

The Annuities Market

December 2006



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EXECUTIVE SUMMARY

INTRODUCTION

In May 2006 the Government published *Security in retirement: towards a new pensions system*¹, a response to the challenges identified by the Pensions Commission's second report.² *Security in retirement* set out reforms to the state pensions system, and proposals for new "personal accounts" to enable individuals on low to middle incomes to save for their retirement.

This paper looks at the "decumulation" side of pensions – the use of retirement savings to provide a regular income in later years. It sets out in more detail the Government's policy and the evidence base behind it. A pension can be generated in two ways: a defined benefit scheme pays a proportion of final salary as an income, depending on how long the employee has contributed to the scheme. With a defined contribution scheme an individual builds up a pension fund which is turned into a retirement income for life through the purchase of an annuity.

The annuities market has tripled in size since 1991, with nearly 300,000 new contracts in 2005 totalling £8 billion in premiums.³ Demand for annuities will increase further as more pension savings are accumulated on a defined contribution basis, and the new system of personal accounts generates an estimated additional eight million new pension savers.⁴

Given the projected increase in demand for annuities, it is all the more important that the annuities market is working efficiently, and that consumers understand the choices open to them. Only around half of people take up the so-called "open market option" (OMO) of shopping around for their annuity to get the best deal. The Government intends to work with stakeholders to review the working of the OMO. It will also publish a long-term strategy for increasing financial capability in the UK which, among other things, is intended to boost consumers' understanding of the financial issues arising from pension saving and decumulation.

ANNUITIES — PENSIONS TAX RELIEF

The Government provides support for all pensioners, both financially and through improved access to services. The Government demonstrates its commitment to all pensioners through the basic State Pension, supported by additional support for the poorest. All individuals have a guaranteed income in retirement, delivered through the Minimum Income Guarantee.

The Government also encourages and supports people to make additional pension provision for themselves, by providing generous tax incentives for retirement saving. These totalled £14.3 billion across the UK in 2005–06.⁵

¹ *Security in retirement: towards a new pensions system* (Cm. 6841), DWP, May 2006.

² *A New Pension Settlement for the Twenty-First Century*. The Second Report of the Pensions Commission, 2005.

³ *Association of British Insurers, 2006*.

⁴ *Security in retirement*, page 45. May 2006.

⁵ This is a net figure. It includes tax relief given on all contributions by employees, employers and the national insurance rebate contribution. It also estimates relief on income within the fund. The figure nets off income tax recouped from pensions currently in payment. Source: HMRC.

Tax relief is given on pension contributions and the capital growth of the pension fund. The fundamental reason for giving this tax relief is to provide a pension income.⁶ Therefore when an individual comes to take their pension benefits they can take up to 25 per cent of the pension fund as a tax-free lump sum; the remainder must be converted into a pension – or in other words annuitised⁷ – between the ages of 50 (rising to 55 from 2010) and 75.

The Government welcomes the support of the Pensions Commission for the requirement to annuitise. This paper also responds to the future challenges highlighted by the Commission.

ANNUITIES – CONSUMER ISSUES

Value for money Annuities offer the benefits people want from a retirement income: “simplicity”, “security”, “a guaranteed income level” and “little or no risk”.⁸ Yet there remains some opposition to the requirement to annuitise: people argue that annuities are poor value for money or inflexible; or that they should be able to pass on accumulated savings to heirs. Chapter 2 of this paper sets out the evidence against these arguments.

A sizeable body of independent research – including the most comprehensive ever UK pricing survey published in March 2006 – suggests annuities are priced fairly.⁹ Today’s annuity rates need to be seen in the context of the low inflationary environment. People tend to underestimate how long they will live, so a guaranteed income for life looks less attractive if the purchaser believes it only needs to last for 15 years, say, whereas it actually needs to cover 19 years.¹⁰

The nature of annuities is often misunderstood. An annuity is an insurance product that pools risk between people. In the event of an annuitant’s early death, the unused part of their fund helps to pay the pension of those who live longer than expected. It is not “pure profit” for the provider.

The key challenge is to create flexibility within this market to enable individuals to purchase products that meet their needs.

Flexibility Flexibility is increasing in the annuities market. Individuals can choose when to annuitise, subject to age limits of 50 and 75, and providers continue to be innovative. There is now an increasing range of annuities available, including those that facilitate a flexible retirement and allow an individual to make scheduled withdrawals over several years instead of converting the whole pension fund. Annuities can also be tailored to an individual’s health or lifestyle, including dependents, and there are some that allow investment risk. Recent tax changes have also allowed providers to expand the range of annuity options in the early stages of retirement, including a value-protected annuity that allows some return of capital in the event of death before 75.

⁶ For the member or after a member’s death for a dependant – typically a spouse.

⁷ Where a scheme pension is not paid direct. Annuities are purchased by individuals in small to medium sized defined contribution pension schemes, which may be personal or occupational schemes. Some defined benefit schemes and large defined contribution schemes secure members’ benefits through purchasing annuities, but most pay scheme pensions.

⁸ *The Pension Annuity Market: Consumer Perceptions*, Association of British Insurers, 2005.

⁹ *Survey of annuity pricing*, DWP Research Paper 318, Edmund Cannon and Ian Tonks, 2006.

¹⁰ *How long do people expect to live? Results and implications*, O’Brien, C., Fenn, P. and Diacon, S., Centre for Risk and Insurance Studies, The University of Nottingham, 2005.

Bequests More than half of an individual's pension fund may consist of accumulated tax relief: the fundamental reason for requiring annuitisation rather than allowing funds to be passed on to heirs. There would be no rationale for the taxpayer to subsidise bequests through pensions tax reliefs. If individuals wish to save to pass assets on after death there are a number of non-pension savings and investment vehicles they can choose from.

These common issues that people have with annuities point to the need for better consumer education, which the Government will take forward in its long-term strategy on financial capability to be published shortly.

PENSIONS COMMISSION VIEWS

The Pensions Commission endorsed the principle of the Government's policy on annuities. They stated:¹¹

"Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time." (The Second Report of the Pensions Commission; page 227)

The Commission also highlighted a number of challenges in respect of annuities. Chapter 3 of this paper addresses the Pensions Commission views.

Widening access to drawdown products *"Government should investigate whether there are changes to regulation or tax treatment which can encourage the development of a wider market for drawdown products."* (The Second Report of the Pensions Commission; page 33)

An individual can leave their pension fund invested until they reach the age of 75 – and assume some exposure to investment risk – while at the same time drawing an income by taking small portions of their fund.

The Government has discussed this issue with the industry and consumer groups, but has found no support for the idea that the current tax or regulatory regime – which became more flexible on A-Day¹² – limits provision of drawdown products for the mass-market. Drawdown products are inherently more expensive than annuities because of the need to manage the fund actively. So it is likely to remain viable only for those with either large pension funds or sufficient other assets to bear investment risk. Consumer groups also did not see any advantage to developing mass-market drawdown products. However, there is increasing industry interest in what can be thought of as "mid-market" type products that combine elements of annuities and drawdown.

The Government therefore concludes that there is no evidence to suggest tax or regulatory barriers are inhibiting the market; rather it is the nature of drawdown products that limit their take-up.

¹¹ The Second Report of the Pensions Commission; relevant pages cited.

¹² A-Day refers to the comprehensive reform of pensions tax rules that came into force on 6 April 2006. Pre A-Day, individuals in drawdown could take an income equal to 35–100 per cent of a comparable annuity, while leaving the fund invested in an asset allocation of the individual's choice. After A-Day, there is no minimum income and the maximum income drawdown will be equal to 120 per cent of a comparable annuity.

Encouraging later annuitisation *“The primary focus of policy should be to encourage and facilitate later annuitisation.”* (The Second Report of the Pensions Commission; page 152)

Almost all individuals buy their annuity between the ages 60 and 69. This reflects current retirement patterns, with around two-thirds buying their annuity when they retire.¹³ Few people use the current flexibility provided by the 50–75 age limit. As people work longer, there is likely to be some natural movement towards later annuitisation.

The Government agrees with the Pensions Commission that delaying annuitisation up to 75 could be beneficial for many.¹⁴ Evidence does suggest that the benefits of later annuitisation are poorly understood. As set out in Chapter 3, delaying annuitisation retains the flexibility of when to annuitise, which can be valuable since annuity rates tend to increase with the age of annuitisation. It also gives individuals the opportunity to make additional pension contributions and allows their pension fund to enjoy additional investment growth. In extended periods of retirement some pensioners may want to take this into account. It is, however, difficult to make generalisations as the best age to annuitise will be for individuals to consider in the light of other income sources, life expectancy and attitudes to risk. The Government concludes that there is no case for policy measures to encourage later annuitisation across the board, beyond wider changes to facilitate longer working lives.

Age limits on annuitisation *“The ages of first and last possible annuitisation should rise over time in line with life expectancy.”* (The Second Report of the Pensions Commission; page 33)

The age of earliest possible annuitisation will rise from 50 to 55 in 2010, in line with Government policy to encourage greater participation in the labour market by older workers. The upper age limit does not currently appear to be a constraint: just one in twenty annuitise between ages 70 and 74.¹⁵

The Government does not believe there is currently a case for changing the current upper limit. Since working longer is an integral part of reforms to meet the pensions challenge, the Government will of course continue to keep both the lower and upper limits under review.

Cash limit on requirement to annuitise *“The Government should consider whether there is a case for a cash limit to the amount which individuals are required to annuitise at any age.”* (The Second Report of the Pensions Commission; page 33)

This proposal would allow individuals to annuitise to achieve a certain income level only and take the remaining cash out of their pension fund, subject to a tax charge. The Government continues to reject this option. The purpose of tax relief on pensions saving is to generate a retirement income. People can already draw 25 per cent of their pension fund in cash. It remains an option for people to save in a retirement vehicle for a basic income and invest elsewhere to generate an additional lump sum. The Government also believes that this change would be regressive. It would benefit those very few individuals with large pension funds while adding unnecessary complexity.

Market capacity issues *“In its debt issuance strategy, government should ensure that there are no artificial constraints on the supply of long-dated and index linked gilts.”* (The Second Report of the Pensions Commission; page 33)

¹³ *Annuities: The Consumer Experience*, Association of British Insurers, 2002. Also Pensions Commission second report, page 227.

¹⁴ *Annuities: A briefing document from the Actuarial Profession*, The Actuarial Profession, March 2004.

¹⁵ Association of British Insurers, 2002.

The annuities market has tripled over the past 15 years. The Pensions Commission's analysis suggests that supply of backing assets was not a block to the further expansion of the annuities market. The Government's debt management objective is to minimise cost subject to risk. In line with this objective, the Government has weighted its gilt issuance programme increasingly towards longer maturities and has extended the yield curve to 50 years during 2005–06.

Longevity bonds *“Government should consider the issue of longevity bonds which absorb (at an appropriate price) the risks relating to uncertain future mortality rates among very old people (e.g. over 90 year olds).”* (The Second Report of the Pensions Commission; page 33)

The Government maintains an open mind on issuing longevity bonds,¹⁶ but has no current plans to do so. Although an argument could be made for governments issuing longevity bonds, the decision to do so would imply an outright transfer of additional longevity risk onto the Government's balance sheet, which would raise policy issues that extend beyond a strict interpretation of debt management policy.

MARKET DEVELOPMENTS

The range of annuities available to consumers has grown significantly as the size of the market has grown. This includes products tailored towards individual lifestyle characteristics, such as for those who want to take on some investment risk or adopt a more flexible approach to retirement. The tax rules allow further flexibility in the early stages of retirement: before 75 providers can offer value-protected annuities allowing some money back on death or short-term annuities for a period of up to five years.

Industry continues to be active in looking to introduce new products, including those which combine features of annuities and drawdown, so-called “mid-market” products. The Government continues to welcome innovative ideas and is keen to discuss with industry and consumer groups the extent to which such products are in line with the principle of securing an income retirement, and understand whether there are any barriers stifling innovation.

Open market option Under the longstanding OMO, an individual is not required to purchase an annuity from the provider with whom they made their pension saving. They can shop around any providers to get the best deal for them. However, the numbers switching provider have been static in recent years and so people could be missing out on better deals when buying their annuity. The Association of British Insurers and the Financial Services Authority have worked hard to improve practices and consumer understanding about the OMO, but the advent of personal accounts has added extra impetus. The Government believes that it is a good time to work with key stakeholders to review the workings of the open market.

ALTERNATIVELY SECURED PENSIONS

In the course of developing its proposals for the new tax regime of A-Day, the Government received representations from certain religious groups that have principled religious objections to the pooling of mortality risk in annuities. Following consultation, the Government therefore brought forward legislation for Alternatively Secured Pensions (ASP) in Finance Act 2004 with subsequent refinement in Finance Act 2006. The Government has

¹⁶ This is a bond that has an interest rate linked to overall life expectancy rates. It increases in value if longevity rises and shrinks if it falls.

always made clear that the main reason for introducing ASP was to meet the needs of those who have a principled religious objection to the pooling of mortality risk. However, while the majority of the industry understands this, a minority continues to explore the scope for using ASP more widely to accumulate capital rather than to provide an income.

The changes announced at PBR 2006 aim to bring practice and policy intention into line and provide a fair balance between meeting the needs of those with principled religious objections to annuitisation while meeting the longstanding intention of the Government which provides generous tax relief on pensions in order that savings produce an income in retirement.

CONTINUING ENGAGEMENT WITH INDUSTRY

Since 1997 the Government has formally and informally engaged with industry on market developments on decumulation issues. In 2002 the “Modernising Annuities”¹⁷ consultation was launched on the future shape of annuity policy. In drawing together this current paper, the Government has fully engaged with industry on key market issues.

The Government recognises the importance of continuing to work with industry and other stakeholders. In particular, as detailed above, the Government is keen to:

- work with industry and other stakeholders on the review of the operating of the OMO;
- discuss with industry where they feel there are innovative products that meet the principles of a retirement income, but cannot be offered because of some specific tax or other barrier; and
- hold a continuing dialogue on all aspects of the annuity market to ensure it can continue to be innovative and meets the future challenges.

¹⁷ Modernising Annuities. http://www.hmrc.gov.uk/pdfs/mod_annuities.pdf.

SECURING AN INCOME IN RETIREMENT

Introduction I.1 In May 2006 the Government¹ published *Security In Retirement: towards a new pensions system*, responding to challenges set out by the Pensions Commission.² This White Paper set out reforms to the state pensions system, and proposals for new “personal accounts” to enable individuals on low to middle incomes to save for their retirement.

I.2 It is important that people can generate a secure retirement income from their pension fund. This is done by purchasing an annuity – a contract which exchanges the pension fund for a guaranteed regular income for life. The new system of personal accounts will also generate retirement income through annuitisation.³

I.3 The UK annuities market has more than tripled in size in the past fifteen years, with nearly 300,000 new contracts written in 2005 totalling £8 billion.⁴ This trend is expected to continue; in addition personal accounts will result in an estimated eight million new pensions savers.

I.4 The Government also committed in the White Paper⁵ to set “out more technical details on annuities and the underlying evidence base later in the year.” This paper fulfils that commitment and also responds to views of the Pensions Commission.

Table I.I: The annuity market

	Number of new policies	New premiums (£m)
2005	292,000	7,897
2004	349,000	7,504
2003	341,000	7,409
2002	330,000	7,248
2001	257,000	6,286
2000	250,000	5,731
1999	232,000	5,716
1998	232,000	5,755
1997	176,000	3,944
1996	147,000	3,994
1995	127,000	3,047
1994	115,000	2,623

Source: Association of British Insurers.

The Government’s commitment to all pensioners I.5 The state pension system seeks to achieve two objectives – to tackle pensioner poverty, and to provide a foundation for retirement incomes for all. The actions that the Government has taken since 1997 – establishing Pension Credit, Winter Fuel Payments and real term increases in the value of the basic State Pension—have helped pensioners escape from poverty.

¹ *Security in retirement: towards a new Pensions system*, Cm.6851, May 2006.

² Report of the Second Pensions Commission.

³ *Security in retirement*, Page 45.

⁴ Association of British Insurers, 2006.

⁵ *Security in retirement*, Page 59.

I.6 The Government demonstrates its commitment to all pensioners with guaranteed rises in the basic State Pension equivalent to the higher of RPI inflation or 2.5 per cent, as well as via provision of a State Second Pension. During the next Parliament, the Government will re-link the uprating of the basic State Pension to average earnings. The Government's objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. The Government will make a statement on the precise date at the beginning of the next Parliament.

I.7 Pension Credit channels more help to low and middle-income pensioners via a guaranteed minimum income and by rewarding those who have saved for retirement.

I.8 The Government recognises that people have differing needs and expectations for their lifestyle in retirement, and choose to save for retirement to provide a regular income to meet these needs. The Government provides generous tax incentives, £14.3 billion in 2005–06 to encourage people to make additional pensions provision.⁶

The “annuities deal”

I.9 In return for the generous tax relief on pensions saving, the Government requires individuals to turn their pension fund into a secure retirement income.⁷ This longstanding requirement dates back to the 1920s.

I.10 Tax relief is given on pension contributions and capital growth. On retirement, up to 25 per cent of the fund can be taken as a tax-free lump sum. The remainder must be annuitised at anytime between the ages of 50 (rising to 55 in 2010) and 75. Up to the age of 75 individuals have several options for drawing their income, including delaying annuitising, keeping their fund invested or buying short-term annuities. At 75 any individuals that has not already done so are required to annuitise.

What do individuals want in retirement?

I.11 Annuities therefore appear to match the income needs of those in retirement. While differences in spending habits across pensioner income groups and ages can make generalisations difficult,⁸ most pensioners require an element of regular income in their retirement to meet their outgoings. When asked, people commonly cite “simplicity”, “security”, “a guaranteed income level” and “little or no risk” as ideal characteristics of retirement income product.⁹

I.12 Consumers continue to have poor understanding of how long they will live. They are increasingly aware of a general upward trend in life expectancy but less so on how it might impact on them as individuals. Research shows that many expect to live to a similar age as the previous generation.¹⁰ The tendency for individuals to underestimate life expectancy lasts well into their retirement. In their 60s (when people are most likely to buy annuities) men underestimate their longevity by around 3 years and women by 4.5 years.¹¹ A clear risk faced by pensioners is that of outliving their assets, including their pension fund. Annuities remove this risk.

How annuities work

I.13 Annuities offer the peace of mind of a guaranteed income for life. Insurers have the detailed actuarial data to allow them to anticipate broadly how long a group of people will live for on average. This puts insurers in a better position to manage the risk of a group of individuals' funds running out during their lifetime than individuals would on their own.

⁶ Source: HMRC.

⁷ For a member or on a member's death a dependent—typically a spouse.

⁸ *Older People, Income, Wealth and Expenditure* Focus on Older People, 2005.

⁹ *The Pension Annuity Market: Consumer Perceptions*, Association of British Insurers, 2005.

¹⁰ *The Second Report of the Pensions Commission*.

¹¹ *How long do people expect to live? Results and implications*, O'Brien, C., Fenn, P. and Diacon, S., Centre for Risk and Insurance Studies, The University of Nottingham, June 2005.

I.14 Insurers do this by efficiently spreading – or “pooling”—this longevity risk among individuals. Because some people in a pool of annuitants die earlier than expected, the insurance company can afford to carry on paying those living longer than expected. So annuities are effectively insurance contracts: they insure an individual against the risk of out-living their pension fund.¹²

I.15 These mortality issues are fundamental to understanding what annuities are providing. The FSA defines mortality cross subsidy as follows: “insurance companies set their annuity rates knowing that some annuitants will die before their average life expectancy and some will live beyond it. Lifetime annuities are able to provide annuitants with an income for life because the unused funds of those who die earlier than expected help to pay the annuities of those who live on. This process is called mortality cross-subsidy.” “Mortality drag” is a related concept. The FSA defines as it: “to compensate for losing the cross-subsidy if you delay buying an annuity, your investments need to grow by an extra amount.”¹³

I.16 The insurer sets the price of an annuity by taking into account the age and gender of the individual. Just like any other insurance product insurers will rely on the “pooling” – in this case of mortality – to average out the individual’s experience.

¹² The seminal economic analysis of annuities is by Yaari (1956) and is based on them providing basic insurance properties. *Uncertain lifetime, life assurance and the theory of the consumer*, Yaari, M, Review of Economic Studies, vol. 32, no. 2, pp. 137–50 (1965). It is well known result from economics that introducing access to insurance is beneficial for individuals who do not like facing exposure to risk.

¹³ Source: FSA fact sheet – *Income withdrawal: A retirement option for you?*, April 2006, FSA Consumer website: www.fsa.gov.uk/consumer

2

ANNUITIES: SOME CONSUMER ISSUES

Introduction 2.1 Although annuities appear to match consumers' retirement needs, common issues continue to be raised around annuitisation. Given that many individuals may well have spent over 30 years contributing to a pension to meet their needs and aspirations in retirement, the Government understands that consumers want the best deal. The Government takes these consumer concerns seriously and welcomes the opportunity to respond to them in this paper.

Flexibility of retirement income policy

2.2 Individuals have discretion when to annuitise between the ages of 50 (55 from 2010) and 75 to suit their personal circumstances, and they can take up to 25 per cent of their pension fund as a tax-free lump sum. Consumers also have more choice in the type of annuity they purchase than ever before. These include annuities that facilitate a flexible retirement, those tailored to an individual's health or lifestyle and those that take on some investment risk.

2.3 There is also the flexibility for providers to offer individuals an annuity for up to 10 years, which will continue to pay income where the individual dies during that period; or a value protected annuity that offers some return of capital in the event of death before 75. Whether these products are taken up will depend on the extent to which consumers value the product features on offer. Individuals can also defer taking an annuity and instead take income drawdown until 75, whereby the fund remains invested with income drawn gradually from it.

Value for money

2.4 Annuity rates are lower¹ than in the recent past and many have expressed concerns that standard annuities offer "poor value for money". There are two key reasons why annuity rates at any given age are now lower than in the recent past: lower interest rates and increasing longevity.² Care needs to be taken when assessing the value for money of today's annuity rate, particularly when comparing with other prevailing asset yields or life expectancy over time. Lower interest rates normally come with lower inflation, and so the real purchasing power of an income stream is better maintained in a low inflation environment.

2.5 Independent studies have looked at how the expected income stream from an annuity over the life of a typical consumer in today's values relates to the size of the pension fund passed on to the insurer.³ This so-called "moneys worth" ratio is likely to be slightly less than one so the life insurer can cover their costs exposure to risk and make a commercially viable return. This focus purely on financial returns does not completely capture the benefits of annuities as it does not take into account the peace of mind provided by a guaranteed income stream. This element is more difficult to quantify but is a key characteristic of an annuity.

2.6 A sizeable body of independent evidence – including the most comprehensive ever UK annuities pricing survey – indicates that annuities are fairly priced. These studies typically find the "money's worth" is consistently in the region of 0.85–1.05.⁴ Box 2.1 includes some extracts from this research.

¹ *Annuities, Money Management*, October 2006.

² These issues are discussed in *Survey of annuity pricing*, DWP research Paper 318, Cannon, E. and Tonks, I. 2006.

³ In actuarial terms these studies compare the expected Net Present Value of the income stream with the premium paid to the insurer on annuitising.

⁴ These are discussed in Cannon and Tonks (2006).

Bequests

2.7 If there were no requirement to annuitise before 75, a higher rate taxpayer might be able to defer taking any benefit and, on death, pass a substantial pension fund of up to £1.5 million to their heirs. More than half of this fund could consist of accumulated tax relief. Such tax reliefs are not there to be passed on at the cost of all taxpayers. There is no rationale for the tax payer to subsidise bequests in this way.

2.8 No one should have entered into a pension scheme with the aim of being able to pass on their pension fund on death. Those who want to save for a bequest have a range of other savings and investment vehicles available to them.

Early death

2.9 Another consumer concern is the risk of dying soon after purchasing the annuity. This would mean that neither the annuitant nor the annuitant's estate received significant financial benefit. This misunderstands the nature of annuities. Annuities are insurance products. The benefit of buying insurance is peace of mind provided even if an event did not occur and no claim was made. But if the insured event does not occur (in this case living longer than expected) there is no return of the premium (the pension fund) so an annuitants' early death does not result in "pure profit" for the insurer. Rather it contributes to paying the pensions of those who live longer than expected.

2.10 The Government has responded to these "early death concerns" by giving providers the scope of offering value-protected annuities in the early stages of retirement. In this "value-protected" annuity product, the difference between the initial premium paid and the cumulated payments made to the annuitant (assuming this difference is positive) is paid to the estate if the annuitant dies in early retirement. This sum is subject to a tax charge, and the value protection option expires at age 75.

Improving understanding

2.11 The Government accepts that more needs to be done to continue to improve understanding of this aspect of pensions policy. The Government will publish a long-term strategy for increasing financial capability shortly. This will be a consultative document and the Government will welcome views on increasing consumers' understanding of this critical area of personal finance.

Box 2.1: Extracts from the latest most comprehensive available evidence on the pricing of annuities, DWP Research Paper, 318, Edmund Cannon and Ian Tonks, 2006

“Cannon and Tonks’ estimates of the money’s worth are reproduced in Table 4.4. In all cases the money’s worth is very close to unity, implying that annuities were sold at a rate which was approximately fair in actuarial terms.”

“Cannon and Tonks (2004b) have documented the declining number of annuity providers over the last 50 years, although the money’s worth calculations of Cannon and Tonks (2004a) discussed already suggest that this has had no impact on prices.”

“The market for annuities appears to function satisfactorily: analysis of the money’s worth suggests no evidence of monopoly pricing of annuities, and the providers have absorbed the growth in annuity demand to date.”

Source: Survey of annuity pricing

3

PENSIONS COMMISSION VIEWS

3.1 The Government welcomes the Pensions Commission’s endorsement of the requirement to annuitise by 75. The Pensions Commission commented:¹

“Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time.” (The Second Report of the Pensions Commission; page 227)

3.2 The Commission also set out its views on the future challenge for the annuities market in the future, and made some comments on the details of Government policy. This chapter addresses these in turn:

“Government should investigate whether there are changes to regulation or tax treatment which can encourage the development of a wider market for drawdown products.” (The Second Report of the Pensions Commission; page 33)

Encouraging income drawdown

3.3 Income drawdown is an alternative to buying an annuity for those up to the age of 75. Under this option the pension fund is invested and assumes some exposure to investment risk. Within set limits needed to prevent a fund from running out, individuals can draw an income by taking out small portions of their fund. Individuals are then required to annuitise by 75.

3.4 Because of the need to obtain investment advice and absorb continuing review costs, drawdown is only viable for larger pension funds: the Pensions Commission suggested a minimum of £100,000. This would currently amount to less than 5 per cent of funds. Table 3.1 shows the number and average value of income drawdown policies purchased over the last two years.

Table 3.1: Drawdown products sold

	Number of income drawdown policies purchased	Average purchase price, £
Q2 2006	6,092	105,925
Q1 2006	4,064	97,026
Q4 2005	3,446	112,442
Q3 2005	3,024	121,240
Q2 2005	2,580	147,833
Q1 2005	2,719	124,632
Q4 2004	3,131	125,580
Q3 2004	3,427	112,123
Q2 2004	2,983	122,380
Q1 2004	3,224	116,630

Source: Association of British Insurers.

¹ The Second Report of the Pensions Commission (relevant pages cited).

Tax and regulation issues

3.5 Limits are set on withdrawal to prevent a fund from running out of money. Changes made to coincide with pension simplification at A-Day have brought added flexibility to the drawdown regime. Prior to A-Day, individuals could take an income equal to 35–100 per cent of a comparable annuity they could have purchased with their pension fund assets. After A-Day, there is no minimum income and the maximum income drawdown is equal to 120 per cent of a comparable annuity.

3.6 As part of the wider consultation on the Pensions Commission report, the Government spoke with key providers and consumer groups about the drawdown market. Many felt that the fundamentals of the current decumulation tax and regulation regime did not pose barriers to mass-market drawdown.

3.7 Providers are developing products that look to add characteristics of standard annuities to drawdown products or add drawdown characteristics to an annuity. These have the potential to be tailored towards consumers with more modest funds but who want to take some elements of investment and mortality risk. Several such products are either on or close to the market.

3.8 The Government concluded there were no tax or regulatory barriers to mass-market drawdown in the near future. Rather, low take up is a result of the need for a large pension fund or other source of assets to make draw down economic. Box 3.1 discusses the economics of mass market drawdown in more detail.

Box 3.1: The economics of mass-market drawdown

Drawdown income comes from a fund invested in the stock market or from some other asset subject to market risk conditions. There will be a need for investment advice and regular reviews to ensure the fund does not run out of money. Drawdown consequently costs more to administer than conventional annuities. Over the life of the contract, these costs are estimated to be equivalent to around 5 per cent of the initial fund value. This percentage is likely to fall for larger funds since there is a larger stock of assets against which to set-off fixed costs.

By contrast, the ongoing costs of managing a conventional annuity contract are relatively modest. Although the provider needs continually to ensure that it has sufficient reserves to meet its total liabilities, there is no need for review at the individual level. And because the annuity sales process is simpler than for drawdown, commissions tend to be lower – typically 1-1.5 per cent.

Under drawdown, the growth of the fund will depend on investment performance, and for small funds this may not be large enough to offset the higher charges. Also, those with smaller funds are typically less likely to have other retirement income or savings to rely on in the event of poor investment performance in drawdown.

The potential risk of drawdown will be harder for them to bear. FSA consumer information warns that “income withdrawal is complex and not suitable for everyone.”²

Ages of annuitising

“the focus should be to encourage and facilitate later annuitisation.” (The Second Report of the Pensions Commission; page 152)

² FSA fact sheet www.fsa.gov.uk/consumer.

When do individuals annuitise? **3.9** Table 3.2 shows the latest evidence from the Association of British Insurers (ABI) on age of annuity purchase. It shows that the overwhelming majority of individuals annuitise between the ages of 60 and 69, with just one in twenty annuitising after 70. These figures are consistent with more up-to-date data cited by the Pensions Commission.³

Table 3.2: Age of annuitisation

Age of annuitisation	per cent
Before 60	14
60–64	40
65–69	41
70–74	5

Source: ABI 2002.

3.10 Any individual delaying annuitisation is likely to need other income to draw on in the meantime. For many the choice to exit the labour market “is one principally influenced by their financial security in having achieved savings sufficient for retirement income.”⁴ It is therefore not surprising that the pattern of current annuitisation largely reflects retirement patterns, with almost two-thirds buying their annuity when they retire.

Impact of longer working lives

3.11 As well as saving more in response to increased life expectancy, many individuals may choose to work longer to build up a retirement income. The Government has taken steps to outlaw age discrimination and promote older working. More years in work can enable greater accruals of state pension entitlements as well as giving the opportunity to benefit from tax relief on pension scheme contributions.

3.12 The continued success of the Government’s policy to extend working lives is likely to see a natural rise in the future in the numbers annuitising later. Since 1997, the employment rate of those aged between 50 and State Pension Age has increased from 65 per cent to over 70 per cent, and there are now more than a million individuals over State Pension Age who are in work.⁵ The Government has set a long-term aspiration to reach an employment rate equivalent to 80 per cent of the working-age population.⁶ This will include a million older workers.

3.13 Greater choice of retirement income products may also facilitate a shift towards later annuitisation. Growth in more “mid-market” type products that combine elements of annuities and drawdown may also facilitate the delay of full annuitisation.

At what age should individuals annuitise?

3.14 There are many variables for individuals to consider when deciding the best age at which to annuitise.⁷ While delaying will be beneficial for many, it is difficult to generalise. People have different needs in retirement, not to mention a diverse range of asset ownership and mortality patterns.⁸ As already noted the decision to annuitise for most people is driven by the decision to retire.

3.15 In general, annuities become more attractive relative to alternative assets at older ages. This reflects the principle of mortality pooling. Delaying annuitisation also gives individuals the opportunity to make additional pension contributions and for their fund to enjoy additional investment growth.

³ Association of British Insurers, 2002; Pensions Commission second report.

⁴ *The Pension Annuity Market: Developing a Middle Market*, Association of British Insurers, 2005.

⁵ Labour Force Survey; 2005 Spring Quarter.

⁶ *A new deal for welfare: Empowering people to work* (Cm. 6730), DWP, 2006.

⁷ *Annuity Options*, David Blake, Andrew Cairns and Kevin Dowd, Prepared for the Global Issues in Insurance Regulation conference, London, April 2002.

⁸ *Pension Wealth of ELSA Respondents*, Banks, James, Carl Emmerson and Gemma Tetlow (2005); Estimating IFS Working Paper WP -5/09, Institute for Fiscal Studies: www.ifs.org.uk/wps/wp0509.pdf.

3.16 Life expectancy adds another dimension. Between 1981 and 2002, life expectancy at age 50 increased by four and a half years for men and three years for women.⁹ For those aged 65 and over, life expectancy increased by three years and two years respectively. As a result many people may now spend up to thirty years or more in retirement. Over such an extended retirement period, it might be optimal for some consumers to assume some risk by delaying annuitising in order to secure the benefits of later annuitising in the future.

3.17 Given the range of factors involved, the Government does not believe a case exists for specific policy measures to encourage later annuitisation beyond changes to extend working lives. But it does, however, believe that consumers need more information and advice so that they can make informed decisions. This will be addressed in the Government's long-term strategy on financial capability.

3.18 The Pensions Commission also made the related recommendation that:

"The ages of first and last possible annuitisation should rise over time in line with life expectancy." (The Second Report of the Pensions Commission; page 33)

Minimum age already increasing

3.19 The minimum age for annuitisation will rise to 55 from 2010, as part of the Government's policy to promote active ageing and encourage greater participation in the labour market by older workers. There are no plans for further changes.

3.20 There is currently no pressure on the upper limit: only 5 percent of people annuitise after 70. This reflects current retirement patterns. The beneficiaries of raising the limit past 75 would be the very small number who can afford to defer all or most of their annuity.

Returns on alternative assets by around 75

3.21 The latest evidence from the Government Actuary's Department (GAD) also shows that increasingly during an individual's early 70s the rates of return required from investments in conventional assets become unrealistically high for any individual in retirement to justify further delaying annuitisation. This reflects the "mortality cross-subsidy" that those living after this age receive from annuitising discussed earlier.

3.22 Any investment that could provide an expected yield greater than an annuity after 75 would inevitably carry a significant degree of risk, which people in the later stages of life may be ill-equipped to bear.

Box 3.2: How annuities compare to alternative assets at age 75

The gap between the available annuity rate at a given age and the conventional interest rate is often referred to as "mortality drag". To compensate for losing the mortality cross-subsidy if an individual delays buying an annuity, investments in alternative assets would need to grow by an extra amount. This "mortality drag" increases with the age of annuitising as the benefits of mortality cross-subsidy increase.

Analysis by the GAD using the 2004-based population projections suggests that, on the basis of projected population mortality at age 75, men would need to make an investment return of around 3 percentage points above gilt yields and women around 2 percentage points to make delaying annuitisation worthwhile.

3.23 The Government does not believe there is currently a case for increasing age limits. However, facilitating later retirement is an integral part of pensions reform, and the Government will monitor both limits for consistency with this policy.

⁹ www.statistics.gov.uk/CCI/nugget.asp?ID=881&Pos=1&ColRank=1&Rank=374.

Cash limit to annuitising

“Government should consider whether there is a case for a cash limit to the amount which individuals are required to annuitise at any age.” (The Second Report of the Pensions Commission; page 33)

3.24 Under this recommendation, individuals would annuitise to a minimum income level and be able to withdraw the rest of their fund as a lump sum – subject to an appropriate tax charge. Although no level was recommended, it has often been suggested it should be a level sufficient to keep an individual off state benefits.

3.25 If the threshold income were set at such a level, at most the biggest 5 per cent of pension funds would be eligible to withdraw the remainder of their fund as a lump sum. So the concession would largely be irrelevant for pensions savers – as acknowledged by the Pensions Commission.¹⁰ It would have limited impact on demand for annuities.

3.26 This proposal would breach the Government’s fundamental principle that tax-privileged pension savings must be used to generate a pension income in retirement. People who want only a basic pension income are already free to save less – and take less tax relief – while saving more in a non-pension fund to use as they wish. The Government also believes that this change would be regressive. It would benefit those very few individuals with large pension funds while adding unnecessary complexity.

3.27 The Government therefore continues to rule out introducing this option.

Supply issues

“In its debt issuance strategy, government should ensure that there are no artificial constraints on the supply of long-dated and index linked gilts.” (The Second Report of the Pensions Commission: Page 33.)

3.28 Life insurers tend to match their annuity liabilities either with government bonds or with similarly low-risk assets such as corporate bonds or mortgages. Concerns are sometimes expressed relating to the supply of capital to support the annuity market, and particularly the supply of bonds. Some have suggested that increased demand for long-dated government debt by insurance companies that have issued annuities may have implications for the Government’s bond issuance. The Pensions Commission’s analysis suggests that supply was not an inherent block to expansion of the annuity market, and the market has absorbed a tripling of demand over the past 15 years.

3.29 The Government’s debt management objective is to minimise cost subject to risk. In line with this objective, the Government has weighted its gilt issuance programme increasingly towards longer maturities over the last few years (from 28 per cent of total issuance in 2003–04 to 47 per cent in 2005–06) and has extended the yield curve to 50 years during 2005–06.¹¹

“government should consider the issue of longevity bonds which absorb (at an appropriate price) the risks relating to uncertain future mortality rates among very old people (e.g. over 90 year olds).” (The Second Report of the Pensions Commission: Page 33.)

3.30 The decision to issue longevity bonds would transfer additional longevity risk onto the Government’s balance sheet, which would raise policy issues that extend beyond a strict interpretation of debt management policy. The Pensions Commission themselves say “the

¹⁰ Pensions Commission second report.

¹¹ Further details of the Government’s financing programme for 2006–07 can be found in the Debt and Reserves Management Report 2006–07, which was published alongside the Budget.

Government should not be an issuer of longevity bonds on a significant scale.” The Government maintains an open mind on issuing longevity bonds, but has no current plans to issue such bonds.

4

MARKET DEVELOPMENTS

4.1 The UK annuity market has tripled in size in the last 15 years. It is the largest market in the world with nearly 300,000 new contracts written in 2005 and premiums totalling around £8 billion.¹ It is at the forefront of innovation. The ABI has recently set up a new Retirement Income Group, made up of technical and marketing experts from its membership, which aims to strengthen industry thinking and practice on product innovation.

Recent developments

4.2 Over recent years there has been an increasing range of annuity products available on the market which give individuals more choice. Most individuals traditionally purchased a standard flat-rate annuity, which pays out the same amount every month until they die. New types of annuity products have more features, and are tailored to meet specific lifestyle needs and tastes. Box 4.1 illustrates some of the different types of annuities available.

Box 4.1: Choice of annuities

Single-level annuities are the simplest type of annuity. They pay out exactly the same amount to an individual (the “annuitant”) every month until the annuitant dies.

Guaranteed annuities pay out an annuity payment each month for at least the length of the guarantee period, even if the annuitant dies before the end of the guarantee period; in which case the guaranteed annuity payments are made into the annuitant’s estate. The maximum guarantee is ten years.

Inflation-linked annuities increase the annual payments by the rate of increase in the Retail Prices Index (RPI) to give payments protection against inflation. Escalating annuities increase by say 3 or 5 per cent to give the pensioner some protection against inflation and to allow for possible increased income needs as the annuitant ages.

Joint-life or last-survivor annuities pay an agreed annuity payment to an annuitant and the annuitant’s partner while both are alive. Following the death of the annuitant the contract pays either the same amount or an agreed reduced amount each month until the partner dies. The reduction in last-survivor annuities is typically a half to one third.

Investment-linked annuities involve the fund backing the annuity being invested in an equity product. The annuitant receives an annuity payment that is related to the performance of the equity market.

Impaired-life annuities pay an increased annuity payment if the annuitant has health problems, such as cancer, chronic asthma, diabetes, heart attack, high blood pressure, kidney failure, multiple sclerosis or stroke. Enhanced annuities pay a higher annuity payment related to actuarial considerations.

Phased-retirement or staggered-vesting annuities mean that instead of converting the whole pension fund, withdrawals are scheduled over several years. This is achieved by splitting the fund into many separate segments.

With-profits annuities link income directly to the performance of the insurance company’s with-profits fund. Typically, income is made up of two parts: a minimum starting income and bonuses.

Short-term annuities allow an individual before 75 to use part of a pension fund to buy a fixed-term annuity lasting up to five years. They can choose annuity options in much the same way as basic annuities.

Value-protected annuities will pay a lump sum on the death of the annuitant, equivalent to the difference between the original purchase price and total payments made. The lump sum is taxed at 35 per cent. They are only available until aged 75.

¹ Association of British Insurers, 2006.

4.3 In recent years annuities have become available that support flexible or phased retirement. These offer the flexibility to change the level of income taken when moving from part-time to full retirement. Instead of converting the whole pension fund at once, withdrawals can be scheduled over several years which is achieved by splitting the fund into separate segments.

4.4 Investment-linked annuities (with-profits or unit-linked) can offer a monthly income together with another element that will vary depending on the investment performance of an underlying asset. These are attractive alternatives for those who want the opportunity for continued investment growth, but want to secure an income in retirement.

Greater flexibility

4.5 Current tax rules enable providers to offer consumers further choice in the way they can draw an income in the early stages of retirement. For example value protected annuities in the early stages of retirement return some capital in the event of death before 75. Providers can also now offer short-term annuities until 75. Whether or not these newer products become mainstream will depend on the extent to which consumers value these characteristics or providers choose to offer them.

Growth of a “mid-market”

4.6 There is also increasing interest in so-called “mid-market” type products, which combine elements of a guaranteed income for life with some control over how much additional income can be taken out each year and how the fund is invested. These features can potentially offer:

- peace of mind from a guaranteed income;
- the ability for consumers to secure returns related to their longevity experience by entering a mortality pool;
- the ability for their fund to bear some investment risk; and
- the ability to vary the rate they can withdraw capital.

4.7 Whether such “mid-market” type products fall within the current pensions tax framework depends on the exact nature of the product being proposed. The current tax framework allows significant flexibility. The Government fully supports providers looking at new and innovative ways of providing income in retirement. Any new product, however, need to be consistent with the principle of turning retirement saving into a pension income for life. Such product characteristics would at a minimum include characteristics:

- from age 75 the product must offer a guaranteed income for life commensurate with the size of the fund and must provide for an annual income to be paid;
- it must not pay out lump sums during the member’s life (other than in the form of authorised lump sums set out in the tax rules);
- it must not permit any funds or income to be passed for the benefit of others (including on the death of a member) except as
 - pension for dependants (typically a spouse);
 - payments under a guarantee after the death of the member;
 - payments to comply with a pension sharing order;
 - as value protection/return of funds (where members dies before age 75); or

- part of the normal pooling of annuity funds, which secures the payment of the annuity for life; and
- be transparent in terms of what the product offers – particularly in terms of risk and value for money.

4.8 The Government is keen to take representations from industry where they feel that there are innovative products which meet the above characteristics but cannot be offered because of a specific tax or other reason.

Market challenges 4.9 Continuing innovation will be important in a changing market. The annuity market will continue to face challenges going forward. These include:

- *the continued shift of private sector pensions provision from defined benefit (DB) to defined contribution (DC) schemes will continue to boost annuity demand.* The Pensions Commission estimated that the number of active members of open DB schemes in the private sector has fallen by 60 per cent since 1995, by 50 per cent since 2000, and could fall by a further 10–20 per cent in the future. Many DB schemes essentially self-annuitise; so this transition will lead to greater demand for insurance sector annuities in the future.² Longer-term personal accounts will be rolled out in 2012;
- *life expectancy, both at birth and at 65, has increased dramatically; this trend is expected to continue.* Estimating future trends in life expectancy remains an uncertain science. Analysis by the Government Actuary's Department presented in the second Pensions Commission Report shows that the average man aged 65 in 2050 is now projected to live a further 23.6 years beyond that date, compared with the 2002-based estimate of 21.7 years. The figure for the average woman has increased from 24.4 to 25.9 years. The expected figures for 2020 have increased from 20.3 to 20.9 for men and 23.1 to 23.4 for women; and³
- *the number of older people working longer will continue to increase and retirement patterns could further change.* Since 1997, the employment rate of those aged between 50 and State Pension Age has increased from 65 per cent to over 70 per cent.⁴ The Government aims to have more than one million older workers in the labour market.

4.10 The annuity market has responded to challenges and has absorbed a tripling of demand in the last 15 years. This has been done against the background of the greater flexibility, choice and innovation documented above. There are no reasons why this should not continue in the future. The Government welcomes a dialogue with industry if there are prospective new products that provide a lifetime income but cannot be offered because of some specific tax (or other) barrier.

² The First Report of the Pensions Commission.

³ The Second Report of the Pensions Commission.

⁴ Labour Force Survey; Spring 2005.

THE OPEN MARKET OPTION

Exercising the open market option

4.11 It has been a longstanding Government policy that individuals can shop around for their annuity rather than remaining with the provider with whom they made their pension saving with. By exercising this so-called Open Market Option (OMO) an individual may obtain a better deal taking into account their personal needs and aspirations. Industry figures suggest that some people may be able to improve their annuity rate by as much as 30 per cent.⁵

4.12 This does not, of course, mean all individuals will or should always opt to buy their annuity from a different provider. That will depend on what different firms offer in respect of rates and types of annuity. In some cases an existing pension plan provider may actually offer the best deal.

4.13 Indeed despite the OMO the majority of people decide to stay with their existing pension provider. In 2005, only around one-third of people exercised their OMO to change their annuity provider. This figure has changed little in recent years.

Table 4.1: Numbers using the OMO to buy an annuity

	2000	2001	2002	2003	2004	2005
Per cent buying	27	33	35	31	33	32

4.14 Perhaps a better measure of how the open market is functioning is the number of people actively shopping around for their annuity, as opposed to the number who switch. This is more difficult to quantify. Research shows there has been some increase in both consumers' knowledge and understanding of annuities and use of the open market. In 2001 approximately two-thirds of annuitants did not even know even they could shop around for an annuity.⁶ More recent analysis by the ABI reported "an encouraging level of awareness in the right to shop around".⁷ Although this is welcome, around half of consumers still simply accept the annuity offered by their provider without even shopping around.

4.15 There are a number of factors that may explain why so few people make use of the OMO. They include:⁸

- consumer inertia and apathy;
- lack of awareness;
- complexity in application forms;
- lengthy timescales, particularly in transferring funds from one provider to another;
- people with smaller pension funds may find it difficult to find an annuity provider willing to quote (and difficult to find an adviser willing to help);

⁵ "Pensions: Annuities", *Money Management*, October 2006, pages 60–65; www.sharingpensions.co.uk/pension_annuity2.pdf; and www.fsa.gov.uk/tables

⁶ *MORI Financial Services, October 2001. Reported in Bulletin Number 6, October 2002, Comparative Tables Pension Annuities*, www.fsa.gov.uk/pubs/other/bulletin6.pdf

⁷ *Serious about Saving – Annuities, Bonus or Burden*, Association of British Insurers, 2005.

⁸ *Pensions Annuity Market: Developing a Middle Market*, Association of British Insurers, 2005.

- the percentage increase achieved through the open market may not look that attractive where pension funds are relatively small, though over many years they may prove worthwhile; or
- some people prefer to stay with the company with whom they have had a good relationship over the accumulation phase.

4.16 Various initiatives have been introduced to address the underlying causes of the problems noted above. For example, the FSA comparative tables have represented a major step forward in providing an accessible and easy way to exercise the OMO.

4.17 The FSA has also undertaken work to increase the financial capability of consumers and the ABI has worked with FSA support to set minimum industry standards and introduce a degree of consistency in consumer communication. This has been further revised and is very clear about what providers are required to say, for example in literature, about the open market option.

Reviewing the open market option

4.18 However with the increasing shift to defined contribution schemes and the new focus added by personal accounts that will be rolled out in 2012, the Government believes it is an appropriate time to review the operation of the OMO. HM Treasury and the Department of Work and Pensions will work together with a range of stakeholders to improve the operation of the OMO for consumers.

4.19 The review will build on the work done by industry and the FSA in recent years. It will ensure that the OMO continues to work well after the introduction of personal accounts. The design of the decumulation process for personal accounts will draw on the results of this review in creating a system that supports individuals in making good decisions about their annuities.

4.20 The review will have three fundamental aims:

1. To increase substantially the number of people exercising the OMO where appropriate.
2. To ensure that people make informed choices about their annuity type and fully understand the consequences of their choice.
3. To increase the number of people obtaining the best rate for their given choice.

4.24 With these aims in mind the review will explore:

- whether measures of success, such as an increase in the percentage of consumers exercising the open market option over a set period, should be set;
- the ways in which individuals are currently informed about the options of particular annuities, and whether changes should be made; and
- the potential for a more structured approach to annuity purchase. One stage could be where the individual decides the type of annuity that best suits their circumstances aided by suitable information and guidance. Following this, another stage could involve a consumer selecting the provider offering the best deal on this product, for instance with the aid of the FSA's comparative tables.

4.25 The review will also address the impact of abolishing the arrangements for contracting out of the State Second Pension on a defined contribution basis on the annuity market. The Department for Work and Pensions has recently conducted a consultation exercise on the possibility of removing the restrictions on the rights accrued in such schemes prior to abolition. This would include the requirement to take out a dual-life annuity if the person is married or in a civil partnership. If these restrictions are removed, the member could purchase a single-life annuity and potentially leave a survivor with no private pension. The OMO review should include consideration of this issue as well as the question of joint life annuities more generally.

CONTINUING ENGAGEMENT WITH INDUSTRY

Since 1997 the Government has formally and informally engaged with industry on market developments on decumulation issues. In 2002 the “Modernising Annuities”⁹ consultation was launched on the future shape of annuity policy. In drawing together this current paper, the Government has fully engaged with industry on key market issues.

The Government recognises the importance of continuing to work with industry and other stakeholders. In particular, as detailed above, the Government is keen to:

- work with industry and other stakeholders on the review of the operating of the OMO;
- discuss with industry where they feel there are innovative products that meet the principles of a retirement income, but cannot be offered because of some specific tax or other barrier; and
- hold a continuing dialogue on all aspects of the annuity market to ensure it can continue to be innovative and meets the future challenges.

⁹ Modernising Annuities. http://www.hmrc.gov.uk/pdfs/mod_annuities.pdf.

5

ALTERNATIVELY SECURED PENSIONS

INTRODUCTION

5.1 Successive Governments have offered tax relief on contributions to and investment growth in approved pension schemes in order that the savings produce an income in retirement. This principle remains central to the simplified tax regime introduced from April 2006 under provisions in Finance Acts 2004, 2005 and 2006. By saving in a tax-privileged pension, individuals are committing to using the funds for a secure income in retirement. This long-term commitment is recognised by the more generous tax treatment that pensions enjoy in comparison to other forms of saving.

5.2 The Government continues to believe that, other than for those who are paid a pension directly from their scheme, annuities are the best way to secure an income for life in retirement and welcomes the endorsement by the Pensions Commission of this fundamental principle. An annuity provides a guaranteed income for life regardless of how long that life turns out to be. As the Pensions Commission noted, people tend to underestimate how long they will live for in retirement, and without an annuity they could risk seeing their pension fund disappear if they withdrew portions until the end of their life. This would typically happen at the end of people's lives when they may be less able to deal with the consequences of this. A significant body of comprehensive independent research – including that most recently published in March 2006 – consistently shows annuities are priced fairly and do offer value for money.¹

5.3 Nevertheless, in the course of developing its proposals for the new tax regime the Government received representations from certain religious groups that have principled religious objections to the pooling of mortality risk in annuities. The Government therefore set out in paragraph 3.5 of the consultation document “Simplifying the taxation of pensions” (December 2003) its proposals for Alternately Secured Pension (ASP). The ASP option and the rules that applied to any sums remaining on the death of an ASP member were then enacted in Finance Act 2004.

5.4 The Government has always been clear that the principal reason for introducing ASP was to meet the specific need of a specific group. For example the then Financial Secretary said in July 2004:

- *“We have made this concession because people hold significant, principled, religious objections to the pooling of mortality risk. We will keep the matter under review and check to see whether abuse is occurring. We stand ready to make any changes that are needed to preserve the integrity of the tax system.”²*

5.5 Following the Finance Act 2004 the Government was concerned that without further changes ASP would be a widely available mechanism for avoiding annuitisation and enabling individuals to produce from their pension saving not a secure income in retirement but a capital sum that they could pass on to their heirs after age 75. The Government therefore announced in Budget 2006 proposals, enacted in Finance Act 2006, to apply inheritance tax to capital sums left in ASP fund.

5.6 The Government has received representations from the pensions and insurance industries that this measure has removed the risk of tax loss and that for the vast majority of customers, an annuity remains the best way of producing a secure income in retirement.

¹ Cannon and Tonks, 2006.

² Hansard — Finance Bill, Standing Committee, 8 June (column: 485).

However while the majority of the industry understands this, a minority continue to explore the scope for using ASP to accumulate capital rather than provide for an income. Such development both undermines the principle of producing a secure income from tax-privileged pension saving, and by deferring tax charges, has costs to the Exchequer.

5.7 The Government has considered whether it would be feasible to limit the availability of ASP to particular religious groups, but has concluded that such an arrangement would be impractical. The Government has also considered the option of withdrawing access to ASP altogether. However, to do so would deny the opportunity of taking advantage of tax-privileged pension saving to those with principled religious objections to annuitisation.

5.8 The Government therefore intends instead to introduce changes to the tax regime for ASPs to ensure that pension saving is used to provide an income in retirement. There will be two changes to the rules that currently apply to ASPs. First, there will be a requirement to withdraw a minimum level of income each year from an ASP fund. If the minimum income is not withdrawn then a scheme sanction charge will apply to the difference between the actual income drawn and the minimum amount. Secondly, the facility to pass on funds on death as a transfer lump sum death benefit will be removed from the authorised payment rules.

5.9 The Government has considered carefully the appropriate level for setting the minimum income. The Government wants to set a realistic level of minimum income to ensure that ASP funds are not used to build up capital after age 75 and do not endanger their ability to pay an income for the remainder of the individual's life.

5.10 The current maximum rate for ASP withdrawals of 70 per cent of the comparable annuity rate for a 75 year old was introduced to fix a general point at which it was very unlikely that the individual would outlive their savings if they took income up to this maximum each year. It has been generally accepted that this presents a low probability of the individual outliving their savings. While the Government considers that 70 per cent may be within a range of figures that will strike a balance between preventing the ASP fund being depleted too quickly and at the same time ensuring that the fund is used as intended to provide a retirement income, the Government recognises the case for a lower level as an additional safeguard for the security of the fund – and therefore intends that the new minimum rate be 65 per cent of the comparable annuity rate for a 75 year old.

5.11 The Government also recognises that there needs to be a range between the minimum and maximum amounts that an ASP fund can pay out, and therefore intends to increase the current maximum rate to 90% of the comparable annuity rate for a 75 year old. The Government believes that this would still provide an acceptable safeguard against the fund being seriously depleted if the individual exceeds normal life expectancy.

5.12 The second change to remove transfer lump sum death benefits from the authorised payment rules will mean that such payments in the future will be unauthorised and attract unauthorised payment charges of up to 70 per cent. This means that on the death of a member any remaining ASP funds can be authorised payments only where they are used to pay dependants' pension benefits, paid to a charity or in limited circumstances be repaid to the employer. The Inheritance Tax charges introduced in Finance Act 2006 on ASP funds will remain in place. The Government will be consulting with interested parties on how best to ensure the changes to the ASP rules are workable and that they interact correctly with the new unauthorised payment provisions. The changes will apply both to members and dependants ASP funds.

5.13 HM Revenue and Customs is publishing draft legislation on the changes on the HMRC website.³ The Government intends to include this legislation in the 2007 Finance Bill with effect from 6 April 2007. HM Revenue and Customs welcomes comments on whether the draft legislation meets the policy intentions.

5.14 These proposals will bring practice and policy intention into line, and provide a fair balance between meeting the needs of those with principled religious objections to annuitisation and the needs of the wider public who are provided with tax relief in order to enable individuals to produce an income in retirement. However, if these proposals prove unworkable, or there is continued evidence of use of pension tax relief to provide capital sums after retirement, the Government will need to consider whether to remove access to ASP altogether.

Tax regime for decumulation: other issues

5.15 More generally, the Government does not regard it as a proper use of tax privileged pension savings to provide:

- for payments outside the scope of the authorised benefit rules;
- a tax-advantaged route for some individuals to pass on wealth that would otherwise be subject to the mainstream IHT rules; or
- for pension benefits and funds to be passed to connected persons (other than as acceptable forms of dependants' benefits).

5.16 Schemes or arrangements designed to achieve the effects of the above are contrary to the underlying purpose to which tax relieved pension savings are intended to be put, and the Government will, where necessary, act against any such schemes or arrangements to ensure the new pension rules cannot be used for such purposes.

5.17 For example, HMRC has become aware of plans to use the rules for scheme pensions in order to preserve the maximum remaining pension pot on death of a scheme member and allocate this to the pension funds of other members of the scheme, who were connected with the deceased.

5.18 It would be wrong to allow a few who are intent on making inappropriate use of tax reliefs for pension savings when the cost of providing that relief falls to all taxpayers. Those who appropriately access the generous new tax reliefs for pension saving in order to produce a secure retirement income have a right to expect that others will also do the same.

5.19 Government will include legislation in Finance Bill 2007 to counteract such schemes, and will not hesitate to act decisively in the future against any arrangements which emerge which are designed to frustrate the Government's intention that tax-relieved pension savings are used only for their intended purposes.

³ Available at <http://www.hmrc.gov.uk/pbr2006>.

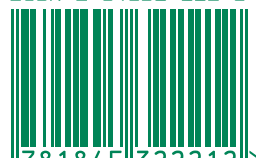
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CONCLUSIONS

6.1 The Government is committed to encouraging and supporting people to make pension savings. Generous tax reliefs are given on pension contributions and investment returns. In exchange, pension savings must ultimately be used to provide a pension in retirement via the purchase of an annuity (or a scheme pension). As set out in this paper, the Government believes that annuities meet consumers' needs in retirement. The Government's forthcoming long-term strategy on financial capability will, amongst other issues, look at ways to improve consumer's knowledge of annuities and the various flexibilities available.

6.2 Overall, the annuities market in the UK has responded well to increasing demand, tripling in size since 1991. The market has also introduced more variety of annuity products offering more flexibility and choice to individuals. The Government will continue to monitor annuities policy as the market develops and grows further and will address any barriers to efficiency as necessary to ensure the annuities market works effectively for consumers. To this end, this paper announces a review of the open market option whereby consumers can shop around to get the best annuity deal for their situation. Working with key stakeholders in and outside Government, the review will improve the open market option to ensure substantially more people take the opportunity to get the best deal for them in their retirement.

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