

Income in Retirement - are Annuities the Answer?

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PREFACE

The team at AUTIF first became interested in the question of annuities in the early 1990s when interest rates and annuity rates were still high. We were preparing a fact sheet for the public which compared PEPs and pensions and asked Nigel Hacking of Aspens, who has helped with this paper, to carry out some calculations comparing the likely income in retirement for those who saved through a personal pension and took an annuity, and those who took a PEP. The closeness of the comparison surprised all of us, and ever since then we have been wondering why people are forced to take an annuity, particularly given the lack of flexibility.

The persistent and welcome falls in interest rates over the past few years have drawn the question to the attention of a much wider audience. Last year we asked Oonagh McDonald if she would research the history and background of annuities and set out her conclusions on the current state of the market. This paper is the result. I have not seen such a comprehensive and intelligible treatment of annuities elsewhere. This paper does not answer all the questions. What we hope it will do is to inform and to stimulate the search for better solutions.

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Introduction

The current debate on UK pensions has focused almost entirely on how people make provision for their retirement – not on the more crucial question of how they will actually receive income in their retirement. This paper questions the present arrangements, specifically the obligation on people to buy annuities, and makes some proposals for change.

Under current law, people are obliged to purchase an annuity¹ by the age of 75, a requirement laid down in the 1986 Social Security Act for holders of personal pension plans. This repeated the obligation laid down in the Millard-Tucker Commission Report, 1954 and the subsequent Finance Act, 1956, which introduced tax reliefs on retirement annuity contracts for the self-employed, and was reiterated in the Income and Corporation Taxes Act, 1989. During that period, male life expectancy has increased considerably so that the obligation to purchase an annuity occurs about three years before the average life expectancy with the consequent loss of capital!

The general obligation to purchase an annuity apparently dates back to the 1921 Finance Act, when, as a result of pressure from the Conference of Superannuation Funds, the precursor of the National Association of Pension Funds, tax relief on employees' contributions to pension trust funds approved by the Inland Revenue, was introduced. In addition, the investment income from the funds was made free of tax, and income tax was only payable on pensions, when they were paid. These provisions were extended to all pension schemes, including self-employed pension schemes in successive Finance Acts (notably 1947; 1952, 1965 and 1970). The thrust to change the

taxation of pension trusts came from the inflationary pressures of World War I, which led the employers to become concerned about the impact of inflation and increased taxation on the value of the pensions which the fund could pay.

The effect of taxing the income from the pension fund (because both the capital and interest elements of an annuity purchased through an insurance company were taxed) was to encourage the payment of lump sum pensions, since these are not taxed. The Inland Revenue has, of course, been battling to reduce the lump sum entitlement ever since. But the 1921 Act covered the trust funds, which usually paid pension annuities and the Conference was quite satisfied that lump sums were not allowed by the Revenue in the tax-exempt 1921 Act funds. The Act set up the structure of the taxation of pensions which has become the norm since then.

The justification for the obligation to purchase an annuity has a long history as well. The now familiar arguments were stated as far back as 1888 in the Ridley Commission on the Civil Service:

‘The payment... of a lump sum is open to the obvious objection that in the event of improvidence or misfortune in the use of it, the retired public servant may be reduced to circumstances which might lead to his being an applicant for public and private charity’. And if civil servants cannot be trusted to manage their affairs, what hope is there for the rest of us!

The requirement to purchase an annuity applies only to those who have saved for retirement through personal pension plans, retirement annuity contracts, prior to 1988, or were members of defined contribution (money purchase) occupational pension schemes or who have provided themselves with supplements to their main pension through AVCs or FSAVCs (additional voluntary contributions and free

¹An annuity is defined as a ‘series of payments, which may be subject to increases, made at stated intervals until a particular event occurs. This event is most commonly at the end of a specified period or the death of the person receiving the annuity’.

standing additional voluntary contributions). For many people, this does not require specific action on their part, since their annuities will be bought for them through their occupational pension schemes (compulsory purchase annuities). The only exceptions are those who saved through defined benefit occupational schemes, who do not have to buy an annuity. Their pensions are paid out of the pension fund.

The growing number who make their own pension arrangements in whole or in part, do have to buy an annuity. For both classes, annuities have many drawbacks: they are complicated, they often offer poor value, they are risky, and they represent only one of several ways that retirees can secure their retirement income. The purpose of this paper is to show that the obligation to have an annuity is increasingly outdated, and that alternative ways of achieving the same objective – keeping retired people off social security – are available.

OCCUPATIONAL PENSIONS

There are two basic forms of occupational pension: defined contribution or money purchase (DC) and defined benefit (DB). In the first, the pool of money is accrued from employee and employer contributions and tax-free investment growth, but in the second, the rules specify the amount to be paid out, and the scheme is funded accordingly. In the first, the focus is on how much the worker and/or employer pays into a pension fund, and in the second on how much the worker will be paid out of the fund once he/she retires. In the former, the amount of pension depends on how much has been paid into the scheme and how well the investment has been managed. In the latter, the amount of pension received depends on the salary at or near retirement and on the number of years the individual has been a member of the scheme. The defined benefit scheme has the advantages of security: the individual knows before

retirement how much his income will be, that it will be increased in line with inflation (more or less – the rules are complex) and that the income is guaranteed. With the DC or money purchase scheme, the size of the pension depends entirely on the growth in the contributions and annuity rates at retirement.

A defined contribution scheme automatically leads to an annuity, and the retiree usually has to take no specific action, because the pension fund trustees will make the arrangements. In a defined contribution scheme a person must, on retirement, convert the accumulated sum into retirement benefits, i.e. a lump sum and income, the latter being provided through a compulsory purchase annuity. This converts the tax free pension fund into an income for life, which is taxable like ordinary income, with little or no return at death. The annuity is bought from an authorised life office, which invests the money in long-term stocks such as gilts. The yield on these investments determines the annuity rate and the amount of income the pensioner receives.

Is there a shift to DC schemes?

It is often claimed that employers are replacing the more traditional DB schemes with DC schemes, which are regarded as better for the employer, who no longer has to ensure that the pension fund matches the pension obligations, but less beneficial for the employee who has to assume more of the risk. However, the National Association of Pension Funds' annual review of UK occupational pension schemes, covering 613 organisations with assets of over £370 billion and some 6.8 million members and 4 million pensioners, puts this into perspective. The 1997 survey showed some movement towards DC (money purchase schemes), but the shift is slow, especially among the larger schemes. Compared to 1996, the number of schemes offering only money purchase benefits remained unchanged at 15%, but there was a small increase, from 4 to 6%, in schemes

offering a mixture of final salary and money purchase, (while retaining DB schemes for existing members).

The survey showed that 22 schemes introduced new money purchase sections during the year and 27 employers set up new money purchase schemes. By contrast, five schemes moved in the opposite direction, that is, they became final salary schemes.

However, although the NAPF survey is extremely important, it tends to cover the larger employers, and other surveys give a rather different picture. The Hartshead Solway pension scheme administration survey shows that 28% of the schemes assessed were considering significant changes to their products, with 73% looking at a defined contribution element and 50% at a fully defined contribution scheme. Major employers such as Zeneca, Barclays and Glaxo Wellcome have switched to defined contribution schemes, at least for new entrants. But although the shift to DC schemes continues, the pace of change has slowed down.

Another survey, Towers Perrin's survey of a hundred companies published in June 1998, showed that 38 companies already operated some form of defined contribution scheme. Taken together, these companies employed 350,000 people with a typical participant employing about 7,500. The range of occupations was very wide, including: hotels and leisure; high technology and electronics; oil and mining; pharmaceuticals and financial services. The other 62 companies did not currently offer a defined contribution scheme, but about a dozen were actively considering switching to a DC scheme and the rest were keeping the option under review.

Some employers cite the 1995 Pensions Act as one of the reasons for switching to DC schemes. The Act passed in response both to the Maxwell pension scandal and to pensions' misselling, is designed to protect employees in occupational pension schemes, and imposes a complex set of obligations on employees and trustees of pension schemes with

the principal aim of protecting employees in defined benefit schemes. But while the Act may well achieve its objective, it will do so at the price of increased bureaucracy and cost. Its minimum funding requirements, the ending of contribution holidays, and the open-ended nature of the guaranteed pension as well as the inflexibility of the defined benefit schemes - all these have led employers to reconsider their options.

However, not all the reasons given by employers for switching to DC schemes have to do with the Pensions Act. According to this survey, employers had three main objectives:

- 1) to control costs by removing the defined benefit guarantee and simplifying the administration of the scheme;
- 2) to ensure cost certainty, and
- 3) to make better provision for employees. Employers recognise that people change jobs several times during their working lives, so it is important to offer competitive benefits.

When a defined contribution scheme is introduced, employers often close the defined benefit scheme to new employees and give existing members the option of remaining in the current scheme. Some companies offer existing members the option of joining the new defined contribution scheme for future service, leaving the accrued benefits in the defined benefit scheme, and some allow members to join the new scheme for future service benefits and to transfer past service entitlements from the defined benefit scheme. In a small number of cases, younger employees were offered defined contribution arrangements as an initial plan, with the possibility of joining a defined benefit scheme at a later stage.

In all these cases, employees face much more complex choices than they did in the old days, when it was simply a matter of joining the company pension

scheme where you expected to spend most of your career. This places new burdens on employers to ensure that employees understand the implications of the choices facing them.

The future of DC schemes

Product providers have taken the view that defined contribution schemes will become the most important form of pension provision over the next decade. Flemings, for example, predicts that the money purchase market will increase to over £50 billion in value within ten years.

Defined contribution schemes take several forms:

- 1) Group contracted-out money purchase schemes. These are occupational schemes contracted-out of SERPS, but are rarely offered at present owing to administrative costs and the introduction of age-related rebates.
- 2) Group contracted-in money purchase schemes, that is, contracted into SERPS. These two types of money purchase scheme can be offered simultaneously as long as an appropriate personal pension is provided to collect the national insurance rebate.
- 3) A group personal pension scheme (GPP) is a collection of personal pensions taken out by a group of employees with a single provider, who offers favourable terms. If the employee moves to another job, he/she loses that advantage. There are other drawbacks, such as the risk that the transfer value may be lower than the contributions paid in if the employee changes job within a few years of joining the scheme.

However, the group personal pension scheme seems to be gaining in popularity. One provider, Winterthur Life, argues that “GPPs can provide a more flexible and less onerous pensions’ framework for larger employers. Ultimately the key decisions are about how much choice and freedom one wants to offer employees, the extent to which the employer wishes to be involved, and the financial commitment which employer and employee are prepared to undertake”. Other providers,

such as National Mutual, argue that “the trend for conversion from corporate schemes will gather pace as the effects of the Pensions Act take grip and advisers complete their reviews of existing corporate schemes.”

Money purchase schemes and GPPs are virtually identical, apart from certain regulatory requirements. Most pension providers have still not introduced a level charging structure so that projected cash transfer values after five years are some way behind the total value of the contributions paid in, according to the Personal Investment Authority’s third annual report on disclosure in the life and pensions industry. This is bad news for members of a group personal pension scheme where transfer values are crucial. Both schemes would certainly increase the number of retirees being obliged to purchase annuities, since that will be the form retirement income must take.

The Towers Perrin survey also shows that the majority of the companies surveyed (82%), use the members’ funds to purchase an annuity from an insurance company on retirement. Of these, 55% conduct a full market search for each new retiree; 14% use a panel of preferred providers from which individual members may choose; 14% have a special arrangement with a single insurance company and 10% leave the search to the individual member. A minority of companies (29%) converts the member’s fund into an annuity within the pension scheme at a rate determined by the scheme’s actuary, without offering the individual the choice of using an insurance company.

Almost all of the respondents (92%) offer members a wide choice at retirement with 100% allowing members to select the size of the spouse’s pension. For pre-1997 service-related contributions, 63% permit a non-escalating pension and 80% allow pensions increasing at a fixed rate to be purchased. Over 65% provide an option to purchase an index-linked pension, while 83% offer a five year guarantee period as an option. If there is no choice, then the scheme automatically fixes the size of the spouse’s pension

and the level of pension increases, and incorporates a five year guarantee period. These schemes all convert members' accumulated funds at retirement within the pension scheme into an 'annuity'.

These options raise important issues for trustees and, even more importantly, for retirees. These include not allowing the retiree any choice, regardless of his individual circumstances, and the lack of comparison of the internal annuity with the market at any one time, bearing in mind that the rates vary widely not only from one month to the next, but also between providers. Where the trustees conduct a full market search, questions arise over its efficiency, and where a panel is involved, over the extent to which the panel is kept up-to-date and therefore, whether the best providers at any one time are represented. All of these issues will become increasingly relevant as the number of defined contribution schemes increases.

PERSONAL PENSION PLANS

The right to take out such a plan and to opt out of the employer's pensions scheme was introduced in the Social Security Act, 1986 and first became available in July, 1988. At the same time, retirement annuity contracts were replaced by personal pension plans, although regular contributions to such plans can and do continue.

Personal pension plans may take a variety of forms, including appropriate personal pension schemes (or rebate only schemes, which are contracted out of SERPS); a group personal pension plan, which is simply a collection of individual personal pension schemes organised by the same employer; or an individual personal pension plan, taken out by the self-employed or by those individuals who opt-out of their employer's scheme. These are all defined contribution or money purchase schemes in which the size of the fund on retirement depends on the size of the individual's contributions, (which in turn are subject to both minimum and maximum contributions, laid down

by the Inland Revenue), and the costs and management of the investment fund. The individual, of course, takes all the investment risk.

The 1988 Act required the pension plan holder to take the accumulated value of the pension fund to purchase an annuity (although 25% of the fund can be taken as a tax-free lump sum). Income drawdown was introduced in the Finance Act, 1995, to allow personal pension plan holders to take the tax-free income on retirement but to defer the annuity purchase until the age of 75, if desired, and to draw down an agreed amount of income from the remaining capital.

CHOOSING AN ANNUITY

From the consumers' point of view, the choice of annuity presents two major problems: the requirement to make a choice immediately on retirement (for most retirees) and the bewildering array of choices, each with its own advantages and disadvantages. The details given below indicate the complexity of the choice to be made.

- (i) People emerging from defined contribution schemes must convert their accumulated funds into retirement benefits: a lump sum and a compulsory purchase annuity (where the scheme does not provide an internal annuity). The trustees of the pension scheme usually pay for the annuity but the individual member chooses the form of benefits received, frequently with the help of the trustees.
- (ii) The situation for personal pension policyholders is rather different. They can delay the purchase of an annuity until the age of 75 and may either allow the pension fund to accumulate with tax relief until then, or they can make use of income withdrawal. This gives the individual greater flexibility and the possibility of using the fund for reinvestment. The risk here is that the fund will be depleted to such an extent that the value of the annuity will drop, even if reasonable annuity rates are

maintained. This option may therefore only be suitable for people with a large pension fund.

- (iii) Holders of personal pension plans can exercise the 'open-market option', that is, they can purchase the annuity from a company other than the one in which they accumulated the pension fund. This is especially useful for those who have a large number of single pension plans as well as a regular pension plan as the pension itself can be provided by more than one provider. The problem here is that, although the option has been available since 1978, many companies do not tell their customers about it, especially if their annuity rates are uncompetitive. Some companies even charge customers when they exercise this option.

Types of annuities

For people without a large pension fund, the choice is limited to an annuity, of which an insurance company will typically offer the following range:

- (i) **Level-term annuities:** these pay a fixed amount in nominal terms for the life of the annuitant.
- (ii) **Escalating annuities:** for example, a constant-growth annuity in which the annuity increases annually at a fixed-rate of 3% or 5%. The problem here is that the starting rate for the pension is much lower than the level-annuity pension and that it takes a long time before the total value of an escalating annuity outweighs that of a non-escalating annuity. A 65 year old man who purchases an escalating annuity has to wait until he is nearly 80 before he gains any real advantage by his purchase.
- (iii) **With-profits annuities:** these allow the retiree to improve income by taking up an investment risk. Instead of relying on gilt yields, the pay-out depends on the level of bonuses declared each year by the chosen annuity company. The problem here is that the amount of the bonus is not known in advance, an obvious disadvantage for those with small pensions.

With-profits annuities can be adapted in a variety of ways, for example by anticipating future bonuses and adding part of them to income in the early years.

The risk here is that annual increases in the pension may be reduced or even disappear altogether. Some life offices offer a two-tier bonus system consisting of a 'reversionary' bonus which, once added to the pension, forms a permanent increase to the value of the annuity, and a terminal bonus which applies for a year at a time and fluctuates in value.

- (iv) **Unit-linked annuities:** here the pension fund is invested in a range of unit-linked funds, and the units are sold to provide income. This gives the pensioner access to equity investment, allowing for an increase in the value of the fund over the long-term. It does, however, put the pensioner's income at risk and is an expensive option because the life office charges extra for fund management. Unit-linked funds are subject to more volatility than with-profits funds, which means the resulting income can increase or decrease according to market conditions. Options (iii) and (iv) do not provide guaranteed income.
- (v) **Investment-linked annuities:** these are structured in the same way as conventional annuities except that the value of future payments fluctuates depending on investment returns instead of providing a guaranteed income. They can be single or joint life, with or without guarantee period and paid monthly etc. Income payments are recalculated each year and depend on the value of the underlying fund. Annuitants give up the guarantee of future income payments in expectation that the higher returns from equities will lead to higher income payments in the future.

When the annuity is purchased the company does not know the return it will obtain over the next 12 months, so the basic income is low until the end of the year when the actual gains are added to the annuity. Since most people want a higher level of income immediately, the annuitant can usually opt for a higher income on the assumption that a certain level of investment return is achieved. At the end of the year

the annuity is adjusted by deducting the anticipated growth and adding the actual growth. It is, however, a difficult matter to judge, and it is usually wiser to buy a fixed annuity when annuity rates are high and a with-profit annuity when they are low.

The advantage of an annuity is the mortality cross-subsidy (in effect, pensioners who die shortly after taking out an annuity subsidise those who live for a long time, as the life office retains the capital, and uses that capital to fund the income of those who live for a long time) and the disadvantage is the fixed rate. The advantage of income drawdown is the ability to invest in equity, but the disadvantage is that there is no mortality subsidy. Investment-linked annuities are the best way of combining insurance against longevity with the ability to obtain long-term growth.

- (vi) **Phased annuities:** these are available on larger personal pensions with a minimum purchase price of £100,000. Here the individual is allowed to 'spend' the retirement fund in stages, thus locking a small proportion of the fund into current annuity rates. This leaves the individual free to decide each year the amount of income and the options he would like to exercise. This total net income will be provided as a combination of the maximum tax free cash and an annuity. Enough segments of the pension fund are encashed to provide the annuity purchase price and tax free cash. The balance of the pension fund continues to be invested.

The attractions of this approach are obvious: flexibility and the opportunity to take advantage of better annuity rates. The disadvantages are that it requires a large pension fund, and, for most people, reliable financial advice. There are, of course, risks too: future annuity rates and investment returns are uncertain.

All of these annuities can come with the following variations:

- (i) **Contingent benefits:** as with the joint-life annuity, where the annuity continues until the death of the

surviving spouse; in the event of the pension scheme member dying first, the annuity sometimes continues at a lower rate, perhaps two-thirds or half of the original annuity. But the problem with joint life annuities is that they pay out between 10% and 25% less a year than a single annuity, a fact which is often not explained to annuity purchasers.

Other ways of providing for dependants include an annuity payable in arrears with proportion (that is, the annuity on death will pay the proportion owing since the last payment) or, as a more expensive alternative, buying an annuity with a guaranteed period. The first means that the insurer will pay out an amount to the survivor to cover the period from the last annuity payment to the death of the annuitant. The second alternative means that the annuity will go on paying out regularly even after the annuitant has died. The usual guaranteed periods are five or ten years. The annuity purchaser has to choose how the annuity is paid out. It could be a continued income, usually for ten years; or a discounted lump sum. This is an amount equal to the cost of buying an annuity up to the end of the guaranteed period. The third option is to select an undiscounted lump sum. This is an amount equal to the total pensions payments due to the end of a guaranteed period.

- (ii) **Minimum guarantee:** annuity payments are guaranteed for a certain period, such as five years, whether or not the annuitant dies before five years. The guarantee itself can be paid in several ways. Companies will allow the continued payment of the pension income; a lump sum payment equal to the total pension payments due to the end of the guaranteed period; or an immediate single payment equal in value to the price of an annuity capable of providing outstanding pension payments. There are differences between the guarantee offered to occupational pension schemes for compulsory purchase annuities, where guarantees of five years only are offered and can be paid as a lump sum less a discount for early payment. However, annuity purchasers from personal pension plans are not allowed to commute the payment to a

lump sum: it must be paid as income. The cost of these annuities rises with age. The Annuity Bureau calculates that a five year guarantee for a 65 year old would reduce the annuity income by 8% compared with that for a 60 year old, but at 70 the difference would be nearer 18%.

- (iii) **Capital protection:** the balance of the capital is paid to the annuitant’s estate when he dies. However, this option is only available for temporary life annuitants and not for compulsory purchase annuitants or for personal pension plan annuitants – in other words, it is not a means of providing for retirement.
- (iv) **Impaired life/rated annuities:** these annuities have attracted more publicity in recent years, although they have been available for some time. The principle behind them is that better annuity rates can be offered to someone whose life expectancy is less than indicated for someone of that age by the mortality tables. A few companies offer special annuities for people with medical conditions severe enough to affect their life expectancy (quality of life is not taken into account). These annuities increase the level of income, sometimes enhancing rates by as much as ten years equivalent. Such annuities involve an underwriting procedure similar to that for PHI insurance.

There is, however, a wide variation in the annuities available. Some companies do not offer impaired life annuities to people faced with compulsory purchase annuities on the grounds that impaired life calculations are built into all annuities purchased in this way. Only serious conditions are likely to make impaired life rates worth seeking. Even then, the ordinary rates offered by some companies are better than the impaired life annuity rates for others. There is a hidden danger for providers of all annuity rates – for unimpaired as well as impaired lives. Such is the pace of development in medical science that cures for killers like cancer and heart disease may lie just over the horizon. Their discovery could dramatically lengthen life-spans and spell severe problems for life

offices and friendly societies with large annuity portfolios. It means that the life offices could make the mistake of assuming that all impaired life annuitants would die, say, within a year or two at the most, but then find that the holders of such annuities were cured and lived far longer than the life offices expected.

Actual annuity purchases

Many purchasers of annuities are unaware of the costs and penalties they may face, when they come to retirement and have to buy an annuity. The value of the fund on retirement is often quite small – typically less than £30,000.

The following figures give some idea of the pension income from an annuity purchase. These rates are for a purchase price of £100,000, paid monthly in advance.

Guaranteed 5 years and with no escalation			
Male aged 60		Male aged 65	
Stalwart Smoker	£8,856.00	Stalwart Smoker	£9,948.00
Standard Life	£7,988.00	Standard Life	£9,104.40
Female aged 60		Female aged 65	
Stalwart Smoker	£7,822.00	Stalwart Smoker	£8,682.00
Commercial Union	£7,081.92	Commercial Union	£8041.00
Guaranteed 5 years, 5% escalation			
Male aged 60		Male aged 65	
Stalwart Smoker:	£5,476.00		£6,564.00
Scottish Life;	£4,853.04		£5,925.00
Female aged 60		Female aged 65	
Stalwart Smoker:	£4,504.00		£5,356.00
Standard Life:	£3,932.00		£4,808.40
Guaranteed 5 years, Index-linked (RPI)			
Male aged 60		Male aged 65	
Equitable Life:	£6,111.96		£7,158.96
Norwich Life;	£5,520.96		£6,534.00
Female aged 60		Female aged 65	
Equitable Life:	£5,388.00		£6,170.04
Scottish Life:	£4,571.04		£5,322.96

(Source: William Burrows Annuities)

These illustrations (drawn from mid-1998 annuity rates) show the attraction of a level-term annuity, where the income immediately available is much higher than that from an index-linked annuity.

On the other hand, the decline in income through the impact of inflation on a level-term annuity is easily seen from the average life expectancy tables:

English Life Tables (a) (1980 to 1982)

Male aged 60 = 16.38 Female aged 60 = 20.89
 Male aged 65 = 13.04 Female aged 65 = 16.98

English Life Tables (b) (1990 to 1992)

Male aged 60 = 17.85 Female aged 60 = 22.08
 Male aged 65 = 14.27 Female aged 65 = 18.11

The Retirement Income Table, page 15, shows very clearly the disadvantages of a level-term annuity. The impact that inflation could have over a period of 18 years or more on annuities purchased at the age of 60 is considerable: if we assume for the purposes of illustration that a male aged 60 has a fund of £100,000 with which to purchase a level-term annuity, an annual rate of inflation of 3.0% reduces the income in real terms from £8,333 p.a. to £4,895 p.a. at the age of 78. The reduction in income could also occur at a time when costs might increase sharply due to the need for long-term care: the current cost of a nursing home is approximately £18,000 per year.

On the other hand, the same assumptions applied to the RPI-linked annuity shows the income remaining constant in real terms at £6,112 p.a. and a with-profits annuity (on the assumption of 8% investment returns) and the same inflation assumptions starts at £8,691 at the age of 60 declining to £6,567 at the age of 78.

However, life offices do not use the English life tables because they are based on the general population. Instead they price their annuities on the life expectancy of their own population of purchasers. This means that life expectancy is likely to be

somewhat higher than the average, given the class, background, work experience and means available to those who purchase annuities.

Annuities can be paid at whatever frequency the purchaser chooses at the beginning of the contract, usually monthly, quarterly, half yearly or annually. Again few purchasers realise that choosing a monthly rather than annual payment can reduce income by an average of 7%.

A further significant disadvantage for DC contribution schemes and personal pension plans compared to DB schemes is the lack of provision for spouses and partners. Much progress has been made in defined benefit schemes in recent years to provide for widows and widowers, and partners as well. The early death of a pensioner with an annuity without such arrangements could result in real hardship for the surviving spouse. That can be seen from the figures given below:

Joint Life 2/3 spouse. Guaranteed 5 years. No escalation.			
Male 60/Female 65.		Male 65/Female 60	
Stalwart Smokers	£7,529.00	Stalwart Smokers:	£8,273.00
Stalwart	£6,779.00	Stalwart	£7,529.00
Joint Life 2/3 spouse. Guaranteed 5 years. Escalating by 5%			
Male 60/Female 65		Male 65/Female 60	
Stalwart Smokers:	£4,231.00		£4,985.00
Legal & General.	£3,694.80		£4,285.32
Joint Life 2/3 Spouse. Guaranteed 5 years. Index linked (RPI)			
Male 60/Female 65		Male 65/Female 60	
Equitable Life:	£4,980.96		£5,610.96
Scottish Life	£4,230.00		£4,853.04

However to a cynically-minded government, a small annuity (based, for example on a fund of £25,000 yielding £2,000 per year), decreasing in value in real terms over the years and disappearing with the death of the annuitant, would still be enough to prevent the pensioner from claiming income support.

The growth in the number of annuitants

Obtaining accurate figures for the total number of annuitants, and for a male/female split, is difficult because the figures are not centrally compiled and many people have a number of different annuities and pension plans. Yet this is significant from the point of view of public policy and the potential source of pressures for changing the obligation to purchase an annuity. Government policies, since 1988 in particular, have led to and will continue to lead to a steep increase in defined contribution schemes of various kinds, and therefore to enormous increases in the numbers of annuitants.

The 1995 figures indicate that at least 5 million individuals will have to purchase annuities at some point in the future. As yet, the numbers are insufficient to call into question this means of retirement income provision, although there are rumblings of discontent. This discontent is bound to grow, as women will increasingly protest at unequal income from their pension funds, and as the poor returns on pension funds become ever more apparent.

The profile of current annuity purchasers, derived from two life offices illustrate some of the difficulties arising from turning annuities into what will probably be the main form of retirement income provision. At the first life office, almost all the purchases of annuities (98%) were through independent financial advisers (IFAs) with the rest through direct sales. In 1997, a total of 16,457 male and 6,712 female annuities were sold with total purchase prices of £519.9 million and £119.5 million respectively, a slice of the market currently worth £5 billion a year. This life office has seen a growing number of female annuitants, though this could be due to its rate structure. This is balanced by the expectation that the market for annuities for women will grow as an increasing number are buying personal pension plans.

The second life office has a male/female split of 76% and 24% with the major source of funds being personal pension funds. Other interesting features

emerge from the company's figures; for example, 90% of the male purchasers are married, but only 41% of them purchase annuities with spouse's benefits. The reason is that the cost of these benefits has a heavy impact on the income received in retirement, as the figures given overleaf show. This puts annuities out of line with other forms of pension provision, where spouse's benefits are an integral part of the retirement package. The choices indicated above, although understandable, show the inadequacies of annuities as a means of providing retirement income. This becomes clearer when the actual choices facing annuity purchasers are examined in later sections.

Funding annuities

What of the funding to provide annuities?

The annuities themselves are funded through investments in undated gilt-edged securities. The life offices make their profits by paying out less over the years to annuitants than they make from investing purchase premiums – and also by keeping whatever capital that is left over when annuitants die, since the capital protection option (that is, when the balance of the capital is paid to the annuitant's estate when he dies), is not open for retirement income. Although the potential market is huge and growing rapidly as purchasers of personal pension plans, AVCs and FSACVs as well as members of defined contribution schemes, have to purchase annuities, interestingly enough, the life offices do not view the market with favour. They tend to move in and out of the market, depending on the perceived profitability. At the same time, any life office will assure the inquirer that the business is not profitable and that they virtually provide annuities as a public service.

Furthermore, annuitants, who survive up to the average period after retirement, cross-subsidise those who live longer. Increased longevity may therefore squeeze profit margins. Competition may also have this effect since insurers who are serious about annuity provision have to quote the highest rates, all of which are published on a weekly or monthly basis.

Annuity rates are set in relation to the yield on gilts and prevailing interest rates. When interest rates are low, the income provided by an annuity will be low as well. The figures given below indicate the way in which annuity rates have fallen during the nineties.

Annuity Rates

October 1990 = 15.64%	October 1995 = 11.09%
October 1991 = 14.15%	October 1996 = 11.07%
October 1992 = 12.89%	October 1997 = 10.15%
October 1993 = 11.12%	May 1998 = 9.53%
October 1994 = 11.90%	March 1999 = 8.86%

Based on a male, aged 65, single life, level-term annuity.

Source: Annuities Solution.

The problem for annuity providers and for the whole area of future pension provision is that interest rates are expected to continue to fall. So the government's intention to reduce public borrowing could defeat another of its declared objectives; to make individuals provide for themselves in retirement. Such an objective cannot be achieved by insisting that people purchase annuities.

Of course, the government could argue that annuity rates are not low in real terms and that people will simply have to adapt to low annuity rates in nominal terms. The government's stated inflation and public expenditure objectives are entirely clear, and they are both achievable and will be achieved. But a level-term annuity at low nominal rates would apply for some eighteen years or more, and few economists are prepared to declare the death of inflation.

The investments underlying annuities vary according to their type. The return from a conventional annuity is fixed at the time of purchase and is closely linked to the yield on gilts, and as the annuity money comes in the insurance company will buy enough of the suitably dated gilt-edged stock to match it. However, investments for annuities are bringing diminishing returns, and not only for the reasons cited above. The advent of the euro is expected to lead to lower

interest rates and to keep them low. Indeed, it is now possible to match or exceed annuity rates simply through prudent investment.

Is income drawdown a solution?

The Inland Revenue proposed to extend the availability of income drawdown (i.e. allowing the individual to take part of the fund in income each year), to insured money purchase occupational pension schemes. A limited version of this proposal is likely to be introduced later this year, and will apply to AVCs and FSAVCs in the first instance. This is part of a drive to make the option available to more investors, an unsurprising move in light of lower interest rates and earlier retirement. By May, 1998, approximately £3 billion of premiums had been invested in drawdown policies, of which £1.3 billion was transacted by Equitable Life.

The attractions of income withdrawal are various. The main one is that it provides greater flexibility in income provision and allows the individual to retain control of his pension fund, features which are likely to become increasingly important in a period when interest rates are likely to be low, and many pensioners will have to fund their own long-term care. It also enables policyholders to avoid poor annuity rates on retirement and take tax-free cash without having to buy an annuity. On the other hand, they can invest the accumulated fund while still withdrawing an income.

The disadvantages are that the costs of drawdown plans are high: commission charges are well in excess of the costs of arranging annuities. There are also significant risks, including the possibility that high income withdrawals may not be sustainable during the deferral period. Withdrawals may also erode the capital value of the fund, especially if investment returns are poor or a high level of income is taken. Investors have been known to withdraw income with funds as low as £10,000 – and have been allowed, even encouraged, to do so by product providers. Funds need to contain at least £250,000 to make withdrawal feasible, in the view of most IFAs.

But there are also risks for those with substantial funds. The investment returns may be less than anticipated, which will deplete the funds available for annuity purchase. While it may seem an advantage to postpone the purchase of an annuity when rates are low, the disadvantage is that they may go lower still. Thus, although income withdrawal may provide a solution for some, it is still overshadowed by the compulsion to purchase an annuity by the age of 75, and decisions about income withdrawal are inevitably made with that in mind, or at least they should be.

Why have compulsory purchase annuities?

In view of the risks and costs involved, the real question arises: why should the purchase of an annuity be compulsory?

The disadvantages of annuities from the point of view of the purchaser are clear:

1. Most purchasers are likely to buy level-term annuities, which are not inflation-protected. An analysis of one life office's annuity sales in 1998 shows that 74.6% were level-term annuities, and 19.3% were escalating annuities of 3% per annum. The industry average is currently 83% compared with the 11.1% who opt for alternatives, including unit-linked and with-profit annuities, income drawdown and phased retirement; and the 5.3% who opt for escalating annuities. The same life office surveyed people about to retire and found that most wished to buy an escalating annuity because they thought it was sensible to provide for future rises in the cost of living. But when it came to the actual purchase, the vast majority opted for a level term annuity. The tables show why: the attraction of maximum income in the early months and years is too great, and perhaps many people do not really believe that they will live to be 70 or 80. Increases in longevity will make this type of annuity less attractive.
2. Annuity purchasers are locked into the interest rates available at the time of purchase. It is an entirely inflexible contract.
3. Finally, it is a disincentive for savers to risk losing their capital through annuity purchase. It should be possible to bequeath the remaining capital to relatives and friends, subject to inheritance tax. This point was expressed forcefully in a letter to the Financial Times, dated July 14th, 1998 entitled:

Government's dictate on annuities is the real pension scandal

'Who, in their right mind, would hand over voluntarily their capital (perhaps saved over 40 years) losing all control of it for a 4.5 or 5% annual return? They can currently get 8% or so, with no risk, in a building society, or capital growth and dividends of 15.5% upwards, or so the pension companies say they can achieve when selling themselves to us.

It must be a scandal to be forced to hand over forever one's hard-saved capital at retirement to an insurance company, which will pay a return, while you are alive, of currently less than a third of what it will earn on it. Why is the government so generous to insurance companies and extortionate to those who have saved for retirement?'

(A.M. Scriven, 8 St Mary's Walk, London SE11 4UA).
4. Furthermore, as the Government seeks to encourage (rather than compel) people to save for their own retirement, the emergence of all the disadvantages of annuities could not have come at a worse time. It is hard to explain why, even with all the tax reliefs available to the personal pension plan holder, people should struggle to save £100,000 or so, only to find that it will only buy them an income of little more than the basic state pension at 1998 rates (the married couple's pension is currently £5,379.92 which with income support, which, assuming no other savings, rises to £5,686.20 plus other benefits such as housing benefit) at the sacrifice of handing over all their capital. And, of course, few forecasters are expecting the rates to improve.

Apart from these disadvantages, there is the consideration that individuals with larger pension funds will have sufficient capital to provide a reasonable level of income in retirement without having to buy an annuity (although the average size of pension funds is currently under £30,000, the range extends from £5,000 to £3 million, the highest known purchase according to one life office). The purchase should therefore be optional rather than compulsory, though this would increase the need to advise people on how to provide for retirement.

ARE THERE ANY ALTERNATIVES TO ANNUITIES?

Annuities are subject to tax like all retirement income (apart from the tax-free lump sum). The advantages from the point of view of the Inland Revenue are two-fold:

- there is a clearly defined income stream which is subject to normal income tax rules, and
- the individual has no access to his capital once an annuity has been purchased. Hence there is no danger of people dissipating their capital and throwing themselves on the mercy of the state.

Setting aside the unduly patronising attitude, these 'advantages' can be obtained by other means, and without the disadvantages of annuities.

One way would be by creating a retirement account in which the individual saved over a period of, say, 30 years and could then draw down the fund over the next 20 years. Assuming retirement at 60 to 65, this would easily cover average life expectancy for both males and females at 60 or 65, and allow for flexibility, for example by building up the fund over 30 years and taking retirement at 55.

The attached table shows how such a fund would look over a 30 year build-up and a 20 year drawdown. The assumptions on which this is based are as follows:

- (i) An investment return, before charges, of 8% per annum, that is a real return of 5% per annum assuming annual inflation of 3%.
- (ii) The assumed 8% return comprises 4% per annum income and 4% per annum capital growth (although this could be somewhat optimistic given the removal of ACT).
- (iii) The 4% per annum investment income is assumed to remain constant throughout the period (that is, the assumption is that there is a constant dividend yield on equities). However, the amount of investment income will increase in absolute terms because the investment income yield is applied to an increasing fund value (except during drawdown).
- (iv) During drawdown, the income drawings are set at a level to reduce the fund to zero over the 30 year period, allowing for the investment returns. These projections are based on achieving this by drawing a level income in absolute terms. Hence in real terms, the projections produce a falling income.
- (v) It would also be possible to use bonds rather than equities, which, while providing greater security, would result in a lower accumulated fund and a lower retirement income.

RETIREMENT INCOME OPTIONS (Retirement Income Fund = £100,000) Male aged 60

ASSUMPTIONS

Price inflation	3.00%	
Investment Returns	8.00%	WP fund
(before charges)	8.00%	Retirement Income Account
Income Increases	2.50%	

EXPENSES OF RETIREMENT INCOME ACCOUNT

Fund Charge	1%
Initial Charge	5%
Admin Fee	£100 per annum
	increasing with RPI

AGE	RETIREMENT INCOME ACCOUNT			RETIREMENT INCOME ACCOUNT
	LEVEL ANNUITY £ PER ANNUM	RPI-LINKED ANNUITY £ PER ANNUM	WITH-PROFITS ANNUITY £ PER ANNUM	INCOME £ PER ANNUM
60	8,333	6,112	8,691	7,000
61	8,090	6,112	8,557	6,966
62	7,855	6,112	8,424	6,932
63	7,626	6,112	8,294	6,899
64	7,404	6,112	8,166	6,865
65	7,188	6,112	8,040	6,832
66	6,979	6,112	7,916	6,799
67	6,775	6,112	7,793	6,766
68	6,578	6,112	7,673	6,733
69	6,387	6,112	7,554	6,700
70	6,201	6,112	7,438	6,668
71	6,020	6,112	7,323	6,635
72	5,845	6,112	7,210	6,603
73	5,674	6,112	7,098	6,571
74	5,509	6,112	6,989	6,539
75	5,349	6,112	6,881	6,507
76	5,193	6,112	6,774	6,476
77	5,042	6,112	6,670	6,444
78	4,895	6,112	6,567	6,413
79	4,752	6,112	6,465	6,382
80	4,614	6,112	6,365	6,351

Note:

Annuities based on market rates in force as at August 1998. All incomes in real terms i.e. discounting for 3% inflation.

CONCLUSION

The further concessions in the direction of income drawdown and the introduction of greater flexibility into the timing of the take-up of pensions shows that the government and its officials are beginning to recognise the disadvantages of annuities. The increasing number of annuitants will bring further pressures of all kinds on the Government to remove the obligation to purchase annuities from both pension plan holders, and members of DC schemes.

The arguments for compulsory annuity purchase were set out in the 1920s and have been reproduced ever since in a mindless fashion. The identifiable and easily taxable income stream provided by annuities, which might be more convenient for the purposes of tax collection, is much less defensible with the advent of self-assessment. The financial services industry has developed in ways which could not have been foreseen in the 1950s. One example of an alternative way of providing retirement income has been provided. Once the compulsory purchase of annuities has been removed, the industry will undoubtedly come forward with viable alternatives.

Those seeking safety at a price would still be able to purchase annuities. But, until the Government removes that obligation, the only revenge we can all take on life offices for such poor quality products is to live much longer than actuarial forecasts.

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