Modernising Annuities

A Consultative Document

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DWP Department for Work and Pensions

Inland Revenue

MODERNISING ANNUITIES
a consultation document

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THIS CONSULTATION EXERCISE

1. This consultation document explores ideas to help everyone who needs to buy an annuity to turn their personal pension savings into retirement income. It follows up the commitment to consult in the 2001 Pre-Budget Report. The Government wants to make it possible for all pension savers to find suitable annuities that provide good value in a more flexible annuity market.

2. You can download additional copies of this document from the Inland Revenue's website at: www.inlandrevenue.gov.uk/pensionschemes/consultation.htm You can also access this through a link on the website of the Department for Work and Pensions: www.dwp.gov.uk

3. If you want a printed copy of this document, please ring 020 7438 7514. If you want an electronic copy, please send an email marked "subscribe annuities" in the subject line to:

   pensionconsult@ir.gsi.gov.uk

4. There are questions for feedback identified in ***bold italics*** in the text. These are repeated in annex 1. You may find these a helpful way to structure your reply.

5. Because of the technical nature of this consultation, there is a glossary of terms in annex 2.

6. A partial regulatory impact assessment is at annex 3.

7. Please send your comments on this consultation to:

Mrs Sue Baker
Savings and pensions policy team
Room 133a, New Wing
Somerset House
London
WC2R 1LB

or to pensionconsult@ir.gsi.gov.uk

Please insert the phrase "response annuities" in the subject line of your email.

8. Unless you ask for your reply to be used in confidence, it may be quoted or summarised in the Government's feedback on the consultation exercise.

9. Please reply by **5 April 2002**.

10. It would be helpful if you could explain whether your reply is personal or on behalf of a representative body; and if the latter, please explain the membership of the body you represent. Replies are also welcome from anyone who has an interest in policy on retirement income – for example from financial services firms who may manufacture or sell financial retirement products, and from their customers.

11. For telephone enquiries about this document generally, please ring 020 7438 7514.

CHAPTER 1: SUMMARY

12. The Government wants pensioners to enjoy secure and reliable incomes throughout their old age. That is why the Government is taking action to tackle pensioner poverty, reward saving and help all pensioners to share in rising prosperity. These policies complement Government support for today's workers who can save for their pensions using the favourable taxation treatment for saving through personal and occupational pensions.

13. The options discussed in this document are designed to help all pension savers achieve better value and make suitable choices when they use annuities to turn their pension savings into retirement income. It proposes ways to make the annuities market work more effectively, enabling everyone buying pension annuities to purchase products that will meet their needs and achieve good value. The Government believes that reform is necessary to make the annuities market work better, so that consumers are better informed and enabled to choose annuities that provide good value; and so that providers have greater flexibility to provide a wider range of annuity products.

14. The Government believes that annuities continue to provide a financially efficient and secure means of turning pension capital saved through defined contribution pension arrangements into income that lasts for all pensioners' retirement.

15. Pension funds built up with the benefit of tax privileges must be turned into retirement income using annuities by the time people saving for pensions reach age 75. This is because:

- tax relief on pension contributions is provided so people can save for an income in retirement, not for other purposes;

- annuities pool people's risk, ensuring that they are the most financially efficient way of turning capital into an income stream; and

- annuities make sure that people continue to receive an income from their savings no matter how long they

survive, thus reducing their possible future need for income-related support from the Government.

16. 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 savings vehicle for non-pension purposes; 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 options on offer so that they make the right choices and receive good value.

17. In particular, this document contains options to increase general understanding of annuities and ways to enable individuals to obtain the information and advice they need to make well-informed and appropriate decisions. It summarises the breadth of coverage of the specific advice required, discussing the role of the Financial Services Authority in educating consumers. And it considers further options to encourage people to get the best value from annuity providers.

18. The document also examines ways to enable some scope for transferring annuities in payment between annuity providers and consults on the case for a new sort of annuity – limited period annuities. These measures could help to deliver significant improvements to the annuity market and, as a consequence, better meet the needs of pensioners. Any new kinds of annuity will have to be practical, affordable and capable of providing pensioners with sufficient income for their lifetimes, without encouraging tax privileged pension vehicles to be used for alternative purposes.

CHAPTER 2:
THE CONTEXT FOR POLICY ON ANNUITIES

As part of its wide ranging policy for supporting pensioners, the Government seeks to ensure that they get good value when they convert their pension savings into retirement income. Annuities provide a reliable way of delivering secure income for the whole of retirement.

the Government's approach to pensions

19. The Government is committed to developing policies which enable pensioners to share in the country's rising prosperity and which tackle pensioner poverty, guaranteeing security for people in their old age. The Government is:

- targeting extra financial support on the poorest pensioners through a minimum income guarantee;
- rewarding today's pensioners on low and modest incomes who have saved for their retirement through the new Pension Credit from 2003;
- helping all pensioners by guaranteeing a rise in the basic state pension of £100 a year for a single pensioner and £160 a year for pensioner couples in 2003-04, and setting the winter fuel payment at £200 a year for this Parliament; and
- creating a sustainable system of support which enables today's workforce - tomorrow's pensioners - to plan ahead and make decent provision for their retirement, protecting themselves against poverty in the future.

20. The Government's first priority has been to help those in greatest need. The reform of Income Support, with the introduction of the Minimum Income Guarantee (MIG), benefits around two million of the poorest pensioners. The Government is committed to raising the MIG in line with earnings throughout this Parliament.

21. For the first time, the Government will also reward pensioners who have saved for their retirement. From 2003 the

Pension Credit will ensure that millions of pensioners who have saved modest amounts – whether through an occupational scheme, a stakeholder pension, the State Second Pension or other savings – will gain from having done so and will be rewarded for their thrift and effort.

22. To help all pensioners, the Government has increased the basic state pension above inflation in April 2001. Next year, the full annual basic state pension will rise by at least £100 a year for a single pensioner (£160 for couples). In future years, all pensioners will benefit from the new guarantee that the basic state pension will rise each year by 2.5% or the increase in the September Retail Price Index, whichever is higher. The winter fuel payment will be maintained at £200 for the remainder of this Parliament. Pensioners also benefit from free TV licences for households with someone aged 75 or over, and free eye tests for those over 60. These guarantees provide extra security for all pensioners over the coming years.

23. To help protect tomorrow's pensioners from poverty, the Government is encouraging today's workers to save for their retirement. There are long standing arrangements for contributory state pensions through workers' payments of National Insurance Contributions. From April this year, the State Earnings Related Pension Scheme (SERPS) will be reformed with the introduction of the State Second Pension. This will provide more support for pensioners whose earnings when working were low or modest, and also for the disabled and carers.

24. Many people are members of occupational pension schemes. These schemes often provide excellent value. Members qualify for income tax relief on their own contributions (within certain limits) and do not pay tax on contributions by employers. Similarly, there is tax relief on the accumulation of the funds while they are invested.

25. People can also save through personal pensions, with broadly similar tax privileges.

26. In addition, the Government is encouraging people of working age to save to provide a pension for their retirement. Stakeholder pensions provide a new pension option, primarily for people on moderate or higher earnings who do not have access to a good occupational scheme, or to a group personal

pension which has the benefit of employer contributions. These became available in April 2001 with similar tax privileges to other pensions. A diverse range of potential savers, including people who are not working, can save through stakeholder pensions.

27. Stakeholder pensions are suitable for many people whose incomes fluctuate or are unpredictable. They are on defined contribution terms with a charging structure which is fair to people who cannot sustain continuous contributions (the annual management charge must be less than 1% of fund value, with no other charges). Over time the growth of stakeholder pensions will mean that there are more people with personal pension funds when they come to retire.

28. That is one key reason why it is important to make sure that the annuity market works satisfactorily when personal pension savings are transformed into retirement income. The policy options discussed in this consultation document are intended to provide better value, through more choice and flexibility, for people who have saved through defined contribution pensions, including personal and stakeholder pensions, particularly those with smaller funds.

the annuity requirement

29. Large occupational pension schemes do not need to use annuities to provide pensions. They can arrange to pay their pension liabilities to their members from their own resources. These funds are often large enough to be able to pool the risks for members of their schemes successfully and at reasonable cost. Most other pension schemes, including personal pensions, stakeholder pensions and additional voluntary contributions (AVCs), must turn pension funds into reliable income for pensioners by buying annuities for life from an insurance company. This is a long standing condition for obtaining tax approval for these kinds of pension schemes which then qualify for favourable tax treatment.

30. Successive Governments have provided these tax privileges for pensions to encourage people of working age to provide income for themselves in retirement. There are certain conditions associated with accepting the terms of pension contracts.

31. In common with other pensions, annuities in payment are taxed as income when pensioners receive them. So the role of tax relief for pensions has sometimes been described as postponing taxation of income until retirement. With the introduction of stakeholder pensions, to which non-earners can contribute with the benefit of tax relief, this concept is no longer quite accurate. But it remains true that tax relief in the savings phase of pensions is awarded to support saving for retirement - and not for any other purpose such as building up capital.

32. The tax rules about when and how annuities should be purchased have become more flexible over time. Originally people had to use all their pension funds at the point of retirement. They could take a quarter of their fund as a tax free lump sum and had then to annuitise the remainder. (The rules for AVCs are slightly different: they must all be used to buy annuities, since they supplement an occupational pension which can itself offer the option of a tax free lump sum.)

33. From 1979 small self administered pension schemes (SSASs - most of which are defined contribution schemes like personal pensions) were able to postpone buying an annuity for five years after their members retired. Since 1995, both members of these schemes and retired people with personal pension funds have been able to postpone buying an annuity until the retired person reaches age 75 so long as they take a minimum income from the fund on retirement. Since 1999, (nearly) all defined contribution pension schemes have had the same flexibility.

34. For brevity, this document uses the term **personal pensions** for all the kinds of pensions which are obliged by the tax rules to buy annuities to provide pension income.

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 savings vehicle for non-pension purposes; 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 options on offer so that they make the right choices and receive good value.

CHAPTER 3: THE ROLE OF ANNUITIES

Annuities provide a financially efficient and secure means of turning pension capital into pension income. Because they pool risk, they ensure that people get better returns without fear of running out of money. And low inflation enables annuities to hold their real value more effectively.

36. For a growing number of people, annuities are an important way of turning personal pension savings into pension income. This chapter is about how that process works and why it is so important.

37. Over time the tax rules about when and how annuities are to be purchased from personal pension savings have become progressively more liberal, permitting an increasing range of annuity products to be used. The key criterion is that the annuity contract between the provider and the pensioner should deliver a sufficient and secure income for the duration of the life of the retired person who buys it in return for surrender of their pension capital.

38. This document explores whether there is scope for developing this flexibility, providing that the key principles in para 35 are respected.

how annuities work

39. Pension annuities pay reliable retirement income to pensioners and ensure that this income does not run out. They are a financially efficient way of using capital to generate income. They do this by pooling risks for the pensioners who buy them. If each annuitant in the pool were to plan to use their capital to obtain a permanent income for the remainder of their life, they would have to arrange simply to draw interest by placing it in a bank account or bond. Annuities in effect give pensioners access to their capital as well.

40. People who survive for a long time after buying an annuity may receive appreciably more than the capital they pay for an annuity and the interest it earns. This is because the capital

paid by people who live for only a short period after buying an annuity goes to enhance returns for people who live longer. (Providers do *not* retain the capital that is not repaid to buyers of annuities to boost their profits.)

41. The tax rules, which require people with personal pension funds to buy annuities, mean that the tax breaks pensions get during their growth phase are, roughly, returned through taxation of annuity payments. (Over someone's lifetime, they get some net tax relief from investing in a pension, partly because some of it can be taken as tax free lump sum.)

42. If pensioners were able to exhaust their personal pension funds, some retired people might, perhaps unintentionally, draw too much income in the early years of retirement and then find themselves forced to rely on means tested benefits later in retirement – just what tax relief on pension contributions is designed to avoid. In countries where it is possible for people to use up their pension funds during retirement in this way, this effect is called double dipping. It is widely perceived as unfair to other taxpayers.

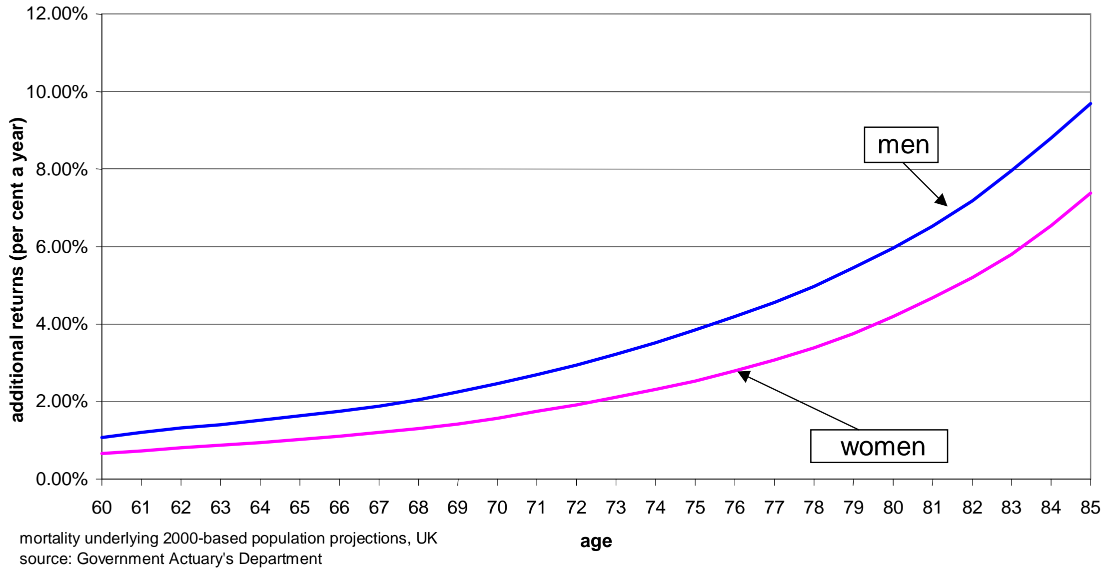
43. Because annuity rates rise with age (table 1), it might seem that it is worth waiting to buy an annuity until later in retirement. But higher annuity rates for older people do not give a full picture of the effects. People who delay buying an annuity, and choose income drawdown instead, have to accept that the use of their funds will become increasingly inefficient. (Paras 69-72 explain in more detail how drawdown works.)

44. The reason why pensioners need to buy an annuity without too much delay arises from **mortality drag**, explained in the box on page 15. The bottom line is that pensioners can be confident of a secure and reliable income if they exchange their capital for an annuity.

the size and distribution of the annuity market

45. The annuity market is already significant with £5.7bn of new annuities bought in 2000. The volume of activity in the annuity market is on a strongly rising path – up 68% in the four years to 2000, almost 14% a year - because defined contribution pensions are now more common.

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



mortality underlying 2000-based population projections, UK
source: Government Actuary's Department

This graph shows the additional investment returns, above returns on fixed interest securities such as gilts, which people would need to achieve to keep pace with the better returns they could get from annuities – assuming that they draw on their capital to provide income before buying an annuity. It is a matter of judgement what returns a residual fund might achieve. It is important to note that the residual fund has to make sustained and reliable returns above fixed interest securities in order to outpace annuities. Clearly this becomes increasingly more difficult as people age, especially for men, whose life expectancy is not as good as for women.

TABLE 1
level annuity rate for a man with £100k capital (no mortality protection, ie single life)

age	annual annuity
55	£7095
60	£7813
65	£8868
70	£10416
74	£12213

Source: rates quoted in November 2001 by The Annuity Bureau, a private independent organisation

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 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 happens 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.

TABLE 2: life expectancies		
age	**men**	**women**
55	81	84
60	82	85
65	82	85
70	83	86
75	85	87
Source: Government Actuary's Department, as in graph 1		

46. The average fund annuitised in 2000 was modest at £25k (allowing for a 25% tax free lump sum, the average vested pension fund must have been just above £30k). This figure may not be representative of people's total pension savings, either now or still less in the future, because:

- most funds (about 43%) turned into annuities are in fact below £10k;

- people now buying annuities may well have other pension rights from occupational schemes; in the future pension rights in personal pension form, including stakeholders, are likely to grow;

- it is already common for people to have several personal pension funds running in parallel. These can result from a sequence of employments, or from financial advice that it is wise to spread investment risk by placing savings in a variety of different funds;

- personal pension schemes, now including stakeholder pensions, have been available only since 1988, only a fraction of a working lifetime. In time people may have three or four decades of savings, with their investment growth, to convert into pension form when they retire;

- so, for now, only a minority of people have very large funds. They may have saved using retirement annuity contracts (the predecessors of personal pensions for people not in occupational schemes).

47. The size or distribution of personal pension funds in future will depend on how people react to the savings opportunities available to them. These include using stakeholder pensions, which began only at the start of this

financial year. The box below attempts some illustrative projections based on current economic conditions.

projecting pension savings

It is impossible to forecast someone's future pension fund precisely since there are so many uncertainties. But it is possible to make some illustrative projections which show how valuable it is to keep up the savings habit for as long as possible.

In the table below all the projections are at 2000 prices and assume that a man on average earnings (taken as £20k a year in 2000) saves 10% of his earnings a year, ie well within what the tax limits on contributions would allow, and buys an annuity at age 65. So the projected funds and annuities are figures meaningful in terms of their current purchasing power.

	10 years of contributions	20 years of contributions	30 years of contributions
pension fund	£22,900	£53,900	£81,600
annuity at end of saving period	£2,040	£4,800	£7,260

The table below shows similar calculations for someone continuously on 1½ average earnings (£30k a year in 2000) with a similar contribution pattern.

	10 years of contributions	20 years of contributions	30 years of contributions
pension fund	£34,300	£80,700	£122,000
annuity at end of saving period	£3,050	£7,180	£10,860

48. With increasing use of personal pensions, it seems reasonable to suppose that in time there will be more large funds, and that people will have an increasing variety of lifestyle patterns within which they will want to use them. This reflects both the trend toward more defined contribution pensions, and patterns in the labour market, with diverse less settled careers.

getting value from annuities

49. People want good **value** when they buy annuities. The Government is determined that they should have access to the means of achieving this.

50. Annuity buyers may worry that, as graph 2 shows, annuity rates have fallen over the last decade or so. However, the absolute level of annuity rates is misleading unless seen in the context of other financial trends. The key question for customers is really how they can get the best reliable return for their personal pension funds when they use them to obtain secure retirement income for the whole of their retirements.

51. A number of factors determine the prices of annuities:

- *interest rates* – the strongest influence and the main reason for the steep decline in annuity rates over the past decade as successive Governments have sought to achieve an environment of low and stable price inflation. This in turn is the main driver for interest rates;

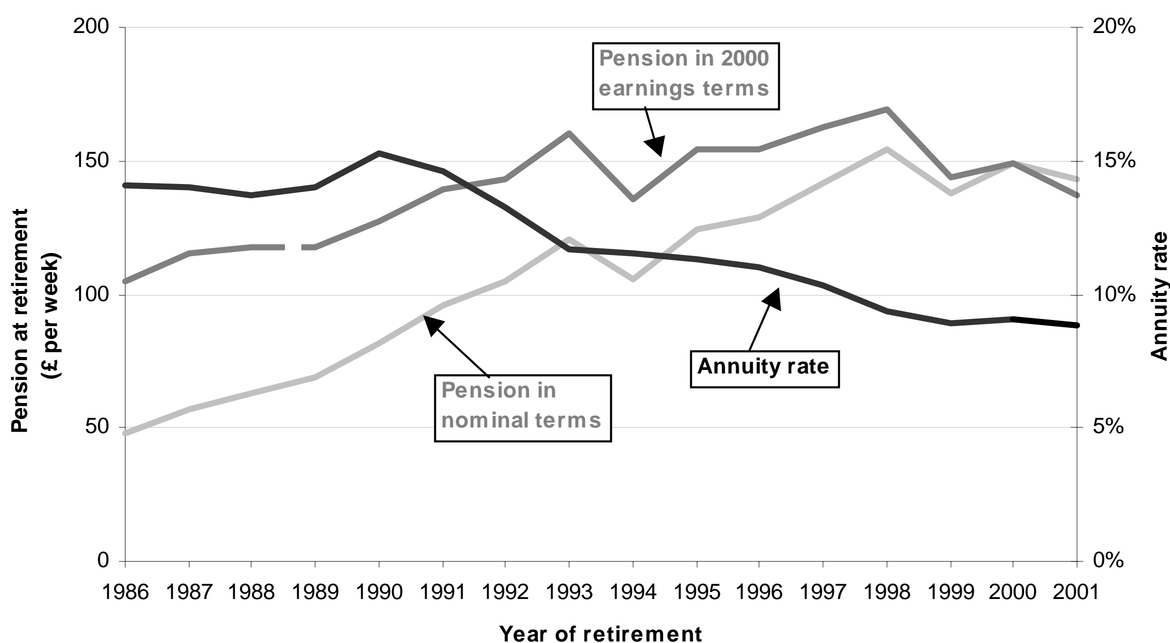
- provider firms' assessments of pensioners' *life expectancy* – an aspect whose importance customers can neglect despite the recent improvements in experts' forecasts. For instance, a man now retiring at 65 can expect on average to live for 17 years, whereas his counterpart in 1961 had a life expectancy of 12 years. In sheer practical terms this means that annuities have to provide income for a longer period of time, so the amount of capital returned each month is less, and annuity rates are rather lower;

- the balance of *supply and demand* in the markets for the long term gilts and bonds which providers buy with their customers' capital in order to honour their promises to provide annuities. Here the influence of the ageing population shows up again since demand for assets to back pensions is rising with increasingly more pensions in payment, while the stock of Government debt (as a proportion of national income) is forecast to be relatively stable. In recent years, the Government has sought to maintain the supply of long gilts while private sector firms have also issued more corporate debt with long maturities. Yet the growing demand for assets of this kind, especially from providers of pensions including annuities, has meant that the yields on long bonds have often been lower than the yields on bonds of shorter maturity, putting pressure on annuity rates.

52. There is no reason to expect any of these factors to change in the foreseeable future. It is also important to appreciate that none of these underlying factors influencing annuity rates mean that annuities are poor value in themselves. In financial terms, annuities are still the most reliable and efficient way of using pension capital to generate secure retirement income.

53. Low inflation, bringing low interest rates, means that flat annuities maintain their real value – their purchasing power – for longer. For the same reason, indexed annuities are relatively cheaper, protecting the purchasing power of pension incomes more effectively. And improving life expectancy means that annuities must last longer, so the percentage returns on annuities now offer narrower margins compared to the returns on fixed interest securities such as gilts.

Graph 2 : pension income from maturing personal pensions



54. Graph 2 shows how lower inflation can help maintain the real value of retirement incomes. Even though nominal annuity rates have fallen, the (flat) annuity income, in earnings indexed terms, which a man of 65 can buy with newly maturing pension funds (accumulated by saving 10% of his earnings over a conservative working lifetime of 30 years) has tended to rise over the past 15 years. Investment performance over the period

of the investment growth of the fund has tended to more than compensate for falling annuity rates.

55. Low inflation rates and increasing life expectancy do mean, however, that nominal returns on pension capital may look very different from what was available in the recent past.

traditional annuities

56. The Inland Revenue's rules about eligible annuities are interpreted fairly flexibly. They require personal pension funds built up with the benefit of tax relief to be converted to an annuity for life by age 75, in return for surrendering the capital to the annuity provider. This flexibility encourages providers of annuities to develop new products. It has already benefited buyers of annuities by increasing the range of products from which they can select, and there is scope for continuing innovation.

57. Nevertheless, over 80% of the market continues to rely on **flat annuities**: that is, annuities which deliver the same income flow in cash to the pensioner year after year. These always give the new pensioner the biggest possible initial income so it is perhaps natural that they are popular.

58. But few people really appreciate how long their retirement may be. They may assume that they will need their annuity income for only a few years and may therefore want to get the most out of it. But even low inflation can cut the real value of a steady cash annuity considerably over a period of years. For instance, 2½% a year inflation (the Government's inflation target) will cut the real value of a flat annuity by 22% over ten years and by nearly 40% over twenty.

59. Annuities with a **rising profile** of income are designed to cope with risks of this kind. They can offer fixed percentage or indexed rises in income each year. About a fifth of annuities take this form. Although growing in volume, they are less popular than flat annuities as they provide less income initially for a given amount of pension capital.

60. Indeed the instinct to maximise income early in retirement is not altogether irrational. Low inflation means

that it can take many years before an indexed annuity delivers more income in cash than a flat annuity.

61. It may be helpful to illustrate this with a current example. If a man of 65 buys an indexed annuity instead of a flat annuity, and if inflation is steady at 2½% a year, it will be about 23 years at current market rates before the cash he has received from the indexed annuity is equal to the cash he would have received from a flat annuity over the same period. Even if inflation were 5% a year, it would take 12 years. Both periods would of course be even longer if the real values of the streams of income provided by the different annuities were compared.

new kinds of annuity

62. Retirements are now typically very much longer than used to be the case – frequently a couple of decades compared with perhaps a decade or so a generation ago. Crucially, this means that many retirements now span more than one economic cycle. This is essentially why some annuity providers have developed **investment linked annuities** which arrange some equity exposure, at least at the beginning of the product's term.

63. In the last few years, annuity providers have developed an increasingly diverse range of kinds of annuity which do indeed seek to deliver some equity exposure in the early years of retirement. This part of the market has grown fairly rapidly. From 5% by volume in 1988, investment linked annuities accounted for nearly 20% of the market by volume in 2000.

64. There are various kinds of investment linked annuities. For example, unit-linked annuities offer a fairly direct relationship between the income the annuity pays and the investment performance of the underlying fund. The operation of with-profits annuities, which seek to provide slightly less volatile income, is described in the box on page 22.

65. What all these kinds of annuity have in common is that the pensioners who buy them must accept some equity risk in return for hope of higher returns. This means some degree of uncertainty about the level of income which they will pay, a feature which not every pensioner will find tolerable. Typically providers specify a minimum fund size of around £50k or more

for this kind of annuity, so that pensioners with small annuity incomes are not subject to fluctuations.

how with-profits annuities work

A with-profits annuity is a with-profits endowment policy in reverse.

The new pensioner anticipates bonuses to be achieved by the with-profits fund which backs the annuity by choosing a rate of annual income rise. This determines the starting rate of the annuity. Optimistic assumptions about the assumed future rate of income growth mean a lower starting rate; and conversely less ambitious assumptions about future investment returns allow a higher starting rate for the annuity.

If the underlying investments in the with-profits fund operated by the provider do well, the annuity may deliver slightly better income increases than the pensioner has chosen to assume. Conversely, if the investments in the underlying fund do not perform so well, income growth may be rather worse than the chosen income growth rate.

Providers of this kind of annuity usually try to smooth the variations in the income provided. Some potential customers may find this feature unsatisfactory because providers have to make somewhat arbitrary judgements of how investment returns should be delivered to customers. This process is the mirror image of the judgements which providers of with-profit endowment policies have to make in deciding on the level of bonuses.

With-profits annuities offer their customers hope of better overall income through equity investment. In return the pensioner has to accept some uncertainty about the income the annuity will pay.

66. Recognising the power of mortality drag, some providers of investment linked annuities insist that the product eventually becomes a traditional annuity, for example if income levels fall, or when the pensioner reaches a certain age. The mechanics of how the annuity works do not matter so long as the product guarantees an income for life.

67. Another relatively new kind of annuity is the **impaired life annuity**. Unlike the investment linked annuity, this product is designed to help people whose retirement is likely to be relatively short because their life expectancy is poor. Providers are able to offer better annuity rates because they are able to return more of the pensioner's capital in each monthly income payment.

68. Annuities of this kind can be particularly helpful for people entering long term care, or for people with serious

diseases such as cancer or AIDS. Provider firms are also willing to recognise life threatening conditions and habits, such as heart disease or smoking, with appropriate actuarial adjustments for these customers' lower life expectancies based on their own experience of mortality, sometimes backed up by medical assessments. For group purchases of annuities, providers may also provide special rates which recognise the different mortality patterns of people living in certain areas or in certain occupations.

drawdown

69. Some pensioners choose drawdown to postpone buying an annuity. By contrast with investment-linked annuities, drawdown is transparent. The tax rules simply require that:

- at the start of the process, the pensioner may take a tax free lump sum of up to a quarter of the fund;
- after that the pensioner takes an annual income from the fund up to a limit set by the Government Actuary's Department (GAD) at the rate which someone of their age could obtain for a level lifetime annuity from that fund;
- the pensioner can take a smaller income, so long as it is at least 35% of the GAD limit;
- the pensioner must review his drawings at least every three years to check that the fund can sustain sufficient income for the remainder of the pensioners' life;
- if he wishes, the pensioner can transfer his drawdown account from one provider to another;
- by age 75 the pensioner must convert the remaining capital in his fund into an annuity;
- if the pensioner dies before converting his fund into an annuity, a 35% exit tax is levied on the remaining capital before it is paid into his estate.

70. Drawdown attracts about a quarter of matured retirement savings by volume, though only about 5½% of the transactions.

So pensions in drawdown are clearly at the high end of the range of personal pension funds, averaging over £140k.

71. Some pensioners prefer drawdown because it is transparent, it lets them control their pension funds, and it has potential for legacies if they die before they buy an annuity. Pensioners can if they wish arrange for complete control over the part of their fund which remains invested, and need not delegate choice about the deployment of their funds unless they want to do so. People who choose drawdown usually value this transparent arrangement – they say that they do not want to cede control of their pension assets to an annuity provider in order to retain equity exposure.

72. Drawdown does have significant disadvantages, however:

- it inevitably exposes pensioners who use it to *mortality drag*, with the result that they make less efficient use of their pension capital overall than they could; so
- pensioners who maximise drawdown income may find their *income falls* after a review – for instance if the investment performance of their fund has been disappointing and/or annuity rates have fallen since setting the initial income from the fund;
- similarly, pensioners in these circumstances may find, when they eventually buy a lifetime annuity, that it yields *lower income* than if they had bought an annuity sooner, affecting all the remainder of their retirement;
- *charges* on drawdown facilities are often heavy, including initial fees of up to 6% as well as annual management fees of around 1% a year; so
- drawdown is only suitable for people with *large pension funds* – some providers will only offer it to people with funds of £250k or more in order to make sure that their customers can cope with fluctuations in income and capital reflecting investment performance.

other retirement income options

73. Some people who prefer not to use annuities primarily want **flexibility** in use of their retirement capital. There is an alternative which can be attractive. They can split their personal pension savings and choose to annuitise each part separately, and not all at once. This approach means that they also take their tax free lump sum in several instalments, and that they can arrange a series of upward steps in their income profile in retirement.

74. This approach is sometimes called **staggered vesting** (because the pension is taken in stages). It may be easy to arrange because the pensioner's savings may already be in several separate sub-funds to spread investment risk. This approach can require less active management than drawdown, and so may be cheaper.

75. People can also save for their retirement **outside a pension scheme**. This choice may not be the most financially rewarding use of their money. Among the methods used are:

- *individual savings accounts* (ISAs), a tax privileged savings scheme which can be used for any purpose;

- residential *properties for letting*, yielding a rental income, with capital appreciation over time. It requires judicious choice of investments and careful planning to arrange for property to be realised to deliver a flow of secure retirement income;

- *employee share schemes:* there are several schemes offering opportunities to acquire shares in an employer's business on favourable terms, and the matured funds put together in this way can offer a way of saving for any purpose, including retirement;

- *life insurance products:* investment linked insurance products enable people to save, perhaps regularly, to build up a capital sum which can be arranged to fall due at or near retirement; there are no limits like those on pension contributions though the tax regime is less favourable;

- other *standard saving products* without contribution limits or specially directed tax privileges, using bank accounts, National Savings bonds, direct investments in equities, pooled unitised investment funds, and so on.

76. People who use approaches such as these, which do not benefit from the favourable tax regime applying to pensions, are of course free to use their retirement savings in any way they wish. They may not even bother to earmark them for pension purposes. They can choose to build up assets to leave to their estates when they die.

77. People who have built up non-pension savings, in these or other ways, may decide to use a **purchased life annuity** to generate income from some or all of their capital. This approach can provide confidence that pensioners will have sustainable income. As yet these purchased life annuities are less common than pension annuities. Only about £250m worth of these products are sold a year. But some people clearly find this approach offers a more attractive or straightforward set of options as it gives them more flexibility.

CHAPTER 4: INFORMED CHOICE FOR PEOPLE BUYING ANNUITIES

When pensioners buy an annuity, they need to identify the right kind of product for their circumstances and then buy it at a good price. The Government wants to provide the right conditions to help everyone make these decisions, which can improve retirement incomes by up to a third for all their retirement. This chapter considers how people can be helped to understand and to obtain the information and advice they need to make well informed and appropriate decisions.

78. This chapter explores ideas to help people make suitable and reliable choices about using their pension savings to generate retirement income. In line with the principles in para 35, it is about helping people buying annuities to understand the choices they have and how they can use them to their own benefit.

consumer education

79. Uniquely among financial services regulators around the world, the Financial Services Authority (FSA) has specific statutory responsibilities to promote public understanding of the financial system and to secure appropriate consumer protection. These responsibilities came into effect in December 2001.

80. The FSA has already begun to put in place a comprehensive range of tools to deliver these objectives, using print and electronic media to communicate with consumers directly. And the FSA continues to explore how existing means of reaching consumers of financial services can be expanded, developed and improved. In carrying out this aspect of their responsibilities, the FSA is supported by its Consumer Panel, which ensures that the voice of the consumer is heard.

81. In terms of practical delivery of help to consumers, the FSA already publishes leaflets to help people make informed decisions. In 2001 the FSA began to publish on-line comparative tables about financial products. These tables

enable people to get up to date information about competing products in order to choose for themselves which product might suit them best, or perhaps to begin an informed dialogue with an adviser. The FSA is building up the range of products covered by the tables and is about to begin work on **extending the coverage of the tables to include annuities.**

82. This financial year the FSA is also undertaking a structured programme of work focussing on the implications for financial services of the ageing of the population. This will include the impact on financial services firms and the needs of consumers, particularly those of older consumers. The FSA's theme is considering where consumers are likely to be most vulnerable, both now and in the future. It will also examine the potential risks and opportunities, for firms and consumers, of extended life expectancy, both expected and unexpected. The FSA's work will look in some detail at particular products used by the elderly, including long term care insurance and equity release mortgages as well as annuities. The FSA's findings will be published in spring 2002.

83. The Government has given the FSA responsibility for consumer education because it wants to help people to help themselves. As a result of its current work on the ageing population, the FSA plans to focus more of its effort on helping people prepare for retirement, as well as helping people already retired, so that they can better understand the choices open to them when managing their financial affairs.

84. Better informed consumers will be better able to make appropriate judgements to suit their own circumstances and needs. In this way the Government's tax breaks and basic financial education can be harnessed to give people flexibility and properly informed choice.

choosing the right annuity

85. The decisions needed when buying an annuity are always complex, whatever the size of the fund. There are a number of different types of annuity on the market, reflecting the diversity of people's lives, expectations and attitudes. People may not find it easy to understand what is available and make a good choice. Yet buying the wrong sort of annuity usually means a commitment for the whole of the pensioner's

retirement and so can have serious consequences even if, in its own terms, the product chosen offers a competitive rate.

86. To get the most from a small pension fund, potential annuitants need to:

- take a view about *when to buy*. In practice people with small personal pension funds are likely to be well advised to avoid the more complex and sophisticated options which allow them to draw income from their fund for lengthy periods before they buy an annuity (income drawdown);

- decide *what sort* of annuity to buy. This should include assessing the cost of add-on features like growth and guarantees, and whether that price is worth paying;

- choose *the provider* of the annuity. This may be straightforward, as the decision should ideally be driven by the yield offered by the annuity. Customers should consider using the open market option (see box on page 32). People buying annuities may also wish to think about the financial strength of potential providers and the quality of service they offer. Not all firms offer every option. And, in choosing a provider, people need to establish whether they have any contractual rights with the provider firm they have used to save for their pension, such as guaranteed annuity rates, as these rights might be lost if they buy their annuity from a third party.

things to consider before buying

87. In deciding what sort of annuity to buy, customers will need to consider a number of factors which bear on how suitable a particular annuity will be for their circumstances. These include:

- gender;

- age;

- health (impaired life annuities offer higher returns to those suffering from known medical problems);
- occupation;
- fund size;
- other income sources;
- payment options (eg monthly in advance or in arrears);
- any guarantee period (so that in the event of death shortly after purchase the annuity will continue to pay out for up to 10 years from purchase);
- the pensioner's attitude to investment risk;
- the pensioner's perception of the need for their income to keep pace wholly or partly with inflation;
- dependants and the need for survivor benefits. Annuities are generally single-life or joint-life last survivor. The latter continues to pay benefits to a surviving partner after the death of the annuitant. These may be at the same rate as the pensioner's own annuity or at a given fraction such as a third or a half of this rate. (Some providers insist upon minimum survivor benefits if the annuitant has a partner, though in practice only about a third of pension annuities take up survivor benefits.)

88. It is important to appreciate that this range of factors includes some which do not directly affect prices of annuities. So achieving good value from a particular choice in table 3 (page 31) is not enough. Buyers need to select the *right product* for their needs too.

- ***Given the popularity of flat annuities, are there any measures which should be considered to encourage people buying annuities to look at alternatives?***

value for money

89. The Government is keen to help everyone make the right choices about how to deploy their personal pension savings. The recent introduction of stakeholder pensions has made it possible to save for a pension more cost effectively since there is an upper limit on charges of 1% of fund a year. This has stimulated providers of other kinds of private pensions to reduce and restructure their charges for customers too. It is important that these gains are not damaged by poor decisions about how to use pension capital to generate retirement income.

Table 3: retirement income products	
Non-investment linked annuities	
Flat annuity	Provides a fixed level of income for life, but does not increase over time.
Escalating annuity	Fixed annual rises at, say, 3 or 5%, without investment risk.
RPI-linked annuity	Rises linked to the RPI, without investment risk.
Limited price indexed annuity	A RPI link but capped (often at 5%), without investment risk.
Dependants' benefits	Provides income after the pensioner's death for a spouse or dependent children
Guaranteed period annuities	Promises to pay the annuity for a predetermined period of up to 10 years, whether the pensioner survives or not
Impaired life annuities	Provides higher annuities for people with certain medical conditions limiting their life expectancy
Investment-linked products	
With-profits annuity	Two components – guaranteed minimum and bonuses. Requires the annuitant to choose a quite complex assumed bonus rate (ABR) – see box on page 22.
Unit-linked annuities with investment choices eg • **high,** • **medium** • **tracker**	Generally regarded as high risk, but still with different degrees of risk depending on investment choices.
Drawdown	Highest risk

90. People with personal pension savings are free to buy their annuity from any provider. This is usually called exercising the **open market option**. Some providers of products for pension savings actively encourage their customers to buy annuities from other providers. Yet still only about a third of people buying annuities do shop around in this way.

91. The Government wants people to be able to exercise the choices open to them. It welcomes the recent initiative by the FSA to encourage this. The box below explains what is intended.

the open market option

Recognising that people could often get better value and more choice by shopping around, in August 2001 the FSA published a consultation document (cp106) proposing that firms should be obliged to tell their personal pensions customers, at an appropriate time before their retirement, that their annuities can be bought from a different provider firm. This proposal is designed to ensure that consumers are made aware of their right to shop around to get the best annuity deal on offer to suit their circumstances.

The FSA's consultation process recently closed. The FSA plans to publish the results of the exercise, with its decisions on next steps, shortly.

Shopping around can clearly be worthwhile. Depending on the kind of annuity they are looking for, someone planning to buy an annuity from the tenth best value provider could get a rate 30% (or more) higher by using the open market option and going to the best value provider instead.

Alongside the FSA's initiative, the Association of British Insurers (ABI) issued, also in August 2001, a *Statement Of Good Practice For Pension Maturities*. It expects its member firms to begin to comply with it from January 2002. The standards give further detail about how in practice provider firms offering pension saving and income products should communicate with their customers. The guidelines should ensure that customers are more aware of the choices available to them when they begin their retirement, and are thus able to make more educated choices.

92. At the moment, people who consider switching provider when they buy an annuity are predominantly those with larger funds – typically those with funds at least twice as big as those who stay with the provider of the savings facility. But there should be scope for people with funds of smaller sizes to take advantage of the open market option too.

93. One reason why it is mainly people with larger funds who shop around might be that providers of annuities

sometimes set a minimum size for open market business. This can be quite low but is sometimes appreciably more for certain kinds of annuities. There may be commercial reasons for some restrictions. But these might be dealt with differently – for example by setting different annuity rates for different sizes of funds to reflect providers' costs.

94. The main product choices available are summarised in table 3 on page 31. The list is not exhaustive. For example, some annuities may combine several of the features picked out in the table; and there is considerable variety of investment linked products.

- ***Would it be possible for providers to encourage people with funds of all sizes, including the smallest, to shop around for the best rates?***
- ***Is there any action the Government could take to persuade more providers to accept transfers of smaller funds for conversion into annuities?***
- ***Are there any further steps that could be taken to encourage people to use the open market option?***
- ***How can people be made aware of the FSA's comparative tables as they approach the decision to buy an annuity? How can the tables be made readily available?***
- ***Beyond the comparative tables planned by the FSA, are there further steps which could be taken to improve information for consumers?***
- ***How can the Government encourage providers of drawdown products to provide good value?***

generic advice

95. There is a natural link between employment and a fuller understanding of pension rights and entitlements. The introduction of flexible low-cost stakeholder pensions ought to promote greater interest in pensions at all levels within firms. Annuities are an important part of this picture, especially as

stakeholder pensions require the purchase of an annuity. Recently there has been interest in **delivering advice in the workplace**.

96. The case for this advice may be strongest where an employer offers employees a collective money purchase scheme such as a Group Personal Pension (GPP), or a stakeholder scheme, or (less common) contributes to employees' personal pensions. In the current labour market, however, even employees who are members of occupational schemes will often need to buy an annuity too. For example, they may have an AVC or rights arising under a defined contribution pension from previous employment. So it will often be valuable for a wide range of employees to have ready access to general information on annuity choices.

- ***Could employers, trade unions or others provide generic information about choosing annuities in their pre-retirement packages?***

- ***Could employers, trade unions or others distribute generic material such as the FSA guide to annuities to those with personal and stakeholder pensions as retirement age approaches?***

- ***Are there other ways in which people buying annuities could be helped to find appropriate advice?***

CAT standards

97. In some parts of the retail financial services market, the Government has promoted basic quality standards designed to help people recognise products with good everyday value which they are unlikely to regret buying in retrospect. These are CAT standards: defining products which offer reasonable **c**harges, easy **a**ccess and decent **t**erms – hence CAT.

98. CAT standards were introduced when ISAs were launched in spring 1999 and then later for mortgages in 2000. In both cases they have enjoyed some success. They have encouraged competition in charges in the ISA market, where CAT standard products now account for a fifth or so of sales. And in the mortgage market they encourage loans with fair lock-in terms.

99. It does not follow that CAT standards will help every part of the retail financial savings market. The markets for both ISAs and mortgages are heavily populated, offering users a wide variety of choice which can be overwhelming. CAT standards are designed to help buyers who want everyday decent value find a good place to start when choosing a suitable product, perhaps simply using CAT standard products as reference points.

100. The market for annuities is very different. The range of products available is more limited. The basic traditional annuity product is readily available at keen prices if customers shop around, as the FSA's initiative encourages them to do.

101. Creating a CAT standard annuity might also encourage annuity providers to promote traditional annuities and could deter them from developing new kinds of annuity. Such an outcome would not serve customers well. The Government wants to promote innovation in the annuities market and is therefore not convinced of the case for a CAT standard for annuities.

102. However, there might be scope for alternative means of helping people find appropriate products which offer good deals.

- ***How can people recognise good value annuities on terms they find satisfactory?***

- ***Would it be possible to label products to identify, in simple terms, what sort of people they might suit and who should avoid buying them?***

specific advice

103. Having drawn as appropriate on the sources of generic information available – perhaps published by the FSA – most people should turn to an authorised financial services firm for advice specific to their own circumstances and needs when selecting their annuity.

104. In common with marketing of other investments, advice on annuities is subject to the FSA's rules on **polarisation**.

These require that that advice can only be given either by tied agents on a single firm's products or by independent financial advisers who select a suitable product from across the whole market. The FSA has recently published a consultation document (CP121 - *Reforming Polarisation: Making the Market Work for Consumers*) proposing significant reform of these rules.

105. Subject to the outcome of the FSA's current consultation exercise, the benefits of the proposed reform will help people buying annuities as well as customers for other packaged investment products. Pension providers will then be able, if they wish, to offer other providers' annuities along with their own, giving their customers more choice. This could particularly help customers of firms that offer pensions savings vehicles but prefer not to attract annuity business because other providers are more competitive. In practical terms the proposed reform could mean that it will become easier for people to shop around and compare a variety of providers' annuities to see whether they want to exercise the open market option, and then to select their annuity.

106. At the same time, the proposed improvements in point of sale disclosure of commission and fee structures should help customers appreciate how advice is paid for, whether or not it is actually taken up. And in turn greater transparency about how much advice costs should give people more confidence about taking it up. It could also put pressure on higher cost providers, for example those selling some drawdown products.

107. The Sandler review, commissioned by the Chancellor in June 2001, will also look at the distribution chain for retail financial services products. Its report, due this summer, is also likely to touch on generic issues which have a bearing on how annuities are sold.

- ***Are there any other ways in which the Government could make delivery of specific advice on annuities more accessible?***

- ***How could people buying annuities be made aware whether prices of annuities on offer include the cost of advice?***

simplification

108. The Government recognises that the complexity of the current tax treatment of pensions can be a barrier to helping people understand their pension investments and choices. The rules about pensions have developed through successive reforms and improvements. While each could be justified in its own terms, together they add up to a complicated set of rules about what can be saved and how. There are parallel exercises taking place at the Department for Work and Pensions and at the Inland Revenue to consider whether there is a case for simplifying the rules that apply to pensions.

help for people buying annuities

109. Buying an annuity is usually the culmination of a lengthy saving process. Given its importance, it would be helpful to encourage people saving for pensions to think in advance about the choice they will have to make when they convert their saved pension fund into retirement income.

- ***What could be done to explain how annuities work when savers take out personal and stakeholder pensions?***

- ***Could there be a role for decision trees – already used to help people decide whether a stakeholder pension might suit them – to help people select the range of annuities to investigate further?***

110. More generally, there may be room to improve the clarity of explanatory material provided to people thinking about buying annuities. This is especially important for less well informed consumers.

- ***Would there be value in standardising the forms used to describe annuities so that people can readily make comparisons?***

CHAPTER 5: INCREASING FLEXIBILITY

This chapter considers ways in which the annuity market could offer people more choice and control over the annuities they buy. At the moment the range of annuity products which can be used with pension savings is limited. In principle the Government is willing to allow a greater range of annuity types. By taking an enabling power, the Government intends that new kinds of products yielding retirement income could be permitted, in line with the Government's principles, as the market develops.

what people want from annuities

111. While there is **competition** among providers of annuities, the market for annuities could work better in the interests of its customers. In particular, it would be desirable to encourage new providers to enter the market. The ideas considered in this chapter are therefore designed to encourage new providers of annuities to enter the market on terms which should help them control their exposures. In time they may be able to offer a wide range of products.

112. In the current market there appear to be barriers to entry for new provider firms. Even well established providers find it challenging to price annuities accurately – using their experience to strike an appropriate balance between offering attractive rates and doing business on commercially sustainable terms. A number of interested potential new providers, lacking hands on experience of their customers' mortality through doing annuity business, have so far found this challenge too risky.

113. This must mean that competition is less lively than in many other markets, where new entrants have often introduced new ideas and stimulated established providers to improve their product range and associated services. Where new provider firms are able to enter the market, the consumer gains. The ideas discussed in this chapter therefore seek to stimulate similar effects in the interests of consumers in the annuity market.

- ***How could the market for annuities be encouraged to diversify and become more competitive?***

- ***What could be done to ease restrictions limiting new providers' ability to enter the annuities market?***

- ***How could the wide range of prices in the annuities market be narrowed?***

- ***Are there any information flows that might help new firms enter the annuities market? How could they be provided?***

114. When someone buys a traditional annuity, they may not want to be committed to an inflexible income stream for the remainder of their life. This may be perhaps a couple of decades or more, a period which is usually too long for most people to be able to foresee their needs with confidence. Average periods of retirement have gradually extended from a decade or so forty years ago, with the trend toward early retirement exaggerating the effect.

115. It is natural therefore for people to want greater **control** over their annuities during the course of their payment. That is why the policy options outlined in this chapter are designed to see whether pensioners can have opportunities to adjust their pension annuities during their retirement if that is what they want. This approach is intended to harness the capacity of the modern market for financial services to provide choice, transparency and flexibility.

116. People buying annuities may also want to ensure an adequate **return** for the capital they invest in their pension if their retirement turns out to be short. Of course people are already free to set aside some or all of any part of the pension they take as a lump sum for this purpose. They can, for example, use it to take out insurance policies for the benefit of their heirs; and there is some provision for guaranteeing continuing income from pension annuities whether or not the pensioner survives to receive it.

117. It is important to remember that pension funds attract tax privileges in order to deliver retirement income. When people choose to save for a pension, they explicitly accept these contractual terms. So there are limited grounds for significant

extension of the existing ability of pensioners to use tax advantaged pension savings to benefit their estates. Were tax breaks for pensions to be extended for the purpose of bequests, it would conflict with the principle that pensions tax reliefs are designed to support retirement income and not for other purposes (para 35). In effect, taxpayers as a whole – including people of limited or modest means – would be asked to subsidise people well able to look after their own financial interests. There is nothing to prevent people building up assets outside a pension fund in order to benefit their heirs.

118. The policy options considered in this chapter seek to modernise the rules about using annuities to generate pension income. The thrust is toward improving choice and flexibility. The changes discussed could mean that fewer people resort to the expense and trouble of drawdown to get what they want from their pension savings.

innovation

119. The only requirement about the design of qualifying retirement annuities is that they meet the Government's principles for annuities policy (para 35). These require that they should deliver a secure and sufficient income for life in return for the pensioner surrendering saved pension capital, and are not a tax favoured method of saving for other purposes. In recent years a number of new annuity products on the market have offered new features, sometimes by combining them with linked financial products. Some are now commanding popularity among customers.

120. Some providers of annuities regret that the requirements are not more specific. They say they would prefer strict rules within which they could generate new ideas for product design.

121. The Government believes this would be an opportunity missed. Any firm boundaries which might be laid down could too easily limit provider firms' creativity. Provider firms' ability to develop new ideas for annuity products gives consumers scope to benefit from lively competition and must remain.

122. Instead, the Government proposes to take a new enabling power to allow different kinds of annuity to qualify for use when tax-privileged pension savings are converted to retirement

income. This power will enable secondary legislation to set out the annuity products, or annuity alternatives, people can buy with their pension capital. These new products can then be sold to pensioners when the secondary legislation comes into force. And the power will allow additional kinds of products to be recognised for use in future as the market develops.

123. In this dynamic way the Government can keep the range of income products up to date. The trend toward greater diversity of retirement income products has already begun with investment-linked annuities. Some of the policy options explored in this chapter seek to take this trend further. More new products could improve competition and value for retired people who buy annuities.

- ***Are there other annuity designs that would provide a secure income in retirement with flexibility for customers (without conflicting with the Government's principles)?***

124. Please note that the proposed legislation will not list the products by name but rather will describe the features they should or can have. So it will be constructive if suggestions are generic and avoid unnecessary detail. It will also be important for qualifying annuities to accord with the Government's principles (para 35) about use of tax privileged pension savings, that is, that they should be used to generate retirement income.

limited period annuities

125. People often complain that annuities are inflexible. They point out that the new pensioner has to choose the pattern of their future income stream at the point of purchase, when they may have little way of foreseeing how their future needs might vary over time. This may persuade some people to use drawdown when it might not be in their best interests.

126. The Government therefore wants to explore whether pensioners could buy **annuities for limited periods**. People could be free to choose the period of the annuity, and its level (within limits similar to those on drawdown), so long as they eventually buy an annuity for the remainder of their lives by age 75. Annex 4 suggests how this might work.

127. This approach would have the advantage of allowing people to plan ahead for periods they can foresee reasonably well – for example a few years of part time work early in retirement when less income might be needed; or a known period until children grow up when protection for dependants' income might be desirable. A fresh decision could be made at the end of each limited period annuity about whether to buy a lifetime annuity with the remaining fund, or another annuity, or perhaps to use drawdown for a while. Depending on the provider's range of products, the pensioner could have a choice across the whole market each time he or she purchased a new annuity.

128. There could be advantages for providers too. New entrant firms in particular might find it easier to price limited period annuities, which would lack the open ended exposure to uncertainties about life expectancy entailed in traditional lifetime annuities. This could lead to more competition and choice in the market for annuities generally. So everyone using the annuity market could in time stand to benefit.

129. The ideas in annex 4 describe one possible way of using limited period annuities. There may be other workable ways of using them. Any alternatives need to ensure that pensioners do not run the risk of running out of capital during their lifetimes.

- ***Does the possible outline in annex 4 provide a practical way of using limited period annuities to provide pension income?***

- ***Are there any alternative practical and workable ways to use limited period annuities to provide pension income?***

130. Buying a series of limited period annuities is in some ways similar to activating a pension in stages through staggered vesting. The main difference would be that choosing a series of annuities enables the pensioner to take all the lump sum available from his pension fund immediately, rather than in instalments. A pensioner could also choose to use only part of his fund to buy limited period annuities, perhaps leaving the rest invested or using it to buy a lifetime annuity or reserving it for buying more limited period annuities later.

131. As with drawdown, the part of the pensioner's capital which is not used to buy a limited period annuity would remain invested. The pensioner could choose how, subject to the terms of the provider's scheme. Some pensioners might want to retain full control over the deployment of their funds. One way of doing so might be to use an individual pension account (IPA) to hold funds in a range of pooled investment schemes to achieve an appropriate spread of investment exposures.

132. Like drawdown again, using retirement capital in this way will entail some mortality drag (see para 72). As pensioners get older, they will need increasingly better returns to be confident of being able to outpace the income boost they could get by pooling their risks with others and buying a lifetime annuity which will return a share of *all* of their capital as income (see graph 1). But the management entailed in delivering a series of limited period annuities could be less than for drawdown. Preliminary indications from potential suppliers suggest that limited period annuities might therefore cost less than drawdown.

- ***What might providers charge for limited period annuities? Would they be better value than drawdown?***

133. Some of the innovative annuities recently introduced to the market are contracts within which customers can, in effect, have a series of limited period annuities rather like this policy option. This kind of annuity product will usually be less flexible than limited period annuities could be. They usually offer limited period annuities from only a limited range at each point of choice; and the customer may also have a limited choice about how to invest the part of the pension fund not used to generate annuity income.

134. Limited period annuities will not appeal to everyone. Because of the additional exposure to mortality drag, they are unlikely to suit people with small funds. Some suggestions indicate that an appropriate minimum fund size for people planning to buy a series of limited period annuities might be about £100k – that is, appreciably less than many think suitable for drawdown.

- ***Should there be any limits on the sizes of funds used for limited period annuities? Or can this be left to the market?***

135. If limited period annuities were to appeal to part of the market, there might be modest gains for people buying smaller annuities as well. It would mean that some of the growing demand for life annuities would switch to shorter annuities. Providers of these shorter annuities would seek to back their products with bonds and gilts of shorter duration, switching some demand away from the heavily pressed long ends of these markets. Other things being equal, this might mean slightly better annuity rates for people buying lifetime annuities, especially people with small retirement funds.

136. So if this idea could be developed into a practical form, it could help deliver the Government's aim of giving pensioners more choice and helping them achieve better value from their pension savings.

transfers

137. Sometimes pensioners drawing annuities say that they would like to transfer their annuities to other provider firms. They may have chosen their annuity provider in good faith but come to regret their choice.

138. In some other parts of the market for retail financial services, the ability for consumers to transfer from one provider to another has led to real improvements. In the mortgage market, for instance, transfers – remortgages – have enabled borrowers to get loans on better terms, so improving competition. Current accounts should be subject to similar competitive forces now that the banks have risen to one of the challenges posed by the Cruickshank report of 1999.

139. But mortgages and current accounts do not operate through risk pooling as annuities do. This is a crucial difference. It sets a natural limit on how far transfers can improve competition in the annuity market. Nevertheless the Government would like to explore the scope for using this approach as far as it is feasible.

140. The current tax rules do not stop someone receiving an annuity from arranging to transfer the liability to pay it from one provider to another. But the pensioner may not buy a different kind of annuity (or change its terms) in the process of making the transfer. And of course the original provider must be willing to make the transfer and the new provider willing to accept it, on terms acceptable both to them and to the annuitant. These arrangements must also reflect the terms of commercial providers' annuity products.

141. Annuities are insurance products, which work by pooling the interests and risks faced by a number of customers. It is easy to see how this works for – say – car insurance. Customers whose cars are stolen can get compensation from their insurance company because the remainder of customers who have contributed their premiums to the insurance pool have not been so unlucky and will not get corresponding payments. Similarly, an insurance company can afford to continue paying annuities to its longer lived customers because those who do not survive to collect their annuities for long contributed their pension capital when they bought their annuities and do not draw on all of it.

142. Consider now what would happen if there was complete freedom for people to transfer annuities in payment from one provider to another, and change the kind of annuity in the process. The pensioners who would find it worthwhile to transfer in this way would be those who found – perhaps because of some serious life threatening disease – that their life expectancy had become poorer. They would have an incentive to move their annuities to other providers willing to recognise these customers' reduced survival prospects and to offer impaired life annuities. These customers would indeed get a better deal for the remainder of their lives.

143. Customers who stayed with the original provider would by contrast all tend to have good life expectancies. The provider would certainly have to work on that assumption. In practice it would mean that providers of all new annuities would have to assume that all their long term customers had excellent life expectancies. The annuity rates it could offer at retirement would have to be appreciably poorer.

144. So complete freedom to transfer annuities in payment and change their terms would inevitably mean less attractive

annuity rates to new customers. Restrictions on transfers allow providers to offer better annuity rates through pooling mortality risk. Customers might feel they would have to be vigilant to see whether better rates might be on offer from competing provider firms. Many pensioners might want to avoid this, preferring security and stability.

145. There might, however, be a middle course. If the terms of annuity contracts could provide for **ability to transfer** to another provider (or perhaps to another product with the same provider) **at certain given points** both providers and annuitants would know more clearly where they stood. The policy objective of this extra degree of freedom would be to give providers greater incentives to look after their customers throughout their annuities. At the moment customers have little market leverage once they have bought an annuity. There must be a risk that providers drift into complacent treatment of captive long term customers.

146. If this change were made, at least in some personal pension contracts, pensioners would have some ability to unpick a decision they might have come to regret. And providers would be able to limit their exposure to uncertainty about potential for transfers. If customers chose annuities with scope for transfers, they might face higher costs but in a way which both providers and customers might both find transparent and acceptable. The effect might be rather like a series of limited period annuities.

- ***On what terms could limited transfer annuities work? Would there be extra costs and if so what?***

- ***What limitations would be necessary? Should the legislation specify any restrictions or could the market determine them competitively?***

- ***Could providers give customers a choice of the intervals at which switching might be possible? How would this feed into the other terms of their contracts with their customers?***

147. There may also be scope for easier transfers of **investment linked annuities**, such as with profits annuities. There are now several different kinds of these annuities, all of which may have residual transfer values, at least while they are

partly backed by equities. They may resemble drawdown to some extent.

148. People using drawdown can already move their contracts from one provider to another, provided the terms of their contracts allow it. So it would seem logical to extend the same flexibility to investment linked annuities. In fact there is no legal obstacle to transfers provided the exchange is like for like and the terms of the original provider's contract allow it. For example if a pensioner is disappointed in the performance of his with profits annuity he could arrange to exchange it for another provider's with profits annuity.

149. It might be possible to develop scope for transfers from one *kind* of investment linked annuity to another, perhaps from one product to another with the same firm. This might allow people who had come to regret their original choice to move to another. The change required would simply be to regard investment linked annuities as a common class for the purposes of allowing transfers of annuities in payment.

- ***Would it be feasible to allow pensioners to transfer any investment linked annuity from one provider to another?***
- ***Would any restrictions be necessary to make this possible and need they be specified in the legislation?***

150. If it were to be possible to loosen the rules on transfers in the two ways sketched out above, it might be possible only to apply this flexibility to annuities taken out after a given start date. This would give annuity providers scope to take account of the change of practice in their underwriting arrangements without prejudicing their financial stability and without prejudicing the Government's principles (para 35).

irregular annuities

151. The current rules defining which annuities may be used when turning tax-privileged pension savings into income set limits on how the income paid by the annuity may vary over the lifetime of its payment. The allowable range is:

- flat annuities;
- certain indexed annuities;
- investment linked annuities;
- annuities with benefits for dependants (level, indexed or investment linked).

152. This range has expanded over the years in response to developments in the market and in public policy. While each change was sensible in its own right, it is not obvious that the range now makes sense in the round. There may be other patterns of income delivery which pensioners would find attractive and which would still provide a secure and reliable income for life. If any were to be permitted it would of course be important to stick to the principles in para 35.

- ***Are there any other profiles of income from annuities for which there might be market demand?***

- ***For instance, should incremental steps be possible at certain ages – and if so how?***

- ***Should there be restrictions on the income profiles allowed in order to ensure that annuity income is reliable? If so what?***

insuring pension savings

153. As this document has explained, the favourable tax regime for pensions is designed to encourage people to save to provide themselves with retirement income, and not to build up capital, whether for legacies or any other purpose.

154. However, people who want to protect the capital in their pensions already have considerable scope to do this. They can use the tax free lump sum (usually 25% of the fund) to buy a single premium life insurance policy, or they can buy regular premium life insurance out of taxed income. Pensioners can also buy an annuity that guarantees payments for up to ten years, so that if they do not survive that long the annuity payments are made to their estate for the remainder of the guarantee period. And any pensioner using drawdown who dies before using their remaining capital to buy an annuity is able to remit the unused capital into their estate after an exit tax. In

this respect limited period annuities would work in a way similar to drawdown. In addition, those planning bequests could pay pension income into other savings vehicles like ISAs.

155. This range of insurance options for pensioners allows them to choose among a range of products to suit their varying needs without prejudicing the Government's principle that pension savings are for generating retirement income.

- ***Are there any other insurance options that could be made available without prejudicing the Government's principles (para 35)?***

- ***How can pensioners be made more aware of the current insurance choices available to them?***

CHAPTER 6: ALTERNATIVE IDEAS

People interested in policy on retirement income sometimes suggest other policy changes which would move use of pension funds a long way from the present policy. This chapter explains why the Government is not persuaded of the case for these changes, in line with the principles set out in para 35.

156. As this document has explained, the Government's position is that the tax breaks offered to encourage people to save in pension funds are intended to help people achieve secure retirement income.

157. The ideas in chapter 5 explore some modifications which could provide additional flexibility without departing from the Government's principles (para 35). These could meet many of the concerns people express about annuities.

when to annuitise

158. People reluctant to annuitise, including some who are using drawdown, sometimes ask for the age at which they must buy an annuity with their pension fund to be raised. A common suggestion is to move it from 75 to 80.

159. This recommendation is often also driven by the desire to leave any unused parts of a personal pension fund as bequests. People putting it forward may expect that the annuitisation age will eventually be abolished – or that they will not survive long enough to face the need to buy an annuity.

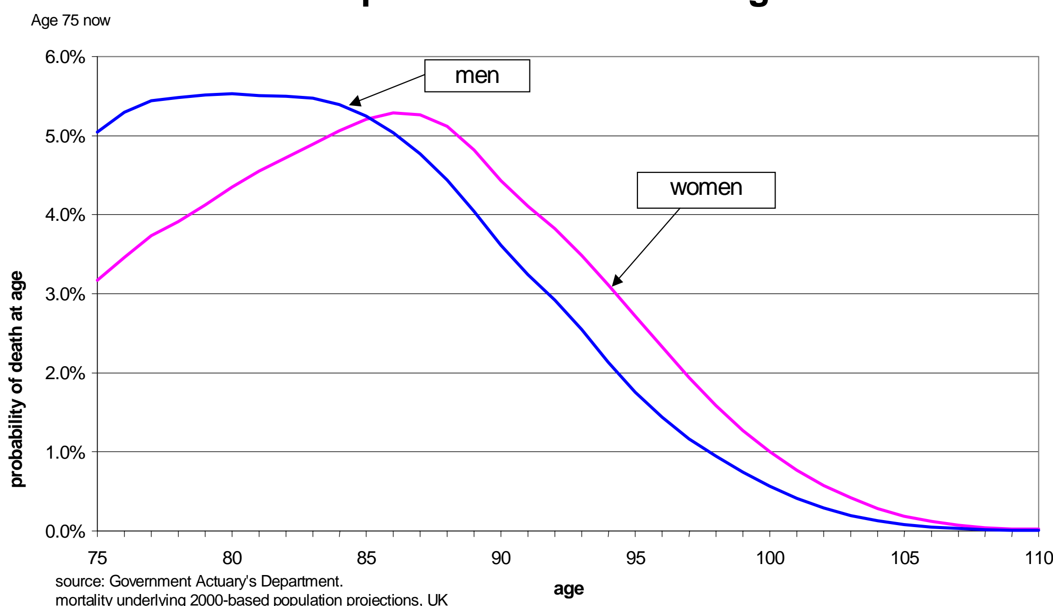
160. Like other pensions, personal pension funds are intended to provide an income for life. Someone of age 75 will typically have a life expectancy of about a decade: ten years for men and 12 for women (see table 2). These averages however conceal a wide dispersion of different outcomes, as graph 3 shows. Of people who reach age 75, 8% of men and 13% of women survive for a further 20 years or more. So at 75 many people will need to make sure that their pension resources will last for a significant period which is very uncertain. Buying an annuity

is a straightforward and efficient way of dealing with this uncertainty.

161. If, at age 75, people were to continue in drawdown for longer, mortality drag would make their use of their pension fund increasingly inefficient (see page 15). And there would be an increasing risk that their funds would be too severely depleted to provide an adequate income – probably at a time of their lives when a worry of this kind would be very troubling.

162. The only reliable way of making sure that people do not outlive their pension assets is to use the fund to buy an annuity. It is a matter of judgement whether 75 is the right upper limit on the age for doing so. But there are sound financial reasons why people should find it good value to annuitise by age 75, and often well before that. As graph 1 (on page 14) shows, mortality drag will by then have become a serious impediment to securing a good income from their pension savings.

GRAPH 3: expected distribution of age at death



163. The Government therefore remains convinced that annuitisation of pension savings is the right approach. There are no plans to alter the age at which buying an annuity becomes essential from 75. Since good financial advice would normally encourage people to annuitise pension savings some years earlier, setting the maximum age at 75 gives people some

flexibility about when and how they fix the financial arrangements for their retirement income.

164. Since this consultation process does not propose to alter the age at which buying an annuity with a personal pension fund is essential, the Government is not suspending the age 75 rule.

capital extraction

165. There have been a number of recommendations that people with some defined level of retirement income, or with a given amount of retirement capital, should be able to extract capital from their personal pension savings.

166. A change on these lines would be a major departure from the principles set out in para 35. It would mean allowing people to break the terms on which their retirement savings had been built up with tax privileges – that is, to deliver income in retirement. If such a change were to be made, the Government would therefore need to recover the tax benefits the pension fund had enjoyed during its existence.

167. If such a policy change were to be contemplated, there would have to be an exit tax on any extracted capital in order to unwind these tax benefits. The rate of this tax would need to reflect both the tax relief on contributions into the fund and the tax free investment growth of the fund – a rate clearly well above the higher marginal rate of tax. Without such a neutralising tax, older people with substantial resources would be able to use their pensions as a tax shelter for their investments, paying capital into a pension with the explicit plan to extract it later. This could not be fair to other taxpayers.

168. If any scope for extraction of capital were to be allowed, it would clearly be essential to allow this privilege only to the largest personal pension funds. Without some restriction of this kind, people would have an incentive to withdraw their capital, spend it, and then qualify for means tested benefits - a form of double dipping which would be unfair to other taxpayers.

169. Even with arrangements for recovery of tax reliefs which had not been used to produce retirement income, there are

good reasons why the Government should hesitate about such a step. It would in effect mean that better off people would be able to save more in a tax advantaged form for purposes other than a pension compared to everyone else. There is already a generous and popular scheme for saving with tax breaks outside a pension in ISAs. Every adult can already save up to £7k a year in an ISA. It is hard to see why better off people, and *only* better off people, should be able to save more than this in non-pension form with tax advantages.

170. If better off people were able to extract capital from their personal pension funds in this way, the costs to other taxpayers could be large. Such a change would strengthen the incentive to save through pensions, though for purposes other than retirement income. Few people save as much as the rules for tax relief on pensions would allow. Some £34bn a year of potential tax relief on pensions goes unclaimed.

171. For people of modest means this is often because they face other demands on their income, or have other priorities during their working years. But even higher rate taxpayers do not save as much as they could in tax privileged pensions. Over £8bn of the unused £34bn could be claimed by higher rate taxpayers, many of whom could no doubt afford to save more if they chose to do so. Even if only a small proportion of that £8bn of unused tax relief were taken up, it would be a significant imposition on other – less wealthy - taxpayers.

172. The Government is therefore not persuaded that it would be right or fair to allow people with large pension funds to extract capital built up with tax breaks.

CHAPTER 7: CONCLUSION

next steps

173. The Government intends to take powers in primary legislation to allow (subsequent) secondary legislation to define which products can be used to turn pension savings into retirement income. Feedback from this consultation will inform how the proposed powers will be used to define the income delivering products which are acceptable for pensions.

174. Readers are invited to think broadly and creatively about how this power could be used. The Government would welcome an active dialogue.

175. When the Government is clear about how the greater flexibility discussed in this document is to be used, the FSA will need to consult about regulation of marketing of the wider range of products. The FSA's current consultation about reform of its polarisation rules is intended to open up opportunities to improve choice and advice for consumers as they resolve their financial affairs at retirement. These could include taking advantage of the more flexible options discussed in this paper.

176. The Government believes that there should be a wider and more informed choice about how people convert their pension savings into retirement income. The policy options explored in this document are designed to extend and modernise the options available without being unfair to other taxpayers.

Department for Work and Pensions
Inland Revenue

February 2002

ANNEX 1: QUESTIONS FOR FEEDBACK

Note: readers may find it helpful to structure their replies using these questions. They repeat questions in the main text set out in ***bold italics***. But any feedback is welcome.

questions from chapter 4

- ***Given the popularity of flat annuities, are there any measures which should be considered to encourage people buying annuities to look at alternatives?***
- ***Would it be possible for providers to encourage people with funds of all sizes, including the smallest, to shop around for the best rates?***
- ***Is there any action the Government could take to persuade more providers to accept transfers of smaller funds for conversion into annuities?***
- ***Are there any further steps which could be taken to encourage people to use the open market option?***
- ***How can people be made aware of the FSA's comparative tables as they approach the decision to buy an annuity? How can the tables be made readily available?***
- ***Beyond the comparative tables planned by the FSA, are there further steps which could be taken to improve information for consumers?***
- ***How can the Government encourage providers of drawdown products to provide good value?***
- ***Could employers, trade unions or others provide generic information about choosing annuities in their pre-retirement packages?***
- ***Could employers, trade unions or others distribute generic material such as the FSA guide to annuities to those with personal and stakeholder pensions as retirement age approaches?***

- ***Are there other ways in which people buying annuities could be helped to find appropriate advice?***
- ***How can people recognise good value annuities on terms they find satisfactory?***
- ***Would it be possible to label products to identify, in simple terms, what sort of people they might suit and who should avoid buying them?***
- ***Are there any other ways in which the Government could make delivery of specific advice on annuities more accessible?***
- ***How could people buying annuities be made aware whether prices of annuities on offer include the cost of advice?***
- ***What could be done to explain how annuities work when savers take out personal and stakeholder pensions?***
- ***Could there be a role for decision trees – already used to help people decide whether a stakeholder pension might suit them – to help people select the range of annuities to investigate further?***
- ***Would there be value in standardising the forms used to describe annuities so that people can readily make comparisons?***

questions from chapter 5

- ***How could the market for annuities be encouraged to diversify and become more competitive?***
- ***What could be done to ease restrictions limiting new providers' ability to enter the annuity market?***
- ***How could the wide range of prices in the annuities market be narrowed?***

- ***Are there any information flows that might help new firms enter the annuities market? How could they be provided?***

- ***Are there other annuity designs that would provide a secure income in retirement with flexibility for customers (without conflicting with the Government's principles)?***

limited period annuities

- ***Does the possible outline in annex 4 provide a practical way of using limited period annuities to provide pension income?***

- ***Are there any alternative practical and workable ways to use limited period annuities to provide pension income?***

- ***What might providers charge for limited period annuities? Would they be better value than drawdown?***

- ***Should there be any limits on the sizes of funds used for limited period annuities? Or can this be left to the market?***

transfers of annuities in payment

- ***On what terms could limited transfer annuities work? Would there be extra costs and if so what?***

- ***What limitations would be necessary? Should the legislation specify any restrictions or could the market determine them competitively?***

- ***Could providers give customers a choice of the intervals at which switching might be possible? How would this feed into the other terms of their contracts with their customers?***

- ***Would it be feasible to allow pensioners to transfer any investment linked annuity from one provider to another?***

- ***Would any restrictions be necessary to make this possible and need they be specified in the legislation?***

<u>irregular annuities</u>

- ***Are there any other profiles of income from annuities for which there might be market demand?***

- ***For instance, should incremental steps be possible at certain ages – and if so how?***

- ***Should there be restrictions on the income profiles allowed in order to ensure that annuity income is reliable? If so what?***

<u>insured annuities</u>

- ***Are there any other insurance options that could be made available without prejudicing the Government's principles (para 35)?***

- ***How can pensioners be made more aware of the current insurance choices available to them?***

Annex 3

- ***Have readers comments on the cost effectiveness issues raised in annex 3?***

Annex 2: glossary of technical terms

ABI	Association of British Insurers
AVC	Additional Voluntary Contributions: extra payments a member of any occupational scheme can choose to make to a *defined contribution* scheme to obtain greater benefits
annuitisation	the use of pension fund capital to purchase an annuity
annuity	an insurance contract that guarantees to pay out annual amounts for a fixed period. Pension annuities must currently guarantee payments for life
bonds	a promise to return a loan of capital plus a specified amount of interest on a particular date
CAT standards	basic standards of quality assurance for financial products that have reasonable Charges, easy Access and decent Terms
Cruickshank report	an independent review of innovation, competition and efficiency in the UK banking market sponsored by the Chancellor of the Exchequer that reported in March 2000
defined contribution pension scheme (money purchase scheme)	a type of pension scheme where the size of members' retirement benefits are determined by the level of contributions to the scheme and their subsequent investment growth
double dipping	where a person draws on and depletes their pension fund, which has benefited from tax reliefs, and then falls back onto means tested state support, so receiving a second retirement subsidy from taxpayers
drawdown	see *income drawdown*

economic cycle a period of economic activity, usually of several years, which in retrospect can be seen to have moved from peak activity, through reduced activity to another peak of activity

endowment policy an investment linked insurance contract for a single pay out on a fixed future date or on earlier death

flat annuity an *annuity* that provides level payments for its whole term

FSA the Financial Services Authority: the independent statutory regulator for financial services business, including pensions

gilts Government *bonds*, commonly used by insurers to underwrite their annuity business

impaired life annuity an annuity giving a higher level of payments to reflect reduced life expectancy, eg because of illness or identified health risks

income drawdown (income withdrawal) the facility for a pension scheme member to draw a retirement income directly from their pension fund and postpone annuity purchase up to a maximum age of 75

indexation increase of payments at regular intervals in line with a specified index of prices or earnings

individual pension account (IPA) a financial instrument that acts as a wrapper for pension scheme investments, facilitating transparency and in specie transfers. Not a pension scheme itself

individual savings account (ISA) a type of savings scheme that can hold cash, equity and insurance investments where no tax is paid on investment income and withdrawals

investment linked annuity an *annuity* where the level of payments depends upon the performance of the underlying investments

life expectancy	the most likely length of life at a particular age. May be based solely on the general population or take additional account of factors such as lifestyle and illness
limited period annuity	a pension annuity designed to provide payments for a fixed period rather than for life
mortality cross subsidy	the boost to annuity income which arises because people who die soon after buying an annuity allow annuity providers to keep paying annuities to people who survive for a long time
mortality drag	the effect which causes people to get worse value if they postpone buying an annuity – see box on page 15
occupational pension scheme	a pension scheme organised by an employer to provide retirement benefits for employees, and into which the employer and sometimes employees pay contributions
open market option	the option to use a pension fund to purchase an annuity from any insurer in the marketplace
personal pension	an individual pension scheme that is not dependent upon employment
polarisation	financial regulation ensuring that a company, or financial adviser tied to a company, can only market their own products
purchased life annuity	an annuity bought by an individual not using the proceeds of a pension scheme
retirement annuity contract	a pension annuity contract between an individual and an insurer predating the personal pension scheme arrangements that were introduced in July 1988

Sandler review	an independent review of the long term retail savings market, commissioned by the Chancellor of the Exchequer in June 2001, to examine the forces and incentives in the personal savings industry and identify whether consumers are being well served
small self administered scheme (SSAS)	an *occupational pension scheme* which manages its own investments and has less than 12 members
staggered vesting	the process of drawing benefits from a pension scheme in stages
stakeholder pension	a type of *personal pension* scheme which meets set criteria for low charges and flexibility
tax free lump sum	the portion of benefits from a pension scheme that can be taken as a tax-free cash payment at *vesting*, normally up to 25% of the value of the pension fund
vesting	the point at which benefits are first drawn from a pension scheme
with profits annuity	an *annuity* where the payments consist of a guaranteed element along with a share in any surplus from the insurer's business – see box on page 22

Annex 3: partial Regulatory Impact Assessment

purpose and intended effect

1. This consultation document seeks views on how the annuities market could become more flexible and competitive. Its aim is to arrive at solutions which will be of benefit to people who use annuities to turn their pension savings into income in retirement.

2. The current requirement is that an annuity must provide an income for life in return for a surrender of capital. This document considers the possibility of introducing limited period annuities which could be purchased in series.

risks

3. Individualised money purchase (defined contribution) pension arrangements, such as personal pension schemes, cannot pool investment and mortality risks. The only way that a scheme member can have a guarantee that they will receive a pension income for the rest of their life, no matter how long that may be, is to transfer to an insurance company by purchasing an annuity.

4. Insurers provide this guarantee by spreading the investment and mortality risk across the pool formed by those people who have bought annuities. The annuity rates offered are based on life expectancy and returns on secure investments. The fact that some people will have a shorter life span than the average provides the insurer with the means to continue paying the annuities of those people who live longer than the average.

5. Any diminution of the annuity purchase requirement reduces this income for life guarantee. For example, limited period annuities would use only a portion of the vested fund and would not pool mortality for the whole of customers' retirements. They therefore carry most of the mortality drag risks (see page 15) associated with income drawdown, i.e. the investment performance of the unannuitised fund needs to compensate for the annuitant's changing life expectancy for the income level to be sustained for subsequent limited period annuities and ultimately for the life-time annuity.

6. Most people have relatively small pension funds at retirement: more than 50% of pensioners aged 65 or under have pension funds of less than £50k, the average being around £30k. For them, purchase of a conventional lifetime annuity is usually best advice, representing the most effective way of converting their pension fund into a stream of lifetime income while containing the investment and mortality risks. But others whose funds or other income are sufficiently large may be less concerned about the prospect of diminishing pension income.

7. At present the scheme member has a number of choices when they come to buy an annuity such as whether it should be for a single or joint life, whether it should be fixed, with profits, or index linked and which provider offers the best bargain. Advice is an important feature in the decision. The suitability of more flexible products will also need to be included as part of the advice. Readers are invited to comment on the impact this will have on costs for financial advisers and consumers.

benefits

8. The policy options in this consultation paper will provide increased flexibility and choice to those who have to convert their pension savings into an annuity:

- limited period annuities would enable people to re-assess their situation in the light of changed financial and personal circumstances on a number of occasions instead of having to make a once and for all decision at the outset of retirement;

- they would bring the benefits of drawdown within the reach of those for whom drawdown would have otherwise been unsuitable;

- they would enable a fresh choice of insurer to be made on each occasion the limited period annuity is purchased;

- insurers would be able to provide limited period annuities using a wider range of financial securities as backing, so lowering costs;

- limited period annuities would enable additional providers to enter the market because they would be able to price the limited period annuity without regard to mortality rates (only a limited number of insurers have sufficiently reliable historical data on mortality to enable them to price life-time annuities appropriately);

- more suppliers should offer limited annuities, improving competition and hopefully value, to the benefit of the annuity purchaser.

costs and savings

9. The effect of the policy options to improve the annuity market is hard to estimate, but the costs to the Exchequer are not expected to be large. They will depend on behavioural change which is difficult to gauge in advance.

10. It is not clear whether there would be any additional costs incurred by providers in developing new more flexible annuity products as they are anyway constantly updating existing products and introducing new ones. Marketing of more flexible annuity products is optional; so no provider is obliged to pick up any extra costs. Those who do so would presumably see longer term benefits from doing so which would outweigh up-front costs.

11. If 5% of the market for new annuities switched to limited period products rather than income drawdown, their costs might be 1% rather than 6%, suggesting a total saving for pension scheme members of around £14m a year.

12. Comments on these aspects would be welcome.

securing compliance

13. Monitoring of compliance with new rules will form part of the Inland Revenue's normal compliance audits of pension schemes.

Annex 4 : how limited period annuities might work

This annex sets out one possible way in which the rules on limited period annuities might work, were they to be permitted for annuities bought with personal pension funds.

1. When someone vests a pension fund (or part of a pension fund) on retirement, they can take a tax free lump sum and with the remainder must do one of the following:
   - buy a retirement annuity for the remainder of their life
   - begin drawdown
   - buy a limited period annuity.

2. If the retired person buys an annuity for n years, its cost must be no more than the cost of a level annuity for n years at a rate r, where r is the rate of a level annuity which could be purchased for life using the whole fund. So the maximum annuity rate is equivalent to the maximum permitted rate of drawdown.

3. If the retired person buys an annuity for n years, it must cost at least 35% of the amount specified in (2). This is equivalent to the minimum rate of drawdown.

4. (2) and (3) together ensure that the amount of the fund not used to buy an annuity must lie within the same range as for drawdown.

5. The limited period annuity must end no later than the date when the pensioner reaches age 75.

6. Annuities in payment are taxed as income through schedule E.

7. At the end of a limited period annuity, the retired person has the same choices as in (1) except that the tax free lump sum cannot be taken again as the pension fund has already been vested.

8. By age 75, the retired person's capital must all be used to buy an annuity.

9. Any capital from a vested fund which is not annuitised when the retired person dies can be paid into his estate after an exit tax is deducted.

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