.

Sarah Meagher

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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. It is compulsory for at least 75% of a money purchase pension fund to be used to purchase an annuity by the age of 75. 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.

Edward Garnier'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.

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 Garnier's Bill and the government's proposals to reform annuities.

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 V, or that appended to the government's consultation paper on annuities published in February 2002, helpful.

CONTENTS

I Background 7

A. What is an annuity 7

B. The role of annuities in private pension provision 7

1. Approved personal pensions 8
2. Occupational pension schemes 10
3. Stakeholder pensions 11

C. The annuities market 12

1. Types of annuities 12
2. Determinants of annuity rates 13
3. Annuity rates 15
4. Innovation in annuities 17
5. The open market option 19

II The campaign for reform 19

A. The arguments for and against annuities 19

B. Retirement Income Reform Campaign 21

C. Previous attempts to amend legislation 23

1. Early attempts 23
2. David Curry's Bill 25

D. Modernising Annuities 29

E. Pensions Green Paper 2002 32

III The Bill 35

IV Further Reading 40

V Glossary 41

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

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[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] The Government Actuary's Department *Survey of Occupational Pension Schemes* found that 70% of private sector schemes are defined contributions schemes.[4] 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

[3] The figure of 20% is based on information in the NAPF's *Annual Survey 2002* table 9 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.

[4] Government Actuary's Department *Occupational pension schemes 2000 Eleventh survey by the Government Actuary Preliminary results for private sector schemes* table 2.2

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.

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 sum, 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.[5]

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 amounts 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.[6] 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.[7] 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.

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

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

[7] see section C below for a description of the different types of annuity.

Therefore the amount of income that may be taken from a pension fund under the drawdown provisions is dependent 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 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.[8]

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.[9] According to the Inland Revenue the average annuity is bought with a fund of £25,000 but funds used for income drawdown average around £140,000.[10]

The recent falls in the stock market have meant that those who have taken out an income drawdown policy have seen a reduction in their fund. During the 1990s many people thought that the stock market would continue to grow and therefore income drawdown would enable pensioners to receive an income and continue to invest. However the fall in the stock market has eliminated gains, forcing people to either lock in their losses through purchasing an annuity from the reduced fund or reduce their income in the short term while hoping that investment returns increase in the future. [11]

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).[12]

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

8 See, for example, "Alternative to annuities is proving costly", *Times*, 16 November 2002
9 Association of British Insurers Statistical Bulletin, *New long-term insurance results,* Q3 2002
10 DWP & Inland Revenue *Modernising annuities: a consultative document* February 2002 p16 &24
11 "Pensions: Win, lose or draw?" *Guardian* 11 January 2003
12 Available from http://www.inlandrevenue.gov.uk/pensionschemes/ir12.pdf

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.[13] 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.[14]

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.[15] These changes 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.[16] 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 23% of defined-contribution occupational schemes have amended their rules to allow drawdown.[17] 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

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*.[18] They began to be sold from 6 April 2001.

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[13] 26% of schemes secure annuities within the scheme and 78% use an open market option (based on multiple responses) NAPF annual survey 2002 p40

[14] Part 20 of IR12

[15] DSS, *A new contract for welfare: partnership in pensions*, December 1998, Cm 4179, p 75

[16] Inland Revenue press release, *Improved flexibility for pension schemes*, 6 July 1999

[17] NAPF survey 2002, p 40

[18] SI 2000/1403

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.

C. The annuities market

1. Types of annuities

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.[19] 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.

[19] 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.

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).[20] 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.

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.[21] 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.[22] 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.[23]

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

Table 1

Expectation of life at age 65

United Kingdom

Years of remaining life

Year	Males	Females
1901	10.6	11.6
1911	10.9	12.3
1921	11.6	13.1
1931	11.2	12.8
1941	11.5	13.6
1951	11.3	13.7
1961	11.8	15.0
1971	12.3	16.3
1981	13.0	16.9
1991	14.1	17.9
2001 (projected)	16.0	19.1
2011 (projected)	17.2	19.8
2021 (projected)	18.1	20.8

Source: Government's Actuaries Department
Published in Social Trends 33

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

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

[22] 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

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

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:

> 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 advances and a reduction in smoking. It is clear that the trend of improving mortality will continue.[24]

The continuous mortality investigation bureau published a working paper in December 2002 based on the mortality experience of cohorts born around 1926. The working paper, *An interim basis for adjusting the "92" series mortality projections for cohort effects* found that the cohorts born around 1926 are living significantly longer than expected. The returns from life offices from 1999 found that the 1992 projections had overestimated male mortality by 10%.[25] Although individual life insurers use their own mortality forecasts, based on this report Legal and General made an additional £140 million provision to cover the annuity payments that would result from increased longevity.[26]

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.[27] 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 4.4% in 2002.[28] 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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[24] Faculty and Institute of Actuaries press release, *Male mortality continues to improve faster than female, say actuaries*, 22 July 1999

[25] Continuous mortality investigation bureau *Working paper 1 An interim basis for adjusting the "92" series mortality projections for cohort effects* December 2002 p9

[26] "L&G forced to pay extra £140m on pensions" *The Times* 25 January 2003

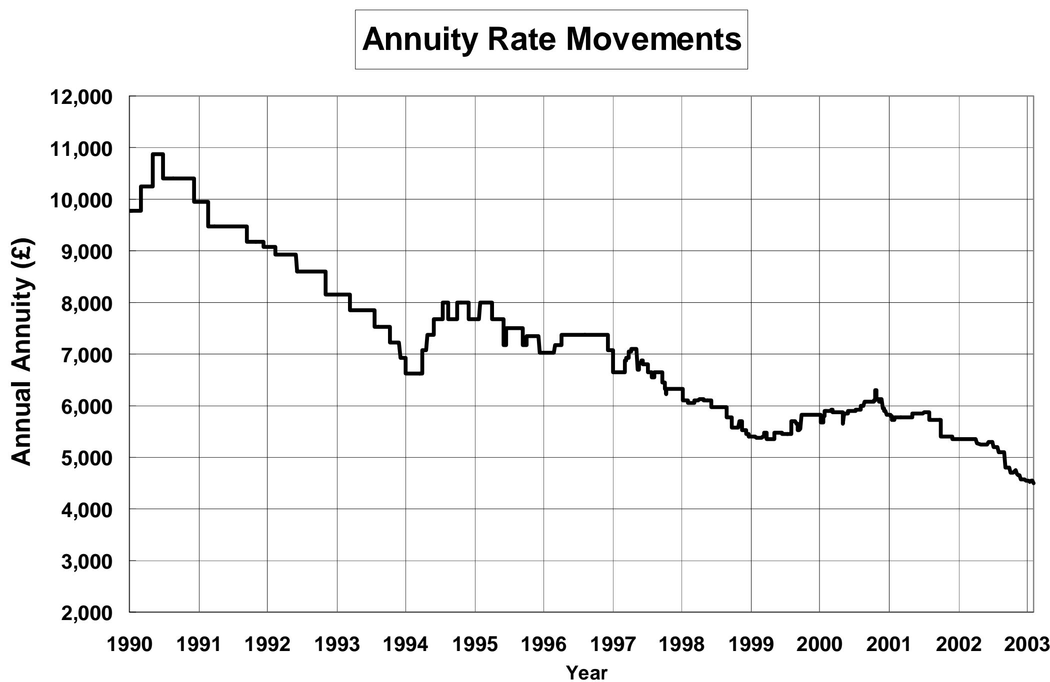
[27] Gilts are issued by the Treasury as a means of borrowing from the private sector. They are purchased at a fixed price which will be repaid to the investor at a fixed date in the future, and produce periodic interest payments – or 'coupons' – at a fixed or index-linked rate.

[28] National Statistics, *Financial Statistics*

3. Annuity rates

The impact of increasing longevity and reduced gilt rate yield has lead to a reduction in annuity rates. Although there is no official annuity rates series the Annuity Bureau produces 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 since 1 January 1990.

Figure 1



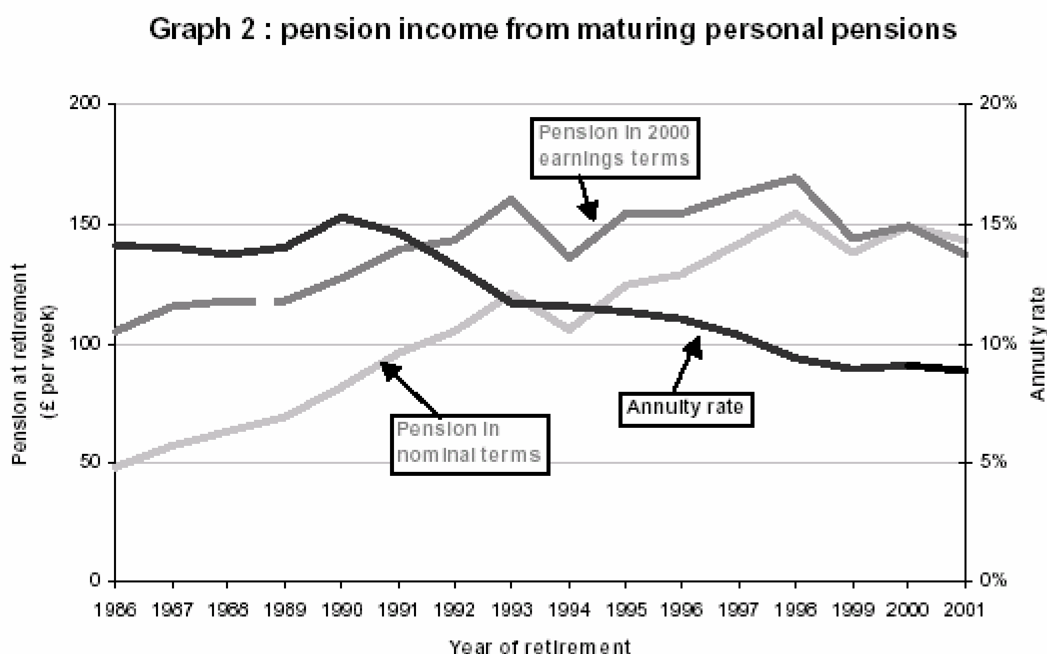
Source: The Annuity Bureau

A fund of £100,000 would have bought an annuity producing annual income of around £10,000 in 1990. Today it would produce around £4,500.

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.

The chart below is taken from the *Modernising Annuities* consultation paper, which shows that although annuity rates have fallen, the pension an individual will receive from

an annuity based on saving 10% of earnings over 30 years has increased in nominal and earning terms:[29]



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.[30]

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) then a man aged 30 contributing 10% of his earnings retiring in 30 years time would receive a pension equivalent to around 24% of his final salary; a similar individual retiring now would receive around 66%.[31]

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[29] DWP & Inland Revenue *Modernising Annuities* February 2002 p19

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

[31] "Age of discontent", *Financial Times*, 11 August 2000

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.[32]

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.[33] 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 Revenue rules, and would over time become the prevalent product in the UK annuity market.[34] 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.[35]

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[32] HM Treasury, *Economic and Fiscal Strategy Report 2001*, para. 5.68

[33] Julie Stark and Chris Curry, "Is there an 'annuity problem'", in ABI, *Insurance Trends April 2001*, p.6

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

[35] *ibid*. p.16

The flexible annuities offered by the Prudential and Canada Life provide increased freedom for individuals to alter their income during retirement. The Canada Life Annuity Growth Account enables individuals to purchase five year annuities, while the rest of the fund is invested. If an individual survives the five year period then a survival bonus is added to the account, this is the cross-subsidy from other individuals dying during the five year period. At the end of the five years another temporary annuity can be bought at a different level of income. At age 85 the fund must be used to purchase a life annuity.[36] The Prudential Flexible Annuity allows individuals to continue to invest in the stock market and vary their income within limits until they reach 90.[37] However these products are only suitable for individuals with large pension funds. The Prudential will not accept funds smaller than £100,000 for the flexible annuity.

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 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".[38]

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.[39] 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. According to figures from the Association of British Insurers in 2000 almost two-thirds of annuities are bought

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[36] "Investment-linked Annuities - A new direction in annuities" *Pensions Management* 1 January 2002

[37] "Investment-linked Annuities - A new direction in annuities" *Pensions Management* 1 January 2002

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

[39] 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

with funds smaller than £20,000 and 43% of annuities are bought with less than £10,000.[40]

5. The open market option

An annuity does not have to be purchased from the firm with which an individual has saved for their pension. The open market option allows individuals to compare different annuity providers in order to maximize their retirement income. It is estimated that 90% of people would receive a higher annuity income if they exercised their open market option; however only around 30% of people purchasing annuities do so.[41]

Since September 2002 the Financial Services Authority has compelled pension providers to inform people approaching retirement about the open market option. The pension provider also has to provide information on the advantages and disadvantages of exercising an open market option, for example the surrender of a guaranteed annuity rate, to enable individuals to make a more informed choice.[42]

However, many people require financial advice in order find the most appropriate annuity with the best annuity provider. Research carried out by the Association of British Insurers found that those who received financial advice on their pension were much more likely to look around for the best possible annuity rate.[43] Financial advice can be expensive, which means that it may not be a viable option for people with funds smaller than £40,000 as they would have to pay a fee for the service as commission would be insufficient to cover the costs of advice. However, a number of specialist annuity financial advisers do offer low cost execution only services to find the best rate for a given individual.[44]

II The 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

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[40] Julie Stark & Chris Curry "Reforming annuities: big bang or softly, softly" *Insurance Trends* January 2002 p4

[41] "Show me the way to go OMO" *Money Management* 1 August 2002

[42] FSA *Disclosure: Trading an endowment policy and buying a pension annuityPS106* April 2002

[43] Julie Stark *Annuities – the customer experience* February 2003

[44] "Show me the way to go OMO" *Money Management* 1 August 2002

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.[45] Research by the ABI about reasons for delaying the purchase of annuity found that only 1% of those who had deferred cited inheritance motivations as a reason for delay. This suggests that the problem of inheritance is not widespread.[46] 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. As life expectancy is continuing to increase, the risks of people overspending in the early years of retirement as they have underestimated how long they will live are significant. For example, it has long been argued that the payment of a lump sum without compulsion to purchase 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

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

[46] Julie Stark *Annuities – the customer experience* February 2003

> reduced to circumstances which might lead to his being an applicant for public or private charity.[47]

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.

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. Retirement Income Reform Campaign

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*.[48] 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.[49] After the March 2000 document was published, the group, which is made up of academics and industry representatives, 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 *Choices* report presented four main proposals to reform annuities:

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 (MRI).

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

[48] Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000, available from http://www.bbk.ac.uk/res/pi/reports/Mar00.pdf

[49] 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.

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.[50]

The *Choices* report set the level of the MRI at around £140 per week, which was almost £70 higher than the rate of the Minimum Income Guarantee at that time. Someone who had weekly income of more than £140 would be unlikely to be receiving income related benefits unless they were receiving additional benefits as a result of disability. The rate of the MRI was set at £140 as this was the equivalent of a Basic State Pension and the amount of SERPS that an individual who had earned average earnings throughout his working life could receive at that time. To ensure that individuals did not fall back on means testing during retirement, the MRI annuity would have to be index linked, and provide survivors' benefits. The RIWP report suggested that around 25% of future pensioners would have a pension fund sufficient to exceed this level.[51] People with smaller pension funds would have to purchase an index linked annuity at the point at which they decided to retire. This would significantly reduce the flexibility that is currently enjoyed by pensioners.[52]

After buying an annuity which would ensure the MRI, the residual fund would be invested, or individuals would be free to take out another annuity with the remainder. The report did not recommend how the residual fund would be treated, but gave five options:

> 1. There should be no restrictions on the application of the Residual Fund, so that funds could be drawn at any time subject to income tax at the individual's highest marginal rate of tax.
>
> 2. There should be a minimum annual withdrawal, but no maximum.
>
> 3. There should be a maximum annual withdrawal, but no minimum.
>
> 4. There should be both a minimum and maximum annual withdrawal as with income drawdown.
>
> 5. Options 2, 3 and 4 plus a suitable capital charge on the Residual Fund (or on the full pension fund if the MRI had not already been drawn) at some future age (e.g. 75) unless it had been used in its entirety to purchase an annuity by this age.

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[50] Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000 p1

[51] Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000 p18

[52] Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000 p16

> Any withdrawals would be subject to income tax at the individual's highest marginal rate.[53]

The RIWP proposed that the rules on inheritance should be the same as those currently applied to income drawdown, which is that a 35% tax charge is applied to the fund before it is returned to the estate.

C. Previous attempts to amend legislation

1. Early attempts

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.[54] 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".[55] 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.[56]

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 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

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53 Retirement Income Working Party, *Improving security and flexibility in retirement: full technical report*, March 2000 p25

54 SC D Deb 16 March 1999 c 294-6

55 SC D Deb 11 March 1999 c 149

56 HC Deb 8 March 1999 c 19

> 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.[57]

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 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.

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[57] SC B Deb 22 June 1999 c 739

> 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.[58]

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".[59] 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.[60]

2. David Curry's Bill

David Curry, who came fifth in the ballot for Private Members' Bills in the 2001-02 session, introduced a *Pension Annuities (Amendment) Bill,* based on the proposals of the Retirement Income Working Party.[61] His Bill would have created a new 'mini-annuity' to provide the **Minimum Retirement Income** which would be sufficient to keep someone off means tested benefits throughout retirement. The remainder of the fund, which would be called the **Retirement Income Fund** left after purchasing this mini-annuity, would remain the property of the individual, and would, therefore, be inheritable. The mini-annuities would have to been index linked and based on unisex actuarial factors.

Although the Bill received a second reading by 139 votes to 25 on 11 January 2002, it did not have the support of the government. Ruth Kelly, the responsible Minister, made the position clear during the debate:

> However, there are fundamental problems with the Bill--problems that are inherent to the Bill and could not be resolved by amendment in Committee. It

58 SC B Deb 22 June 1999 c 745
59 *Pensions Today*, March 2000
60 HC Deb 3 April 2000 c 747-8

> might be useful to hon. Members if I sum up briefly some of the main problems before I go through them in more detail. I believe that the Bill would be costly, and that the cost could run into several hundred million pounds. The Bill would be counter-productive and restrict choice for the majority of pensioners. It could also drive down annuity rates further.[62]

The Bill also completed its passage through committee, where it was amended.[63] However it was unable to complete its Report stage,[64] and fell at the end of the Parliamentary session.

a. Income drawdown and tax implications

Ruth Kelly successfully introduced an amendment at the committee stage which would have put the Retirement Income Fund into the framework of the income drawdown rules. She argued that this would provide better limits for the use of tax privileged pension savings, especially when individuals have very large pension funds. The rules regarding the mini-annuity mean that individuals could over-spend at the beginning of retirement and only have the Minimum Retirement Income to rely on towards the end of their life.

Ruth Kelly argued that the more favourable rules would mean that individuals would divert savings toward their pension fund, not to increase their retirement income, but for other purposes.[65] This would have significant tax implications as a result of increased tax rebates for additional pension saving, while not increasing total saving as it would divert savings toward pension funds. The rules governing inheritance of the retirement fund would enable tax free transfer to a spouse which would provide an incentive to boost pension savings in order to avoid inheritance tax on other forms of savings.

However David Curry explained that he had hoped to include rules relating to taxation in the Bill but was advised that this would be out of order. His intention was that the government would introduce tax rules mirroring the provisions in income drawdown, so that the fund was subject to a 35% tax charge on the death of the individual.[66]

When the Bill was published, the RIRC published a working paper on the tax implications of its proposals and some draft clauses which Mr Curry had intended to introduce as amendments to his Bill during its Committee Stage.[67] 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.

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[61] Bill 12 of 2001-02
[62] HC Deb 11 January 2002 c850
[63] SC Deb (A) 14 and 28 February 2002
[64] HC Deb 12 April 2002, cc296-331
[65] SC Deb (A) 14 February 2002 c22-4
[66] SC Deb (A) 14 February 2002 c32-3
[67] RIRC, *Annuities and taxation*, and RIRC press release, *David Curry MP launches Bill on annuities reform*, 17 December 2001

- 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).[68]

The principle behind these proposals is that they achieve "fiscal neutrality".[69] The RIRC's working paper argues that its proposals contain "a limited danger of increased tax leakage".[70] However, the extent to which fiscal neutrality is achieved will largely depend on behavioural factors which are difficult to predict. The RIRC paper accepted that savings could be diverted towards pensions, but argued that this would be limited in effect as there is little scope for most people to significantly increase their savings.

b. Christian Brethren

At the second reading Howard Flight raised the problems of the Christian Brethren who have theological objections to annuities and therefore do not invest in pensions.[71] The Christian Brethren explained their views on pensions and annuities in their memorandum to the Work and Pensions Select Committee:

> This submission is prepared on behalf of Brethren, Christians known to the Government for many years. There are over 14,000 Brethren in the UK and we are disadvantaged because we are unable to take up any personal or stakeholder pension on account of the present obligatory requirement to purchase a life annuity in any scheme currently available. A life annuity is a commercial speculation on the length of a person's life. Since the earliest days in 1828, Brethren have refused the principle of life insurance. "*Ye are not your own, for ye are bought with a price*." 1 Corinthians 6:19-20. AV.
>
> We look on the necessity of provision for our old age as a righteous obligation according to Holy Scripture—"*But if any provide not for his own, and specially for those of his own house, he has denied the faith, and is worse than an infidel*." 1 Timothy 5:8. AV.[72]

At the Committee stage, Angela Browning introduced amendments which attempted to deal with the Brethren's concerns. She proposed the creation of a *retirement failsafe fund* which would enable the Brethren to invest for their retirement though conventional pensions and receive the tax relief on pension investment. At the point of retirement

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[68] RIRC press release, *David Curry MP launches Bill on annuities reform*, 17 December 2001
[69] Ibid
[70] p 2
[71] HC Deb 11 January 2003 c807
[72] Work and Pensions Committee *The Future of UK pensions first report of session 2002-03* Volume III HC92-III ev 42

instead of being forced to purchase an annuity, they could put their fund into a retirement failsafe fund and draw the income throughout retirement. The proposed features of the failsafe fund were:

- The failsafe fund would have to be 150% of the fund required to purchase the required 'mini-annuity' or the whole of pension savings if insufficient
- There would be an annual requirement to withdraw the minimum retirement income from the failsafe fund
- The remaining fund would be kept separate from the failsafe fund but could be withdrawn at any time
- Once an individual reaches 80 the two funds would be combined. The annual income would be the remaining fund divided by the number of years until the individual reached 100.[73]

However without an annuity to back up this income, there is no guarantee that it would last throughout someone's lifetime. In addition it would be difficult to frame the rules so that people who are not members of the Brethren did not take advantage of the rules to avoid having to purchase an annuity.[74]

Only one amendment relating to the failsafe fund was passed at the committee stage, which meant that there was no definition of the failsafe fund in the Bill. Ruth Kelly therefore introduced an amendment at the Report stage which would have removed the failsafe fund, as she argued that the Bill as it stood was technically flawed and the failsafe fund would not work. An alternative amendment was proposed that would have given the Treasury the ability to create regulations to govern the retirement failsafe fund.[75] However the Treasury amendment was defeated and the other amendment was not moved.[76]

The Brethren have proposed a different solution to their problem, as outlined in their submission to the Work and Pensions Select Committee. They propose a 'lock in cash ISA' which would not be accessible until retirement. Payments into the plan would be made out of taxed income, but withdrawals would not be subject to tax.[77]

c. Timing of annuity purchase

The Bill required individuals to purchase the mini-annuity at the age of 65, or for those whose funds did not exceed the level to provide the minimum retirement income, to annuitise their whole pension fund on reaching 65. For those aged over 65 when the Bill came into force, the purchase would have to be within one year.

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[73] SC Deb (A) 14 February 2002 c8
[74] SC Deb (A) 14 February 2002 c815-6
[75] HC Deb 12 April 2002 cc296-7
[76] HC Deb 12 April 2002 c316
[77] Work and Pensions Committee *The Future of UK pensions first report of session 2002-03* Volume III HC92-III ev 42

Ruth Kelly proposed an amendment which would have reinstated the requirement to purchase an annuity by the age of 75. Howard Flight introduced an amendment designed to provide flexibility for those who remained in employment, enabling them to delay annuity purchase until they ceased to be employed for 3 months after reaching state pension age. This would have increased flexibility for those with smaller pension funds. However both amendments failed.[78]

Howard Flight introduced an amendment which would have enabled people who have already built up pension funds to elect to have this legislation applied to them. If they did not choose to be covered by these rules, then they would continue to be treated under the current annuity rules. However Ruth Kelly opposed this amendment on the grounds that it would add complexity to the pension system which would increase costs and confusion. The amendment was not accepted.[79]

d. Unisex annuities

The Bill required annuities to be provided on a unisex basis, instead of the present rules, under which annuities are calculated separately for men and women. As female life expectancy is longer than men's the level of income women can expect for a given pension fund is significantly lower. According to the Annuity Bureau, a man aged 65 with a pension fund of £100,000 would be able to get a level annuity of £7,556.40 per year, but a woman would only get £6,948.00. However as the annuity would on average be paid for longer to the woman, the capitalised value of the annuities is the same.

Ruth Kelly introduced an amendment at the Report stage which would have enabled insurers to continue to calculate annuities on the basis of sex, as well as other characteristics that are used by actuaries to calculate life expectancy. Ruth Kelly argued that insurers should be free to use all possible means to calculate life expectancy for their customers accurately. In addition the effect of unisex annuities would be to reduce the income that a man would receive, which could reduce his incentive to save for a pension if it would be used partially to subsidise women.[80] However the amendment was defeated.[81]

D. Modernising Annuities

In response to pressure inside and outside of Parliament, the government produced a consultation document, *Modernising Annuities*, on the way forward on annuities in February 2002. The document outlined the Government's approach on annuities, which would govern any possible reforms to annuities:

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[78] SC Deb (A) 28 February 2002 cc41-50
[79] SC Deb (A) 28 February 2002 cc52-54
[80] HC Deb 12 April 2002 c316-7
[81] HC Deb 12 April 2002 c329

> **The Government's approach to annuities**
>
> 35. In developing policy on annuities, the Government is determined that any action
>
> - should, where possible, increase the level of retirement income that people can expect to gain through an annuity:
>
> - should ensure that funds saved with the benefit of tax relief are used to provide a secure income in retirement. Pension savings should not become a tax favoured saving vehicle for non-pension purpose; nor should people be enabled to use their funds other than for retirement income, risking their needing additional support from other taxpayers through the social security system;
>
> - should contribute to the Government's aim of encouraging people to save more for their own retirement. The Government is keen that people should understand annuitisation and the option on offer so that they make the right choices and receive good value. [82]

The consultation document defended the current situation with compulsory annuitisation at 75. This defence was based on actuarial science which suggests that 75 is the latest age at which it would be advisable to take an annuity. This is based on a concept called 'mortality drag', which seeks to demonstrate the increased rate of return required on a fund to compensate for the loss of capital gained from the funds of other annuitants when they die. Additionally life expectancy increases with age as people who die younger have already died. This means that the expected duration of an annuity taken out later does not fall as quickly as one taken out earlier[83]

> Mortality drag
> Some people believe that it is better for a pensioner to wait to buy an annuity because annuity rates are higher for older people (see table 1). This is a false conclusion as this feature is only part of the story.
>
> Annuity providers set their rates by judging the life expectancy of their customers. This judgement determines how much capital they can afford to return each year to people who buy annuities, along with interest. Because older people are more likely to die, the provider can give a bigger capital boost to its older annuity customers. That is why annuity rates rise with age.
>
> If someone decides to start taking benefits from their pension savings, delays buying an annuity, and draws income from their fund, part of their fund remains invested. After a period they could use the residual fund, with any investment growth, to buy an annuity at the rate for their age then. The residual fund needs a strong growth rate if it is to allow the

[82] DWP, Inland Revenue *Modernising Annuities* February 2002 p10-11
[83] ibid. p14-15

pensioner to buy the same level of annuity income as they could have achieved if they had bought an annuity when they first started drawing benefits from the fund.

There are two reasons for this:

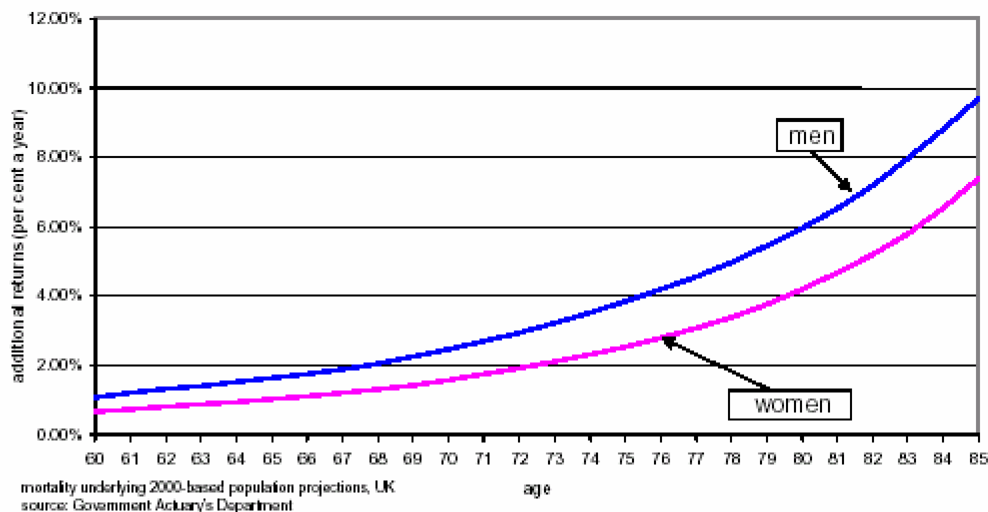
- the residual fund does not benefit from *mortality cross subsidy* until it is used to buy an annuity. The eventual annuity income of people who use drawdown gets less benefit from the early deaths of people born at the same time, because less of their capital is ever pooled;

- *life expectancy increases with age*, as table 2 shows - eg a man of 65 might on average expect to reach age 82, but if he survives to age 75 he can expect to reach age 85. This may at first seem odd. It happen because people who die younger have fallen out of the picture when the life expectancy for people at any given age is calculated. So the older someone is when they buy an annuity, the greater the age the annuity provider must expect them to achieve.

Graph 1 shows how powerful this effect is. It gives the fund growth rates, over and above the returns on gilts, which the residual fund needs to deliver to get the same annuity rate as would have been possible if the pensioner had bought an annuity the year before. These returns would need to be sustained, or bettered, *net of charges*, for the whole of the period before buying an annuity if the pensioner is to gain by waiting to buy an annuity. In a real fund there would be investment fluctuations, perhaps including some periods of poor returns as part of a longer term pattern. Financial advisers therefore often counsel caution in helping someone choose when to convert their retirement fund into income.

Graph 1 thus summarises the impact of mortality drag. The older someone is, the harder their money has to work if they are not to lose by delaying buying an annuity.

GRAPH 1: the additional returns required in drawdown to compensate for mortality drag



The additional investment returns required to outpace mortality drag are 5% by the time a man reaches 75 which is implausibly high.

The document also proposed encouraging competition in the annuities market, to increase value for consumers. The open market option, where pension fund holders are not obliged to purchase an annuity from their pension provider, is central to this strategy. Currently there is a limit on the size of fund that will be accepted by another annuity provider under the open market option, which reduces the number of people able to make use of it. The consultation document asked a number of questions about how the market could be made more competitive, both by increasing consumer awareness and by developing the open market option.

Modernising Annuities also proposed a new type of annuity, limited period annuities, to encourage new entrants into the annuities market, and to provide more choice to consumers. These annuities would be purchased for a limited number of years using a proportion of the pension fund, in a similar way to income drawdown. Such annuities would enable more people to delay buying a whole life annuity until 75 if they chose. They would be suitable for smaller funds than income drawdown, as there would be no uncertainty about the level of income received prior to annuitising the remaining fund. It is thought this would be a suitable product for new entrants into the annuities market to develop, as they would produce less variation in income than income drawdown.

The proposals in the consultation document disappointed many involved in campaigning for annuity reform. Dr Oonagh MacDonald of RIWP said:

> This consultation is very disappointing for the thousands of pension savers who had been hoping for real reform. Its proposals amount to the pensions version of Henry Ford's marketing philosophy - you can have any car you like, as long as it's black. Under Government proposals, there will still be no real choice. People approaching retirement will continue to be forced to use all of their retirement savings on an annuity - a product which is inflexible and provides increasingly disappointing returns.
>
> "I strongly urge anyone in a defined-contribution pension scheme to respond to this consultation, and call for more genuine flexibility for retirement savers.[84]

Commentators called the consultation document a wasted opportunity to reform pensioner income in retirement by simplifying the rules on annuities to make pension saving more attractive to the working age population.[85]

E. Pensions Green Paper 2002

The pensions green paper, *Simplicity, security and choice: working and saving for retirement*, (Cm 5677) was published on 17 December 2002. In his foreword, Andrew Smith, Secretary of State for Work and Pensions, set out its aims:

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[84] RIWP press release 6 February 2002 http://www.rirc.org.uk/

[85] See, e.g., “Enough to put anyone off pensions”, *The Times,* 8 February 2002

> Building on the foundation of our reforms to state provision and to financial services, this Green Paper sets out proposals to simplify occupational and private pensions saving and make flexible retirement easier. Our aim is to help people choose how they plan for retirement, how much they save and how long they keep working.

The green paper proposes simplification of the tax regime surrounding pensions and pension regulation, increased protection for pension schemes and ways to increase the labour market participation of older workers.

The simplification of the tax regime surrounding pensions will lead to the creation of new general benefit rules. These rules will govern what kind of annuities will receive approval:

> The rules about pension income will be more liberal than now. It must:
>
> - start no later than age 75;
> - until 2010, not start before age 50, or by 2010 not before age 55, with an exception for ill health retirement;
> - last for the remainder of the person's life;
> - be paid in instalments at least annually;
> - not be assigned to anyone other than the permitted beneficiaries;
> - not be guaranteed for more than 10 years;
> - up to age 75, not offer a capital guarantee of more than value protection;
> - lie between certain maximum and minimum income limits, if it is not underwritten by an insurance company or promised by an occupational scheme; and
> - be taxed as income in the normal way – that is, under schedule E.
>
> (…)
>
> Subject to what the scheme rules permit, in future all pension schemes will be able to allow:
>
> - until age 75, payment of benefits in stages not necessarily all at once – known in the industry as staggered vesting;
> - more flexible income patterns than a pension or annuity can currently provide within the general benefit rules;
> - until age 75, payment of a limited taxable death benefit offering value protection – that is, a final payment on death of no more than the value of the retirement savings used to establish the income paid by the scheme less the actual amount of pension paid before death, and subject to a tax charge of 35 per cent; and
> - survivors' benefits.[86]

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[86] HM Treasury & Inland Revenue *Simplifying the taxation of pensions: increasing choice and flexibility for all* December 2002 p23

The green paper confirms that **limited period annuities** will be introduced. These will allow people to use a proportion of their pension fund to purchase an annuity which would last for a fixed number of years before 75. At the end of the period annuity the rest of the pension fund could then be used to purchase a life annuity, or another limited period annuity. This would provide an alternative to income drawdown, which allows people to withdraw a limited amount from their pension fund without purchasing an annuity.[87]

The government also proposes to approve **value protected annuities**. These would pay a proportion of the fund to the estate of the pensioner in the event of their death prior to 75. The refund would be the difference between the original value of the fund and the amount of income that had been paid out under the annuity. This would provide a limited money back guarantee at the price of a lower annuity rate.[88] This would be an alternative to guaranteed period annuities which pay out at the full rate for a set period even if the annuitant dies during the period.

The government has also proposed to **reform the income drawdown rules**, which currently allow individuals to continue to invest in their pension scheme and draw an income from it before the age of 75. In the event of an individual's death, the remaining fund is returned to the deceased's estate subject to a tax charge of 35%. At age 75 the remaining fund must be converted into an annuity. The new rules governing pension benefits in general, will allow for **unsecured benefits** that are a pension income which is not secured by an annuity but based on the rate at which capital is extracted and the rate of return on the fund. A technical annex to the HM Treasury and Inland Revenue consultation paper accompanying the green paper describes how this will work:

> **Income from unsecured funds**
>
> **B71** Most income drawn from pension rights is likely to continue to take the form of benefits promised to be paid for the duration of the member's life. These income streams will usually be provided by a pension scheme or financial institution as secured benefits. The new general benefit rules will, however, allow more innovative kinds of pension income for people, known as unsecured benefits, because there is no guarantee that they will continue for life. For these, the successors to drawdown in the present rules, there will need to be some simple rules to prevent matured pension savings being drawn down too quickly.
>
> **B72** Income from unsecured funds will allow:
>
> - a minimum annual income of £1; and

[87] DWP *Simplicity, security and choice: working and saving for retirement* Cm 5677 December 2002 p90
[88] DWP *Simplicity, security and choice: working and saving for retirement* Cm 5677 December 2002 p90

> - a maximum annual income related to the annuity that the funds supporting the pension could achieve on the open market;
>
> provided that
>
> - the maximum income taken is reviewed at intervals of no less than 5 years, or annually after age 75; and
>
> - all income arising from unsecured funds in a year is tested against the maximum income that can be drawn.
>
> **B73** Anyone taking this approach will clearly need regular financial advice about the best way of deploying their pension savings, bearing in mind that value protection will cease at the earlier of age 75 or when payments have exceeded the initial value of the pension.[89]

Effectively it will be possible for individuals not to purchase an annuity when they reach 75, but the pension fund will still have to be used to provide pension income. In the event of death the fund cannot be inherited, but must be used for survivors' benefits. The requirements for survivors' benefits are that they must be paid as regular income, not as a lump sum.[90]

A number of financial advisors see this as a route to increase pension income for couples. They can continue drawdown while both are alive and then when one of them dies purchase a single life annuity, which may give a higher income than a joint life annuity. However drawdown and its replacement will only be suitable for people with large pension funds as the risks of a reduced income as a result of a poor investment returns are significant.[91]

III The Bill

The *Retirement Income Reform Bill* is identical in its provisions to the *Pensions Annuities (Amendment) Bill* as amended in the standing committee. This means that it aims to do the same things as David Curry's Bill, but also inherits its flaws.

The long title of the Bill states that it will

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

[89] HM Treasury & Inland Revenue *Simplifying the taxation of pensions: increasing choice and flexibility for all* December 2002 p47
[90] HM Treasury & Inland Revenue *Simplifying the taxation of pensions: increasing choice and flexibility for all* December 2002 p26
[91] "Age 75 annuity rule is to bite the dust" *Financial Times* 1 February 2003

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 *Income and Corporation Taxes Act 1988*. Presumably, the intention is that the Inland Revenue would make analogous amendments to the present rules should the Bill be passed.

Clause 1 sets out the required amendments to the *Income and Corporation Taxes Act 1988* to remove the current system which allows people to choose when to annuitise and what type of annuity can be purchased. It only amends sections relating to the purchase of annuities from a personal pension fund.

Clause 1(2) would amend the definition of an approved pension scheme so that it would include sums for investment in a retirement income fund or a retirement failsafe fund. The retirement income fund is defined in **clause 1(7)** as the fund remaining after the purchase of an annuity to secure the Minimum Retirement Income. The retirement failsafe fund was introduced at the committee stage of David Curry's Bill to meet the theological concerns of the Brethren regarding pensions. However the Bill does not contain a definition of the failsafe fund. **Clause 1(3)** would allow the Inland Revenue to grant tax approval to schemes which provide for a Retirement Income Fund as part of retirement provision.

Clause 1(4) (a) inserts the requirement for an individual to purchase an annuity which satisfies the Minimum Retirement Income (MRI). **Clause 2** gives the Chancellor of the Exchequer the power to set the MRI for each financial year. The level of the MRI must be set by regulations by 31 January of the preceding financial year. The regulation that would set the level of the MRI would be subject to the negative procedure.

The proposed level of the MRI is not given. The press release issued by Edward Garnier when the Bill was published indicates that the MRI would be set at a level which would keep people above the level of means tested support.[92] 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

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[92] Press release "*Edward Garnier introduces Bill to reform retirement income*" 28 February 2003

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 £98.15, £102.10 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 2003 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 adjustment 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 introduction of the State Pension Credit in October 2003 complicates the situation further, by splitting means-tested provision for pensioners into two parts. The guarantee credit will be broadly equivalent to the MIG, and will be £102.10 for a single 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 £139 in 2003.[93] 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. As the current government is committing to increasing the level of the guarantee credit in line with earnings, the cut off point for the Pension Credit will continue to increase. Therefore the rate of the MRI would have to be significantly higher than the upper limit of the Pension Credit to reduce the chances of someone falling on to the Pension Credit after a number of years, as the MRI annuity will only be increasing in line with inflation not earnings.

[93] for more information on the Pension Credit, see the Library Standard Note *SN/BT/1439 Pensions Credit*

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 £155.80 per week in April 2003, 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	£77.45	£77.45
Occupational Pension	£50.00	£25.00
sub-total	*£127.45*	*£102.45*
Required annuity income	£12.55	£37.55
Total income	**£140.00**	**£140.00**

Clause 1(4) (b) replaces the rules relating to the timing of the purchase of an annuity. At present an annuity can be bought at any point between the age of 50 and 75. Under this clause an individual who is currently in income drawdown would have until 75 to purchase the Minimum Retirement Income annuity; those who are already over 65 at the time the Bill comes into force would have to purchase the annuity within 12 months, and those who had not reached 65 at the time of the Bill coming into force would have to purchase the annuity at age 65.

Clause 1(4) (c) sets out the requirement that the annuity, must be calculated on a unisex basis, by removing the exemption given under section 45 of the *Sex Discrimination Act 1975.* The annuity must provide for an annual increase in income in line with inflation as measured by the retail prices index, limited to 5%.

Clause 1(5) would repeal the current rules relating to income drawdown, as the arrangements for the MRI and retirement income fund give individuals both security for a given level of income and freedom for the usage of the remaining fund. Therefore the current income drawdown rules are unnecessary. However **clause 1(6)** means that this repeal would not affect those who have already entered into income drawdown plans.

Clause 1(7) would define the residual fund or Retirement Income Fund, as a fund which could only be invested in once an individual had purchased a Minimum Retirement Income annuity. Withdrawals from the fund would be classed as income, and therefore taxable at an individual's marginal tax rate. It would be defined as part of a pension scheme for tax purposes, so that investment growth would not be subject to taxation.

Clause 2 as explained above would give the Chancellor of the Exchequer the power to set the level of the MRI each year.

Clause 3 gives the short title of the act and says that it would come into force of 6 April 2005. This would be a year after the introduction of the changes to the tax regime proposed in the pensions green paper.

IV Further Reading

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

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

DWP & Inland Revenue *Modernising Annuities: a consultative document* February 2002

DWP, HM Treasury & Inland Revenue *Simplicity, security and choice: working and saving for retirement* Cm5677 December 2002

HM Treasury & Inland Revenue *Simplifying the taxation of pensions: increasing choice and flexibility for all* December 2002

House of Commons Debates on David Curry's Bill

Second Reading	HC Deb 11 January 2002 cc789-859
Committee Stage	SC Deb (A) 14 February 2002 SC Deb (A) 18 February 2002
Report Stage	HC Deb 12 April 2002 cc296-331

V 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 Pension Service. The full weekly rates in 2002/03 are £75.50 for a single pensioner and £120.80 for a couple.
COMPS - contracted put 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 £75 per week.
Minimum Income Guarantee – the Government's name for Income Support paid to people aged 60 and over. Current rates for 2002/03 are £98.15 for a single person and £149.80 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 –It will be introduced in October 2003 and 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.