“Extending Retirement Choices”

Leslie Gray (UK) and David Riddington (UK)

Summary

The paper deals with the choices available to individuals at retirement when deciding how to generate retirement income. One option, and the one most frequently used one, is to purchase an annuity but these are inflexible and are increasingly seen as poor value for money. Other options are generally available only for very large retirement funds and so have limited application. There has thus been considerable debate on ways in which the options available at retirement can be improved.

The paper looks at four different retirement options including the current annuity option and others not currently possible in under UK legislation. The options cover the whole spectrum of ways in which retirement funds can be converted to retirement income. Having defined four different options, these are now compared with the different needs and priorities which an individual may have when determing how to take their retirement income. Seven different priorities are identified.

The main part of the paper is a discussion on the extent to which each of the four options satisfies each of the seven needs/priorities. To ease comparison and as support to the text, there is a star rating of each option/need combination. These 28 star ratings are summarised in a section of the paper.Although targetted at a UK market, the options and needs are sufficiently general to have an application in any market. Indeed, in looking at the options, the authors looked at systems currently operating in other countries. The purpose of the paper was to open up debate in the UK on how best to extend the choices available on retirement. It is thus neutral in tone and does not favour any one option over any other.

“La Extensión de las Opciones de Jubilación”

Leslie Gray (UK) and David Riddington (UK)

Resumen

Este trabajo trata las opciones de jubilación a disposición del futuro pensionista a la hora de decidirse la manera de generar los ingresos que le corresponderán al jubilarse. Una opción, y de hecho la que está en más uso, es la de comprar una "anuidad" - o sea, un instrumento que te garantiza unos ingresos mensuales fijos durante el período de la jubilación. Sin embargo, la "anuidad" es muy inflexible y se considera cada vez más una mala inversión desde el punto de vista del rendimiento que aporta. A la vez, las demás opciones suelen limitarse a los fondos de inversión muy importantes y, por lo tanto, éstos tienen una aplicación muy restringida. A cuenta de esto, ha habido mucho debate durante los últimos meses sobre la cuestión de como mejorar la oferta de opciones disponibles a la hora de jubilarse.

Este trabajo considera cuatro opciones distintas, incluida la "anuidad" actual y otras opciones no permisibles bajo la legislación británica vigente al respecto. Estas opciones cubren la gama completa de maneras de convertir el capital percibido al jubilarse en ingresos que el pensionista percibirá a lo largo de su jubililación. Tras definir las cuatro opciones distintas, he comparado éstas con las diferentes necesidades y prioridades que tendrá el futuro pensionista a la hora de determinar la mejor manera de percibir su pensión. He tratado siete prioridades distintas.

El tema principal del trabajo es un debate sobre hasta que punto cada una de las cuatro opciones satisface cada una de las siete necesidades/prioridades. En este sentido, para facilitar la comparativa y como apoyo a la palabra escrita, he aplicado un sistema de estrellas a cada combinación de opción/necesidad. Hay 28 categorias de estrellas y he descrito el significado de cada una de éstas en una parte del trabajo.Aunque se pretende que la aplicación de estas estrellas sea respecto del mercado británico, las opciones y las necesidades son lo suficientemente genéricas como para poder aplicarse a cualquier mercado. De hecho, al estudiar las opciones, los autores investigaron los sistemas en uso actual en otros paises. El objetivo de este trabajo fue fomentar un debate en el Reino Unido sobre la mejor manera de extender las alternativas disponibles al futuro pensionista al jubilarse. Por lo tanto, los argumentos presentados son neutrales y no favorecen a ninguna opción sobre las otras opciones.

Extending Retirement Choices

Leslie Gray
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Retirement income options for modern needs

Executive Summary

Introduction

The subject of retirement income is in need of a wide debate. The options currently open to a retiree are limited and, apart from income drawdown, have remained largely unaltered for many years. Income drawdown is currently only suitable for a very limited market.

People have different needs in retirement; changes in work patterns have widened the range of needs but the currently available options are of limited usefulness in satisfying these needs.

We believe the time is now right for an examination of income retirement options with a view to extending them to allow greater flexibility and choice. Before considering what changes should be made, it is first necessary to understand what these retirement needs are, how they can vary over time and the potential trade offs which exist.

Establishing what these needs might be is a key part of this paper. To put these needs in context, we look at a number of different retirement options and the extent to which they satisfy these needs. We do not claim that these are the only options which should be considered nor do we seek to imply that any option is better than any other. We are merely wishing to introduce more choice into the system.

Background

The Government is currently encouraging individuals who can afford to do so to save more for their retirement. It is putting in place a number of initiatives to support this aim, chief of which is the introduction of stakeholder pensions.

The next stage in the process should be to examine the options available at retirement to ensure that those who have saved can maximise the benefit of doing so.

In March 2000, a working party produced the Choices Report which proposed one possible solution to this issue built around the concept of securing via an annuity a Minimum Retirement Income (MRI) and allowing freedom of investment for the balance of the retirement fund once the MRI is secured.

We think such a change would be a welcome extension to retirement options but we feel it will not suit everyone. Other options should also be considered.

The seven criteria

We suggest that there are seven criteria which can be used to evaluate the range of retirement options. Different individuals will attach different levels of importance to each of these criteria. Indeed, a single individual may view the criteria differently at different stages in their retirement.

The seven criteria are

- **Choice.** Within a given option, how many ways are there of tailoring a solution to the needs of the individual?
- **Security.** Having made a choice, how much risk attaches to it? Is it guaranteed that the chosen option will provide the required amount of income throughout the individual's life or is doing so based on a number of assumptions which may or may not materialise?
- **Inheritability.** On the death of an individual after selecting a retirement option, should the remaining fund be shared amongst others who chose the same option or should it be available to go to the individual's dependants?
- **Flexibility.** Having chosen an option, can it be changed at a later date to meet changing circumstances?
- **Self reliance.** How confident can the individual be that, no matter how long they live, they will be unlikely to have to resort to support from the State? Or how confident can the State be that an individual will not become reliant on State benefits as a result of poor choice?
- **Investment efficiency.** What sort of investment choice and return will there be with the option? Are they constrained by the need to

cover guarantees or can there be a good deal of freedom?

- **Cost effectiveness.** How much of the retirement fund will be required from the customer in direct or indirect costs involved in setting up and running the arrangement?

The four options

We look at four different retirement options and assess them against the seven criteria. The four options were chosen to cover the current annuity option and possible extensions.

The four options are

- Traditional annuities
- The proposals in the Choices Report
- A wider annuity market
- A capital-based approach

Summary of findings

We demonstrate that there is scope for widening the choice available to individuals at retirement and we believe this can be accomplished without increasing the likelihood of having to rely on the State.

In some areas, wider choice can be made available by using annuity products which already exist but which current legislation does not allow in an approved pension scheme. In other areas changes in legislation would open up product development opportunities where none currently exists.

A common thread running through a number of options is that choice implies information and, in particular, information which may have informed the original decision should be available in a regular updated format so that the original decision can be reviewed from time to time.

This, in turn, led us to consider that the Combined Benefit Statement, currently being planned as a pre-retirement information tool, could be extended to produce information about benefits in retirement.

Next stages

Throughout this paper, we have been keen to promote the idea of wider retirement choice and to develop a framework which will aid discussion and assessment of any future proposals in this area.

We have suggested a number of possible options and will be very happy to participate in further discussion on these or any other options.

Contents

1. Introduction

Background

The Government is currently putting into place a number of changes as part of its Welfare Reform Programme to encourage individuals to save more for their retirement. Central to these changes is the introduction of stakeholder pensions. To facilitate these changes the personal pensions legislation is being altered for stakeholder pensions and other defined contribution (DC) schemes to include, amongst other things, new contribution limits.

By targeting these changes at DC schemes, the reforms will encourage individuals to build up a retirement fund but none of the changes affects what the individual might do with that sum when he or she retires.

Currently, most individuals have no option other than to purchase an annuity at retirement. For some, income drawdown is an option but typically this is available only for retirement funds in excess of £250,000 putting it beyond the reach of the vast majority of retirees.

The Choices Report

The Choices Report was issued in March 2000. It was produced by the Retirement Income Working Party (RIWP) chaired by Dr Oonagh McDonald.

Its purpose was to identify ways in which the current compulsion to take annuities by age 75 might be amended. The report included four main proposals of which one (the obligation to purchase a Minimum Retirement Income or MRI) was key. The report's main conclusions are summarised in Appendix A.

This report is not a direct response to the Choices Report but it covers much of the same ground. We are concerned that retirement income choices do not seem to be keeping pace with the changing needs of individuals and there is currently less debate on this subject than there is on pre-retirement savings options.

It is hoped that this report along with the Choices report and others will stimulate that debate.

Objectives of this report

This report was commissioned by the Pensions Board of the Faculty and Institute of Actuaries to consider the issues and develop further ideas. Our terms of reference and membership are set out in Appendix B which also covers some of the areas not addressed in this report which we believe merit further investigation.

We support the need for greater choice at retirement. In our view, the option to purchase an annuity is, and will remain, a valuable option but it should not be the *only* option.

Individuals should be able to choose from a number of options which will, as far as possible, meet their needs and attitude to risk. However, complete freedom of choice may have to be restricted by the extent to which Government will not wish to allow individuals to exhaust their retirement funds and then look to the State for support.

This report has been produced as a contribution to the debate on retirement planning. It presents a number of different ways of approaching retirement planning – some permitted under current legislation and some not.

Its purpose is not to present any one option as a preferred or recommended option. Instead, it looks at a range of options, comments on the different features of each and examines how they may or may not satisfy the needs of an individual.

2. Structure of the report

Principles

The purpose of this report is to look at ways of increasing the choice available to those deciding how best to convert their retirement fund into a retirement income. Central to the discussion are two broad principles:

- an individual should have access to a number of different retirement planning options to enable them to choose an option (or combination of options) which best suits their needs and their attitude to risk
- the number of individuals who qualify for State support should not increase

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Options

In later Sections, we examine a number of different retirement planning options and assess these against the criteria. We look at four different options:

a) the current annuity market

b) the proposals in the Choices report

c) more choices – income approach

d) more choices – capital approach

There are obviously many other possible options but we feel that these four cover much of the relevant territory. In particular, option c) is much stronger on setting up regular income payments but with more flexibility than is provided under option a). Option d) is stronger on retaining capital but is intended to have much wider appeal than income drawdown.

Scoring

For ease of presentation, we have attempted to score each assessment. We recognise that there are dangers in adopting such a subjective approach but urge that the scoring system is not looked at in isolation from the accompanying text. The real merit of the scoring system is that it helps in making comparisons between different options – which we do in the summary in Section 7.

Assessment Criteria

Our seven criteria are

- Choice
- Security
- Inheritability
- Flexibility
- Self reliance
- Investment efficiency
- Cost Effectiveness

In more detail, these are as follows.

Choice

If any reform of retirement planning is to be successful, it should give most individuals who retire a wider range of choices and options.

Ideally, there should be a range of options (A, B, C, …..) each with different features. An individual, having reviewed the options and how well the features satisfy their needs, may choose to use one option for all their funds or to use option A for part of their funds and option B for the rest.

Furthermore, the decision should not have to be made once and for all at retirement. It may be more appropriate to follow option C for a while, then convert to option B later.

Inevitably, individuals with larger funds will have greater choice, and will be less constrained by some of the other criteria discussed below. However, if individuals see that they will have greater choice in using their retirement funds, they may be encouraged to save more for this purpose.

Security

Security of income is an important consideration in retirement especially in the later years when other income-earning opportunities will be rare. There are two major areas of uncertainty which may arise in an individual's mind;

- will my income run out while I am still alive?
- what investment return do I need to maintain my income at the right level and can I achieve that return?

The more risk-averse an individual is, the more they will want a solution to retirement income which eliminates these questions. For some, eliminating risk on the first point may be essential but they may be prepared to take a limited risk on the second point to the extent that levels of future income may be unknown and will depend on future investment returns.

Others may be unconcerned about both points in the early years after they retire but will expect to take action on both points eventually.

Inheritability

Some individuals, especially those who have built up a substantial retirement fund, may not be happy with a retirement solution which, on early death, would mean that none of that fund could be passed on to their dependants – even if they understood that, by giving up inheritability, they could receive a higher initial income.

Note that this is not just a comparison between insured and non-insured options. Some forms of insured annuity incorporate a payment on the death of the annuitant and there are different ways in which this payment can be assessed.

Flexibility

The income requirements of individuals can vary at different points in retirement. For some, a higher initial income may be important if they have not yet reached an age where the State pension or some other form of pension benefit becomes payable. This higher income will bridge the gap until the other income comes onstream.

Others may have retired from their main line of employment but are able to supplement their retirement income with part time employment. For them, a low initial amount of retirement income will be the preferred choice.

A different example of the need to have variability in the income payments would arise where the retiree subsequently requires long term care. Here life expectancy may be considerably shortened but with a need for a significant rise in income in the final years.

Self Reliance

This is the opposite of State reliance. The wish to avoid increased State reliance will be an objective of the Government in any extension of retirement planning but it will also be a concern for individuals as any benefits paid by the State will not be substantial. Many individuals will feel that dependence on the State would result in a lower standard of living and they will wish to organise their retirement planning to avoid this possibility.

To meet this objective, individuals may be obliged to follow a particular course of action when a certain threshold is reached. This implies that increased retirement choices also means increased information to individuals to allow them to monitor their position and increased control to ensure that action is taken when it is necessary to do so.

Although this introduces an element of compulsion into a system whose main aim is to create greater choice and flexibility, it will be understood that there must be some limitations on the extent of choice and flexibility. Compulsion is a positive feature as it introduces security at the point where it becomes essential.

Investment Efficiency

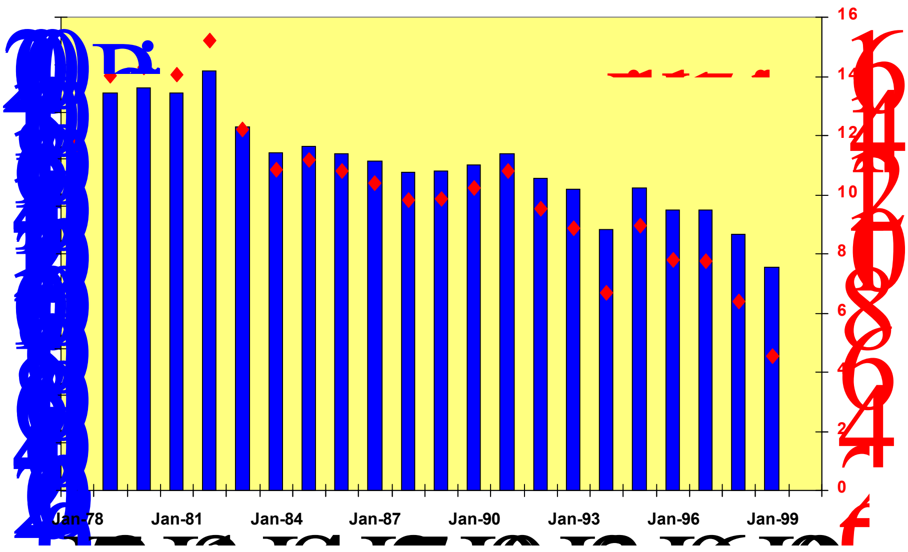
Each choice will involve some form of investment option. Although retirement income may eventually deplete a retirement fund, a substantial part of it will remain invested for some time. Indeed for some retirees, especially younger ones, the fund may continue to grow as a result of investment income exceeding retirement outgo.

This criterion looks at the investment potential of the underlying investment.

Cost Effectiveness

Different arrangements will involve different costs. At one extreme will be arrangements which, once set up, require very little intervention or monitoring by the provider. The low costs involved here will be reflected in the charges paid by the customer. At the other extreme, will be cases where the provider will have much higher costs due to the monitoring and change involved. Furthermore, where the arrangement involves choice and change, the customer may wish to get advice from time to time and there will be costs associated with that.

3. The current annuity market



Male age 65 - single life pension, no guarantee, no escalation

The annuity market

This Section looks at both the traditional annuity market and some of the more recent products available. The traditional annuity is assessed against the criteria in Section 2.

There has been a considerable amount of public and media attention on the subject of annuities. The suitability of annuities, particularly annuities that provide a guaranteed income, has been brought into question by falling annuity rates offered. This fall in rates has been caused by two main factors, falling interest rates and improvements in longevity ie people are living longer.

Traditional annuities are invested in fixed interest investments. The level of annuity thus rises and falls in line with rises and falls in fixed interest investment returns.

Interest rates have fallen significantly over the 1990s. This can be seen by looking at the fall in yields on Government Securities (Gilts) – the drop in yields has reduced the amount of annuity provided by each £10,000 of pension fund at retirement, as the diagram below illustrates.

Gilt yields and annuities

continued on next page

The annuity market (continued)

Questions have therefore been raised as to whether annuities any longer offer good value and whether the requirement to use pension fund proceeds to buy an annuity is still valid. We believe that, even in a world of increased retirement choice, an annuity will still be a favoured option by many individuals. Part of the criticism about current annuities can be met by offering annuities which are not wholly invested in fixed interest investments. This is already happening as we discuss later.

Before that, we look at some of the issues which face purchasers of annuities.

Longevity risk

For many people facing old age a primary concern is outliving one's income. An annuity transfers the financial risk of an individual living much longer than expected to the annuity provider. The provider has to continue the annuity payments even if the annuitant lives to an advanced age.

However there are a number of conflicts of interest for the prospective annuitant which are considered below.

Annuity conflicts

- An inclination to want to maximise initial income

  If there has been insufficient investment in a pension before retirement, it is a natural reaction to invest what limited funds there are to maximise the initial annuity. This reaction will be heightened by the significant gap between income in work and in retirement especially where not all financial commitments will immediately reduce.

- A need to maintain the real value of income

  Even relatively low levels of inflation will eat into the real value of income over a long period of retirement but advance provision does come at a price. For example, for a male retiring at 65, the starting point for an RPI-linked annuity would be some 20% less than a level annuity.

- A need for flexibility in future income levels

  There are different periods in retirement that may require somewhat different income levels. Often these will be higher initially, then lower as financial commitments finally disappear and perhaps pensioners become less active. It may subsequently rise again as more care/support is required from others in order to cope with daily living.

To put these comments in context, we show comparative pensions on different bases in Table 1 in Appendix C.

Compulsion

So why is there compulsion to buy an annuity?

The Government wishes to encourage individuals to save for retirement as this reduces claims on the Government for income support by those who have retired and are unable to work. The more an individual and his or her employers provide retirement income for the individual, the less the Government has to provide. If this is by means of an annuity purchased at retirement, the income provision will continue throughout life.

Approved pensions plans are a major part of the Government's approach to encouragement. These plans give tax reliefs and, in return, the Government has hitherto placed an obligation on the investor to secure an income in retirement by purchasing a lifetime annuity.

The concern from the DSS is that taking away the compulsion to purchase income will lead potentially to greater reliance on the State for income in later retirement. Evidence from other countries with no annuity compulsion suggests this is a valid concern.

However there is a general trend towards less State reliance and thus less compulsion and more freedom of choice. Current practice in retirement planning should be looked at in the context of this trend.

Good value?

So are traditional annuities good value?

- The open annuity market is very competitive with the top companies providing significantly better rates than others.
- The actual underlying investments (eg commercial mortgages, private financial initiatives) often used to back annuities provide a better return than direct gilt investment. These investments are not usually available for an individual investor.
- The product provider is covering all the longevity risk.

However

- Annuity levels are dependent on the returns from fixed interest investments at the time the annuity is purchased. Many consider these returns will fall further in future
- Traditional annuities invest in fixed interest investments which perform less well than equity investments

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Recent annuity developments

Recent developments in the annuity market have largely centred around moving away from annuities based on fixed interest investments and moving towards unit-linked and, more particularly, with profit annuities. These start to address the investment issue but at the expense of guarantee of income levels.

With Profits. Bonuses are added to the policy based on the performance of an insurance company's with profit fund, which normally has a substantial equity component. There is a choice over the level of bonuses which may be anticipated. If the actual bonus is more than the anticipated bonus then payments go up; if less, payments go down.

Unit Linked – the income will go up (or down) in a way directly linked to the performance of the investments held.

Combination Annuities – where the requirement to purchase an annuity payable throughout life is met not by a single annuity transaction at retirement but by combining a series of annuity transactions end to end. These are discussed further in Section 4 – at this stage it is worth noting that this does allow more variation in the annuity payments but, currently, the same annuity provider must be used for the total combination annuity transaction.

Assessment

Traditional annuity products can be assessed against the criteria in Section 2 as follows. As indicated in the preceding discussion, alternatives to traditional annuities are less restrictive in some areas.

Choice
✩✩

There is limited choice of the form of annuity which can be taken (eg it can be level or index-linked) and there is no choice on what can be done once the annuity has been taken out. It cannot be converted to another form of retirement income vehicle.

Security
✩✩✩✩✩

A traditional annuity provides absolute security of income because there is a guarantee of the current and future level. The annuity will be payable no matter how long the annuitant lives.

Inheritability
✩

Some forms of annuity allow a payment to be made to the annuitant's estate on early death eg if an the annuitant dies in the first five years of the annuity, the value of the balance of five years' payments can be made. Other options are available but they are limited and some are not available under approved pension schemes.

Flexibility ☆	Different levels of income can be accommodated but only if predetermined and in accordance with an established rule. This will involve increasing payments. It is not possible to incorporate other forms of variation.
Self Reliance ☆☆☆	This arrangement provides significant protection against reliance on the State due to income payments being guaranteed but does not provide absolute protection as the level of income may eventually prove inadequate especially if annuity increases were not incorporated at outset.
Investment Efficiency ☆	Gilts or other fixed interest investments are an effective way of matching the annuity payments but they do not incorporate the growth potential of equity based investments.
Cost Effectiveness ☆☆☆☆☆	This is the most cost effective option. Once an annuity is set up, the payments are made regularly and any changes to the payments will be on a pre-determined formula. Since there is no scope for variation, the annuitant does not need regular advice on future options.
Summary	The least attractive point about the traditional annuity is its inflexibility but this does mean it is cost effective and it does provide security on the level of income.

4. The Choices Report

Introduction

The Choices Report was produced in March 2000 by the Retirement Income Working party (RIWP) chaired by Dr Oonagh McDonald. It was a response to some of the problems and issues described in previous sections. The Summary from the Choices Report is reproduced in Appendix A.

The Choices Report introduced the idea of a "Minimum Retirement Income" (MRI). On retirement, an individual's only obligation would be to secure an index-linked income from all their pensions of not less than the MRI, providing of course that they had sufficient funds to do this. Basic State Pension would count towards the required income, as would other entitlements to pension income. An individual would be required to secure the balance of the MRI by using enough of their accumulated pension funds to buy a suitable annuity at their chosen retirement age. After doing this, their Residual Fund could be used to provide further income, or invested for further growth, with few restrictions.

The MRI would be set at a sufficiently high level to ensure that an individual would not have to rely on State benefits at any time during their lifetime. The Choices Report proposed an MRI of £140 a week, increasing in line with prices. It was hoped that, by limiting the requirement to buying an annuity to this slice of income, more innovative uses could be found for an individual's Residual Fund, possibly involving new products, and certainly offering more choice.

This proposal can be assessed against the criteria developed earlier.

Choice

☆☆☆

There is no choice over the form of the annuity backing the MRI – it must be index-linked. However, once the MRI is secured, there is considerable choice over the use of the Residual Fund.

The Residual Funds might be drawn down at any time, or a minimum annual withdrawal might be specified, or a maximum, or both. Equally, an individual could use the Residual Fund to buy more annuity.

While this would offer a great deal of choice to those with large accumulated funds, those with smaller funds would be less well placed. At their MRI Start Age (the age at which they had decided to retire or draw a retirement income), they would be required to buy an annuity which would top up any other pensions to the level of the MRI.

Security ☆☆☆☆	Like the traditional annuity, the purchase of an annuity to secure the MRI secures payment levels and duration. However, the existence of the uninvested assets in the Residual Fund means that it is slightly less secure.
Inheritability ☆☆	Since the Residual Fund can pass to an annuitant's estate, in this respect it is a more inheritable proposition than a conventional annuity. On the other hand, since the MRI is the only annuity likely to be set up under these proposals, if it did not include compulsory provision for dependants it is possible that none would be made and any surviving dependant would be left to rely entirely on the Residual Fund. In many respects, this is less satisfactory for the dependants than the position under a traditional annuity where, in the absence of a focus on the MRI, the needs of the dependant may be taken more into account.
Flexibility ☆☆☆	Individuals could use their Residual Fund to cater for variable needs. An individual would also be free to choose their own MRI Start Age. However, once an individual had decided this age and secured their MRI, it would be impossible to convert the MRI into another form of income.
Self Reliance ☆☆☆☆	If the MRI is sufficiently high (and the individual has enough income or funds to secure the MRI), the chance of an individual having to fall back on State benefits should be minimal especially as the MRI is index-linked. However, it should be noted that the future levels of State Benefits and MRI could be very different from those projected today. The proposal assumes that today's levels of costs, pensions, and income remain broadly in line (in real terms).
Investment Efficiency ☆☆	The Residual Fund would be relatively free of constraints on investment efficiency. The MRI would be locked into an index-linked annuity, backed by suitable assets (at present, index-linked annuities backed by Government bonds to satisfy regulatory requirements). This option thus offers some scope for investment linked to real assets.
Cost Effectiveness ☆☆☆☆	Since a significant part of the retirement fund is invested in an annuity, cost effectiveness is similar to that for the traditional annuity. However, there will be additional costs involved in the operation of the Residual Fund.

Summary

The proposals in the Choices Report go some way towards increasing flexibility and meeting the needs of the individual and State. Its main strength (the idea of the MRI) is also a weakness, in that it requires a fixed income to be secured from a set age. This limits the flexibility but also the cost.

5. More Choices – Income Approach

Annuities – a way forward

Much of the discussion on annuities has concentrated on the most common form available – an *immediate annuity* ie one commencing immediately on purchase and payable throughout life. To develop the annuity model further, we need to look beyond that to other forms of annuity eg

- *Deferred annuities*, where the annuity does not start immediately but after a prescribed period but, once started, is payable throughout life, and
- *Temporary annuities,* where the annuity commences immediately on purchase but is payable for a limited number of years or until death if earlier

Since an immediate annuity can be considered as a temporary annuity followed by a deferred annuity, breaking down the annuity in this way may offer scope for greater flexibility.

A combination annuity can combine a series of temporary annuities with a deferred annuity or an immediate annuity with a deferred annuity in a package that provides flexibility of income levels and some ability to redirect the type of income or underlying investment in the future. One difference from currently allowed packages might be that the combination does not need to be locked into one provider.

Temporary and Deferred Annuities

The first stage would be to use part of the retirement fund to purchase a deferred annuity commencing from (say) age 80. Continuing with the principles in the Choices Report, the annuity could be the expected MRI level at age 80. Buying the deferred annuity at retirement protects the individual from having to rely on the State in old age. It lessens the need for restrictions on the Residual Fund.

Part of the balance of the retirement fund would then be used to purchase a temporary annuity of at least the MRI. The remainder of the retirement fund would remain invested. When the temporary annuity expires, a further temporary annuity for at least the MRI would then be purchased. This could be repeated until the age at which the deferred annuity becomes payable.

The following example develops this further. It illustrates a possible use of temporary and deferred annuities in a situation where the person retires prior to State pension age (SPA). Examples of the possible cost of buying a deferred annuity are shown in Table 2 of Appendix C.

Annuity Example

- **Pre SPA**

A deferred annuity is bought to secure MRI from age 80. A temporary annuity provides at least MRI before the State benefit commences. The remainder of the fund remains invested.

- **From SPA to age 80:**

The original temporary annuity has now expired. A new temporary annuity is set up for at least MRI but allowing for the State benefit. There may be a series of temporary annuities during this period to cater for the annuitant's need for different levels of income but each, when taken with the State benefit, would be at least the MRI. The residual fund remains invested.

- **From age 80:**

The temporary annuities cease. Income comes from the State benefit and the deferred annuity, at least equalling MRI in total. Any balance of the fund can remain invested but may used at this point to purchase an immediate annuity at age 80.

Further annuity product developments

The previous example concerned combining two types of annuity each of which had a level of income which at purchase was either fixed or varied in accordance with a predetermined rule. The next example is concerned with varying annuity levels in other ways.

Pension funds are not allowed to pay higher benefits to pensioners who suffer disability. The only way to obtain such cover is via a separate insurance policy. It would be consistent with extending retirement choice if individuals were permitted to use part of their accumulated funds to secure an annuity with disability-related increases if desired. This would encourage both providers and purchasers to give attention to the financial needs of long term care (LTC).

Some form of test would be required to determine the eligibility for the LTC payments and this would require wide discussion. It might be based on inability to perform a number of Activities of Daily Living (ADLs) – similar tests are now common in insurance policies that pay out on illness or disability.

The payments might be made to a recognised provider of LTC.

Capital Protected Annuities

Another possible development would deal with issue of non-inheritance under annuities. This could be met by purchasing an annuity with associated life cover. The form of cover could vary but, typically, might be the original purchase price less the annuity instalments already paid. This will obviously reduce the amount of annuity as an additional benefit (the death benefit) is now being provided. These annuities are often called *capital protected annuities.*

Opportunities

Examples of the cost of capital protected annuities relative to conventional annuities are in Table 3 of Appendix C. These annuities are currently possible but are not permitted under approved pensions plans.

These annuities, with appropriate changes in legislation, annuities should be able to play an increasing role in retirement planning of the future.

Assessment

The deferred and temporary combination annuity described above is now assessed against the criteria in Section 2.

Choice

☆☆☆☆

Since only a limited amount of the available funds need be annuitised at retirement, there is more choice in both the timing and the use of the remaining capital. The individual must purchase at least a series of temporary annuities but, since only a limited amount of the retirement fund is annuitised at retirement, it allows the individual to adopt a different approach to providing retirement income should they wish to do so at a later stage.

Security

☆☆☆

The purchase of the deferred annuity ensures that there is security of income in extreme old age no matter how long the annuitant lives. There is also security of income during the period of each temporary annuity. However, since there is no certainty that the non-annuitised fund will continue to be able to purchase further levels of temporary annuity at the requisite level, it is less secure than earlier options.

Inheritability

☆☆☆☆

Any retirement funds not annuitised can be inherited. Compared to previous options, less is annuitised so inheritability is higher.

Flexibility

☆☆☆☆

As illustrated in the example given earlier, the annuity amounts can vary to meet different needs of the individual at different times. This approach is also potentially more adaptable to meet any LTC demands which might arise as they could be met from the non-annuitised funds. However, in practice, this may be limited as the later the need for LTC arose, the less likelihood there would be of sufficient non-annuitised funds.

Self Reliance

☆☆☆

The need to rely on the State at extreme old age is eliminated by the purchase of the deferred annuity. In the absence of any controls, there is a risk that there may not be enough funds to purchase temporary annuities at the necessary level to avoid State reliance at earlier ages.

Investment Efficiency

☆☆☆☆

For the non-annuitised funds, there would be a conflict between absolute freedom of investment choice (and thus the opportunity to maximise investment return) and the need to invest in a way which would ensure that sufficient funds were available to buy temporary annuities at the appropriate level on a continuing basis. Since some restriction seems likely, investment efficiency will be affected but, since less is annuitised at any time compared to earlier options, it scores more highly.

Cost Effectiveness

☆☆☆

There are a number of different annuity purchases involved in this approach which need not be with the same annuity provider. Some advice may be required to establish the best form of annuity and the best provider.

Summary

The temporary/deferred annuity approach still relies very much on securing income payments but in stages rather than in one outright purchase. Consequently, it does offer more choice and flexibility but less security.

6. More Choices – Capital Approach

Introduction

In previous sections we have looked at a number of different options which are, to a greater or lesser degree, based on the purchase of an annuity.

The options in Sections 3 and 5 assume that all of the retirement capital would be committed, either immediately on retirement or over time, to the purchase of some form of annuity. Section 4 discussed the proposals in the Choices report where some £50,000 of the available capital would be used to secure an annuity at retirement. For many retirees, this will be a very large part of the total capital available with the consequence that this option will not represent a real difference from the options discussed in Sections 3 and 5.

Much of the debate around retirement choice has questioned why such annuity purchase should be necessary especially as this is not the case in many other countries. This section addresses that point.

Income Drawdown

There are two important features of income drawdown – and they work in opposite directions as far as the investor is concerned

- The potential for a greater investment return than the return underlying an annuity purchase, and
- The so-called "mortality drag"

The potential for a greater investment return arises from the fact that the retirement fund, whilst being drawn from, will be invested in equity-based assets as opposed to fixed interest assets which are the main investment vehicle for traditional annuities. As a counter to this, as has already been noted, recent annuity development work has concentrated on investment-linked annuities which are largely invested in equity-based assets.

Mortality drag arises because income drawdown plans, on the death of the investor, return the remaining fund to the investor's estate. While this can be seen as a positive feature of income drawdown, it also means that, unlike under an annuity contract, the funds available from early deaths do not subsidise the benefits available to those who live longer leading to larger benefit levels all round.

There is thus an expectation amongst drawdown investors that the higher investment return they will receive will more than compensate for the mortality drag.

Income Drawdown (Continued)

Theoretically, it would be possible to design a drawdown arrangement where, on death, the remaining fund was distributed amongst the survivors thus eliminating the effect of mortality drag. No such product is currently available.

No compulsory annuity purchase at retirement – the Personal Distribution Plan

A positive feature of income drawdown is the ability to invest in a wide range of investments with the potential of a better return prior to securing an annuity. The option discussed here retains that feature.

It assumes that there is no compulsion to purchase an annuity at retirement but that there will be a point in future at which an annuity should be secured in order to be sure that the retiree will have a sufficient and secure income for the rest of their life.

The concept of a sufficient and secure income is, of course, the same concept as was used in the Choices report when it defined the Minimum Retirement Income or MRI. We shall thus continue to use that term in the rest of this section but, in doing so, we are not necessarily suggesting that the level of the MRI should be as proposed in the Choices report. As mentioned elsewhere in this paper, we believe the level of the MRI should be the subject of a wide debate before it is determined. It is expected that the outcome of that debate would depend, in part, on the context in which the MRI is used. We discuss some of the considerations of the MRI later in this section.

The latest point at which the annuity should be purchased will thus not be age-related but will arise at the point where the retirement fund falls to the level at which no more than the MRI can be purchased.

For example, if purchasing an annuity at the MRI level costs £35,000 at age 70 and £30,000 at age 75, and the retirement fund at 60 was £100,000

- There would be no obligation to purchase an annuity at 60 and the whole £100,000 could be invested and drawn from after age 60.
- If the net effect of the investment return and the drawdown were such that the remaining fund was worth £35,000 at age 70 then an annuity at MRI level would have to be purchased at that point.
- If, on the other hand, the fund exceeded £35,000 at age 70, it could continue to be invested and drawn from and if it fell to a value of £30,000 at age 75, then an annuity at MRI level would have to be purchased at that point.

Continued on next page

No compulsory annuity purchase at retirement – the Personal Distribution Plan (continued)

In this paper, we have called the concept of having a retirement fund which could be invested and drawn from until it reached the MRI level a Personal Distribution Plan or PDP.

There are obviously a number of controls and considerations which would have to accompany such an arrangement and these are discussed in the following sections.

MRI requirements

Throughout this paper, we have looked at alternatives to purchasing an annuity at retirement with all of the available retirement funds. One of our tests of any alternative option is that it should not significantly alter the likelihood of the retiree having to rely on State support at a future date. It is for this purpose that we feel that the purchase of an annuity cannot be eliminated entirely from the process and, in the context of the PDP, it should be purchased no later than the point at which it is necessary to secure the MRI.

As we have discussed earlier, there are different forms of annuity available and we need to consider which are the most appropriate in the context of purchasing an MRI.

To meet the criteria of "sufficient and secure income" we believe the MRI and the purchase of the associated annuity should have the following features

- The MRI should be at a level which, including State benefits, will provide a reasonable standard of living.
- The annuity should be indexed. The Government uses different forms of indexation for its retirement benefits – State pensions are indexed at RPI levels and the Minimum Income Guarantee will be indexed in line with earnings. Since only RPI indexation can be matched by assets, it is likely that this is the form of indexation which will be appropriate for the MRI annuity.
- The annuity should payable throughout life.
- The annuity should guarantee payments of at least MRI level plus indexation. It can thus be a traditional annuity or an investment-linked linked annuity with a guaranteed minimum payment.
- The annuity should take into account the circumstances of the annuitant ie it should include a dependant's pension if the annuitant has dependants.

Establishing the constituents of the MRI

For a retiree with no capital other than their retirement fund, it is easy to establish what should comprise the MRI adequacy test – it will be their State benefits plus the annuity purchased with the balance of their retirement fund. It is less easy when they have other capital which is income producing or can be drawn from to secure income. For example, it might be argued that the obligation to purchase an MRI might come sooner for someone with no capital than it would for someone with £25,000 in a building society account which might be generating interest income of some £100 per month gross.

To put it another way, should anything other than State benefits be included in the MRI assessment? It would be possible to specify either amounts or principles by which different forms of capital could be treated for MRI purposes as an equivalent level of income but it would also be necessary to consider the extent to which these assets can contribute to the security objective of the MRI and the practicability of incorporating them in the control mechanisms discussed below.

This is a matter which would require further investigation if the concept of PDPs is to be developed into a working solution.

Triggering the MRI purchase

It is fundamental to the PDP concept that the annuity purchase can be delayed until it is required to secure the MRI. This begs the question of how this can be achieved and the control mechanisms which would be necessary or desirable.

We suggest that two requirements are necessary to ensure that PDPs achieve their objectives

- A PDP manager who would manage the investments of the PDP prior to purchasing an annuity and would ensure that the annuity was purchased when necessary
- A Combined Benefit Statement which would be issued by the PDP Manager and which would provide regular information on the value of an individual's PDPs and how that value compares with the amount necessary to secure the MRI annuity.

Each of these is now discussed in turn.

PDP Manager

Each PDP would be managed by a PDP manager. For the purposes of this description, we shall assume that each individual has only one PDP and thus one PDP Manager but, in reality, there might be several PDPs each with their own manager – the only difference in concept is that one of these PDP Managers would be deemed to be the lead manager who would take on the responsibility of reporting and monitoring the aggregate position.

The PDP manager would manage the PDP investments in accordance with whatever principles are set down for PDPs – we discuss later what must be considered here.

The PDP Manager need not be the product provider with whom the retirement fund was accumulated nor need the funds remain with the same PDP Manager throughout the period prior to the annuity purchase. By the same token, there would be no obligation to purchase the MRI annuity from the PDP Manager holding the funds at that point.

Combined Benefit Statement

It is currently very difficult for an individual to know, prior to retirement, what their likely retirement benefits will be. This is especially so if they are accumulating funds with a number of providers and then have to take into account the likely benefits from all of these providers and add to that the likely State benefits. As a result, many individuals make inadequate provision for their retirement.

To combat this information gap, the Government has proposed the introduction of a Combined Benefit Statement (CBS) summarising all of an individual's benefits and likely total retirement income. An example of a pilot CBS showing this pre-retirement position is in Appendix D.

A lot of work will be necessary if this proposal is to succeed but, if it can be made to work for pre-retirement benefits, we see no reason in principle why it cannot be extended to post-retirement funds.

A post-retirement CBS issued by a PDP Manager would show the current value of the PDP and the amount which would be necessary to buy an annuity to secure the MRI at that date taking into account the annuitant's circumstances. It might go further and show projections of the fund assuming continuation of the current (or selected other) drawdown level to a number of future dates and the amount required to secure MRI annuity on those dates.

PDP investors would then be able to see how close they were to the MRI purchase date and could make informed decisions about their investment choice or advancing the annuity purchase if they wished.

PDP Managers would have the necessary information to warn investors that they were approaching an MRI purchase point. They could write advising investors of this imminent change of circumstances and establish their choice from any available options.

In essence, the post retirement CBS would be seen by the investor as a continuation of the pre-retirement CBS but with some changes in information to reflect the retirement options. There is no reason why this information should, in future, be restricted to the issue of annual paper statements. With web-based technology, the information could be available to investors when they wanted it.

Appendix D also shows an example of a possible post-retirement CBS.

Drawdown rate

Throughout this paper, we have emphasised the need for flexibility in the amount of retirement income an individual could receive. Under income drawdown rules, there is flexibility in the drawdown payment but the upper limit cannot exceed the notional annuity which could be purchased with the available funds. This rule partly exists to prevent too fast a rate of drawdown leaving insufficient funds to provide income in later years.

Under the PDP proposal, we suggest that even greater flexibility could be allowed.

Provided the available funds were always sufficient to purchase the MRI annuity, we see no reason for limiting the level of income which can be taken at any time to the notional annuity figure.

For example, if the retirement fund could purchase a notional annuity of £25,000 per annum, it should be possible to take (say) £30,000 per annum for five years provided that, at any time over these five years, the remaining fund could purchase the MRI annuity.

Such flexibility might be useful, for example, in cases where the individual had retired at age 60 with a retirement fund and had another retirement income which was not due to start until age 65. By purchasing a PDP at age 60, it would be possible to provide a higher income between 60 and 65 until the second retirement income commenced.

Although we are advocating this greater flexibility, we do understand that there are other, fiscal, reasons for restricting the level of income drawdown. It may thus be necessary to have an upper limit on the drawdown amount but one which is greater than the current figure.

Investment choice

Central to the PDP concept, is the requirement that the PDP fund must always be sufficient to purchase the MRI annuity. It is thus necessary to ensure that volatility in investment performance does not prevent this happening. This is a constraint which must be accommodated within the general aim of maximising investment choice prior to securing the MRI.

There are two possible approaches here.

The first is to assess, at outset, the amount necessary to purchase the MRI annuity at that date and require that, via the PDP manager, that part of the total available retirement fund is invested in non-volatile (perhaps annuity tracking) investments. The MRI annuity purchase price will tend to reduce as the individual gets older and the amount of the available funds which have their investment choice restricted in this way will similarly reduce over time.

The second approach is similar to the lifestyle investment option which applies to pre-retirement investment funds. The PDP holder would initially be free to invest their retirement fund in any manner they wished but as they approached the point where the MRI would have to be purchased, the fund should progressively be moved into less volatile assets. The PDP manager would ensure that this happened.

The second approach may be more appropriate for a younger retiree who might get more benefit from the greater investment potential which the wider investment freedom could bring.

Variations on the theme

It would be possible to combine the PDP approach with some of the other ideas raised in this paper.

For example, the retirement funds could be used to purchase, initially, a deferred annuity at the MRI level at a given age. The remaining funds could then be invested with a little more freedom in the knowledge that this "safety net" level of income had already been secured. The test on the fund at any time would then become one of sufficiency to buy a temporary annuity at MRI level up to the starting date of the already-purchased deferred annuity.

There would be a number of practical difficulties here in that, since the MRI is indexed from year to year, it is not possible to predict what the starting point of the deferred annuity should be. Nevertheless, we feel that some approximation here would be acceptable given that the main requirement (establishing a level of income which avoids State support) will be achieved.

Throughout the discussion on PDPs, we have assumed that, on the death of the PDP holder, the balance of the funds (less any tax requirement) would be returned to their estate. Another possible variation might be to distribute this amongst surviving PDP holders in the manner suggested for income drawdown above (provided such an arrangement can be demonstrated to be feasible).

Comparison with income drawdown

PDPs and income drawdown are similar in that, by not using any part of the retirement fund to purchase an annuity initially, the investor can get the benefit of the potential higher returns available from equity-based investments.

PDPs are, arguably, better than income drawdown in that the obligation to purchase an annuity is not based on some arbitrarily chosen age but when it can be demonstrated that there is a need to do so in order to secure the MRI annuity. Furthermore, it should be possible to introduce greater flexibility in the payment under a PDP as the larger the rate of drawdown the sooner the MRI annuity will have to be secured. The PDP holder could be provided with a series of projections which would demonstrate the consequences of different levels of drawdown on the likely MRI purchase age.

However, since the information in the post retirement Combined Benefit Statement is key to the successful operation, PDPs could not be available immediately. The likely date of introduction would depend on how quickly providers could develop systems to provide pre and post-retirement benefit statements.

Nevertheless, we feel that PDPs could ultimately provide a form of income drawdown suitable for those with retirement funds much lower than the current income drawdown limit.

We now evaluate the PDP against the previously defined criteria.

Choice

☆☆☆☆☆

This option gives a large amount of choice since it allows an individual to annuitise their funds at outset or to retain the capital for the longest possible time. Alternatively, the annuitant can retain capital and purchase an annuity at a later date of their choosing.

Security

☆☆☆

Arguably, no less secure than the option in the Choices report since the ability to purchase an MRI will always exist and is forced when necessary.

Inheritability

☆☆☆☆

Since the balance of the retirement fund not annuitised is available to be paid to dependants, this option scores highly on inheritability. Under current rules, income drawdown is more inheritable since there is no obligation to purchase an annuity when it reaches MRI level.

Flexibility ☆☆☆☆	This approach has substantial flexibility. It enables modification to cope with future changes in the MRI. Variable MRI and changes in personal circumstances can be accommodated on the CBS. It offers significant choice to the member and the ability to modify the choice should circumstances change.
Self Reliance ☆☆☆	This should be comparable with the comments under the Choices report since at least the MRI will be available. However it is worth noting that the ability to secure the MRI will be less than under options which involve outright annuity purchase since any option which postpones the purchase of an annuity will not benefit from the cross subsidy available to all annuitants from those who die early. To that extent, more funds will be necessary to secure the MRI.
Investment Efficiency ☆☆☆☆☆	This approach enables members to gain maximum freedom for the investment of their retirement funds. The constraints arise in relation to funds needing to demonstrate meeting the MRI test.
Cost Effectiveness ☆☆	This option is likely to involve the customer in the greatest cost. It is fairly cost-intensive to the annuity provider and the customer may need regular advice. However, this should be looked at in conjunction with the previous criterion ie the opportunity to maximise the investment return. The better investment return may well outweigh the higher cost.
Summary	This approach gives greatest choice since it involves the least commitment to annuity purchase. It also maximises inheritability but is the most costly. It does, however, depend on a major development - the availability of a CBS for retirement benefits.

7. Overall Evaluation of Options

Evaluation

For convenience we have summarised below the "scoring" attributable to the various approaches identified in this report and in the Choices report. We would repeat our earlier comment that this is not intended as a substitute for the text

	Choice	*Security*	*Inheritability*	*Flexibility*	*Self Reliance*	*Investment Efficiency*	*Cost Effectiveness*
Existing Annuity market	☆☆	☆☆☆☆☆	☆	☆	☆☆☆	☆	☆☆☆☆☆
Choices Report	☆☆☆	☆☆☆☆	☆☆	☆☆☆	☆☆☆☆	☆☆	☆☆☆☆
More Choices – Income Approach	☆☆☆☆	☆☆☆	☆☆☆☆	☆☆☆☆	☆☆☆	☆☆☆☆	☆☆☆
More Choices – Capital Approach	☆☆☆☆☆	☆☆☆☆	☆☆☆☆	☆☆☆☆	☆☆☆	☆☆☆☆☆	☆☆

The summary above highlights the (perhaps, unsurprising) conclusion that more choice means less security. Anyone prepared to give up some security can gain more inheritability, flexibility and investment efficiency but at an additional cost. There is little variability in the degree of self reliance but that is largely because the need to avoid falling back on State benefits was central to each option.

8. Implications for Defined Benefit schemes

Level Playing Fields

In this report we have concentrated on greater choice of retirement options for members of Defined Contribution (DC) schemes. We now look briefly at whether the same or similar principles can be available to members of final salary (defined benefit or DB) pension arrangements.

Flexible Benefits at Retirement

DB schemes pay defined benefits on retirement: viz. pension, lump sum, and dependant's benefits etc. These benefits are defined in the scheme rules, and they must fall within the benefits approvable by the Inland Revenue. A certain amount of flexibility is often available. For example many members can choose how much pension to commute to a lump sum. Some schemes allow members to sacrifice some of their own pension so as to increase their dependant's pension.

Extended choice

DB schemes could choose to offer additional options (ie to "flex" the benefit package) if this were permitted or encouraged. DB schemes already score highly against the criteria of security and self-reliance. Such options would extend the choices available to members. Some possibilities might be:

- an option to receive some or all retirement benefits later than normal pension age
- a wider choice of dependant's benefits or other benefits on death
- other risk benefits during retirement, payable for example on severe illness or disability

Large DB schemes might choose to offer such options as an extension to their existing benefit structure. Small DB schemes sometimes secure a member's retirement benefits at retirement with an insurance company. This could provide an opportunity to offer alternative benefit packages, according to the member's preferences at retirement.

There is already the option for members of DB schemes to take a transfer payment up to one year before normal pension age. Members approaching retirement can use this route to transfer to a personal pension contract. Consideration could be given to extending this option up until actual retirement.

Alternatively, if the proposals for DC schemes allow for more flexibility in the level of income, DB schemes could offer similar flexibility if it were accompanied by a certificate from the scheme actuary that the chosen level of income (which might involve step changes up or down in future years) was equivalent in value to the income the scheme would pay normally.

Flexibility after retirement

These approaches could increase the choices open to members of DB schemes at retirement. Further flexibility after retirement could, in theory, be incorporated by allowing continuation of the actuarial certification procedure. This would allow a member to change the size and format of likely future benefits to some other size and format of equivalent value. The difficulty here would be in establishing equivalence in value especially as the real value of a benefit to members in retirement can depend very much on their state of health. This would affect

- how long a income is likely to be payable for and
- the likely date at which a dependant's benefit will be payable.

It can be difficult to get a realistic assessment, for pricing purposes, of a member's health at advanced years.

This suggests that the value equivalence option might have to be restricted to the member's selected retirement date and possibly a limited number of other pre-selected dates.

9. Summary and conclusions

In this paper, we have tried to demonstrate that there are many different ways in which a person can provide income in retirement and, at the same time, address some of the needs and concerns they may have over the adequacy or suitability of the option they have chosen to provide that income.

There are three key messages we wish to make

Retirement needs can be quite diverse. They will depend on the priorities of the individual. They can arise from both predictable and unpredictable circumstances and they can change over time. This implies a fair amount of choice and flexibility in the options available.

Choice implies information. This should cover both the position with the currently chosen option and any other options which may be selected. This information should cover both private and state retirement provision and should, ideally, combine all of a person's arrangements in the statement. The information should be provided consistently and regularly to allow familiarity of use and the monitoring of trends.

The current system affords very little choice. Most people save for their retirement using approved pension plans but more need to be encouraged to do so. Encouraging greater pension savings means widening their appeal in both pre-retirement while the funds are being accumulated and in retirement while the benefits of the savings are being enjoyed. The Government has rightly focussed to date on the former but it now needs to turn its attention to the latter and examine ways in which greater choice and flexibility can be made available within approved pension plans without unduly affecting the fiscal or social priorities they attach to retirement planning.

We recognise that widening retirement choice raises many issues which have not been discussed in this paper. For example, consideration should be given to the ability of individuals, especially in their later years, to cope with the greater complexity which will inevitably accompany greater choice.

The subject therefore needs the widest possible debate. This paper is a contribution to that debate and the actuarial profession will be very happy to contribute further as the debate develops.

Appendix A: Summary of Choices Report

Purpose of the Report

The Report aims to identify ways in which the current compulsion to take annuities by age 75 might be amended. It examines the current provision of retirement income for members of defined contribution pension (DC) plans who are obliged to purchase such annuities, regardless of personal circumstances. It also looks at the shortcomings of existing annuities.

Main Proposals

The Report presents four main proposals:

1. An individual would continue to be free to take a tax-free lump sum from his or her pension fund subject to the current limits
2. When someone retires, they must purchase an index-linked annuity to meet a Minimum Retirement Income (MRI)
3. There should be much greater freedom over the application of any Residual Fund after the Minimum Retirement Income is achieved
4. The current shortcomings of existing annuities should be reduced by government and the financial services industry

Whilst some questions still remain, the members of the Retirement Income Working Party, believe that the report considerably develops the debate around retirement income.

Minimum Retirement Income

The concept of MRI is based on the following simple principles:

- On retirement, an individual's only obligation (assuming sufficient funds exist) should be to ensure an income that, taking into account life expectancy and inflation, will keep the individual above State support for the rest of his or her life
- There should only be an obligation to purchase an annuity from a DC pension plan if individuals are not able to fund the MRI from other sources
- In 1999/2000 the MRI would be set at around £140 per week (equivalent to a Basic State Pension and a SERPS pension for an individual on National Average Earnings). In practice, this would mean purchasing an index-linked annuity to the value of £70 per week, assuming that the individual had no other guaranteed income for life

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The Residual Fund

Having met the MRI, individuals would have greater freedom to use any Residual Funds remaining in their pension plan. The Report proposes that individuals may, as now, draw up to 25% of the original pension fund (pre MRI) tax free. Remaining assets would be then allowed to grow on a tax-privileged basis, until withdrawn, when they would be subject to the individual's highest marginal rate of income tax.

Existing Shortcomings of the Annuity market

Once MRI is accepted, then more innovative ways of providing for further income in retirement from pension plans can be found - not simply based upon annuities.

Conclusions

There are no simple answers to the present problems associated with providing income in retirement. Individuals are different and have differing requirements. This Report offers ideas and solutions to provide individuals with both choice and flexibility whilst ensuring they do not fall back on State benefits. Our aim is to open up public debate on these issues.

Appendix B: Terms of Reference and Limitations

Terms of Reference

The Retirement Choices Working Party was formed with the following terms of reference.

1. To review the Choices report by the Retirement Income Working Party and comment constructively on their proposals.
2. To consider the key issues in relation to the current requirements for a DC scheme to purchase an annuity and to put forward ideas which the actuarial profession could recommend for adoption by the Government either as developments of the proposals in the RIWP report or as alternative proposals.
3. Where appropriate, to indicate areas where further research is needed to formulate or test specific proposals.
4. To comment briefly on any implications for DB schemes.

Membership

- Leslie Gray FFA
- David Hughes FIA
- David Riddington FIA
- Kevin Wesbroom, MA, FIA

Limitations

Inevitably a report like this can only hope to cover part of what is a very complex issue. We set out below some of the areas we have not covered in detail, where further research would be needed before legislation could be introduced or modified.

Overseas Experience

We have paid only limited attention at this stage to the experience and systems which operate in other countries. Some useful summaries of this were given in the Choices Report and there is clearly scope to develop this further.

Minimum Retirement Income level

Much of what we say is predicated on there being a minimum income which an individual should seek to provide in retirement. This amount may vary depending on the circumstances of the individual eg depending on whether they are single or married.

In the Choices Report, this amount was called the Minimum Retirement Income (MRI) and it was suggested that this might be £140 pw index-linked and including State Benefits.

In this report we are more concerned about the "how" of retirement income rather than the "how much". We have therefore not commented on the Choices Report's view on the level of the MRI nor have we offered an alternative view. We have, however, continued to use the term MRI as we support the concept. If greater choice is incorporated into retirement planning, we think the level of the MRI should be subject to wide debate and we would be happy to contribute to that debate.

Annuity Purchase

When we talk about annuities in this report, we are largely talking about annuities which can be purchased by the proceeds of an approved pensions arrangement. There is legislation relating to what can and cannot be done in this context. As you might expect, we have not limited our ideas to only those options which can be provided within current legislation but, for clarity and brevity, we have kept to a minimum any comments on legislative changes and their implications. We imagine that any changes to legislation will involve a great many considerations many of them outside the scope of this report.

Tax

Also for clarity and brevity, we have minimised the comment on tax implications of current or proposed options. We are well aware of the importance of tax in retirement planning but we felt that, at this stage, it was important to concentrate on delivery methods and not dwell too much on their tax implications.

Comparative annuities

The longer an annuitant is expected to live the lower the annuity income. Generally the initial annuity income is lower for younger lives and for females compared with males since on average they are expected to live longer. This can be seen from table 1 below, which compares £1000 a year annuity for a 65 year old male with the alternative annuity bought with the same money for various ages, male and female. It looks at the relativity between single life annuities and longest life (reducing by 50% on male death, female 3 years younger), and also level versus RPI linked annuities.

TABLE 1

£pa	Age 55	Age 60	Age 65	Age 70	Age 75
Male	792	877	1000	1178	1434
Female	775	845	937	1080	1292
LL reducing	755	834	918	1029	1207
Male RPI	569	656	781	966	1209

Deferred annuities

It would be possible to set aside part of a retirement fund to effectively cover the risk of longevity. Table below shows the cost at retirement of buying a £1000 a year pension, payable monthly, but deferred to the age shown. The cost is shown for a variety of retirement ages. The first set of figures is for a level future pension. The second set is for a pension that increases both pre and post payment in line with RPI.

Retirement age
Income from
Income from
Income from

Age 70
Age 75
Age 80

Level Payments

£
£
£

Male
60
6367
4002
2281

65
7869
4870
2750

70

6157
3406

Female
60
6596
4166
2366

65
8180
5102
2877

RPI linked payments

Male
60
11109
7745
4912

65
11792

8115
5102

70

8811
5440

Female
60
11494
8037
5071

65
12255
8480
5318

Annuities & inheritance

It is possible to build various levels of life cover into a conventional annuity to give something at least for inheritance. Comparisons with no life cover conventional annuities are shown below. They correspond to the figures in Table 1 above. Two possible levels of cover have been considered as examples.

1) Capital protected – death benefit of original investment less income received to death

2) Full return – death benefit equal to the original investment

TABLE 3

£ pa	Life cover	Age 60	Age 65	Age 70	Age 75
Male	None	877	1000	1178	1434
	1)	839	929	1049	1206
	2)	599	610	624	641
Female	None	845	937	1080	1292
	1)	816	885	985	1112
	2)	588	587	591	593

Appendix D: Member Information

Information

We set out on the following pages an approach to providing better information to DC members that can be used to ensure MRI adequacy under the Capital approach referred to in section 6 of this report.

Retirement Pension Forecast

The Retirement Pensions Forecast which follows is based on the version issued by the DSS in their press release 00/114. It shows the forecast retirement pension from both State and private pensions.

Retirement Benefit Statement

The concept of a pre-retirement benefit forecast statement could be extended into retirement to produce a "Retirement Benefit Statement" which would show the current state and private pensions being received plus the value of any unallocated retirement funds invested in PDPs and the value of the pension these funds would buy.

The MRI would also be shown and this statement would be mechanism for demonstrating the need to purchase an MRI or reviewing the investment funds for the PDP.

RETIREMENT PENSIONS FORECAST

Name: A Smith
Date of birth: 20.02.57
National Insurance No: AB123456C
Date: 18.04.00

Your State Retirement Pension

The amount of State Retirement Pension you have earned so far:	£289.25 monthly
The amount of additional State Retirement Pension you have earned so far:	£109.76 monthly
The total amount of State Retirement Pension you have earned so far:	**£399.01 monthly**
We have assumed your State Retirement Pension will be payable when you reach the age of	65

Based on the amount you have earned so far if you pay, or are credited with, enough full rate National Insurance contributions the State Retirement Pension payable throughout at State pension age would be:

Basic State Retirement Pension	£527.16 monthly
Additional State Retirement Pension	£172.07 monthly
Total State Retirement Pension	**£699.23 monthly**

Your Company Pension

Your Selected Retirement Age is	65
If your current monthly contributions continue to be paid until the Retirement Age stated, the following benefits may be payable:	£101.45 monthly

Your combined pension

Assuming that both pensions were payable on the same day you would receive a combined pension (before tax) of	**£800.68. monthly**

See [...] for important notes about this forecast.

RETIREMENT BENEFIT STATEMENT

Name: B Smith
Date of birth: 01.08.32
National Insurance No: AB123456C
Date: 01.08.00

Your Current Retirement Income Sources	
Basic State Retirement Pension:	£289.25 monthly
Additional State Retirement Pension:	£109.76 monthly
ABC Scheme Pension:	£456.78 monthly
PQR Stakeholder Pension Plan:	£123.45 monthly
Total Retirement Income monthly	*£979.24*

Capital balances in the XYZ Personal Distribution Plan: £56,789.

Your options	
Your age	68
The total amount of Pension you are receiving:	**979.24 monthly**
The amount of Minimum Retirement Income is:	588.00 monthly

Your income exceeds the Minimum Retirement Income.
You need not take any action

The current value of funds which remain invested in Personal Distribution Plans:	**£56,789**
The approximate amount of index-linked Pension which you could secure with this fund:	£460.00 monthly

See [...] for important notes about this statement.