

Continuing Professional Development Guidance Notes

Pension Fund Withdrawals; and Guidance on Illustrating Critical Yields for the Purposes of Pension Fund Withdrawals

Introduction

Pension fund withdrawals

This edition of Regulatory Update contains the first of a planned series of guidance notes on continuing professional development.

The guidance notes on continuing professional development that follow concern the requirements that apply to designated individuals (and their supervisors) who advise on business in pension fund withdrawals. They apply to both product provider and independent practitioner firms regulated by PIA.

Each regulated firm which carries on pension fund withdrawal business has a duty to ensure that training is provided which is appropriate to the individual and to the firm's business plan. PIA does not specify any particular system of training to be followed or any particular qualification to be achieved in respect of this type of business, but does however expect individuals to have received appropriate training, including training on the matters set out in the following guidance notes. It is expected that training providers, such as the Chartered Insurance Institute, will shortly produce training material on the subject of pension fund withdrawals, which firms may find useful.

Critical yields

In addition, this Regulatory Update contains guidance on the illustration of critical yields for the purposes of pension fund withdrawals. Illustrations of critical yields are commonly issued to investors, although their issue is not required by PIA's Rules. The purpose of this guidance is to ensure that, where illustrations of critical yields are issued, they are prepared on a consistent basis. PIA expects firms to follow the best practice set out in this guidance by 1 December 1998 at the latest.

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PENSION FUND WITHDRAWALS

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1. Introduction: Continuing Professional Development Requirement

Every competent individual is required to undertake, for the purpose of Continuing Professional Development (CPD), a programme of study and training appropriate to the permitted activities in which he engages on behalf of a regulated firm (Rule 2.6.8). A similar requirement applies to new entrants who must, before completing Stage 2 training, receive a formal assessment of their knowledge, their skill in applying that knowledge, and their competence in the relevant permitted activity or activities. Appropriate records must be kept.

2. Definitions

The guidance is intended to cover training requirements for designated individuals who advise on alternatives (such as phased retirement, PFW or a combination of the two) to immediate annuity purchase. Such advice falls outside the definition of a pension transfer given in the glossary to PIA's Rule Book.

If the PFW arrangement involves the transfer of deferred benefits from a defined benefits Occupational Pension Scheme, that transfer will be defined as a pension transfer. Where such advice is given by a competent designated individual with only basic expertise, the advice must be checked by the firm's pension transfer specialist. An IFA firm must hold permitted activity 13 before engaging in such activity, and must comply with the special requirements imposed by that permitted activity.

However, if an immediate income is available from the Occupational Pension Scheme and has been quoted, the transfer of benefits to another pension arrangement would not fall within PIA's definition of a pension transfer. The normal standards of advice would apply to such a transaction (taking into account the available income from the Scheme).

2.1 PIA's definition of a PFW

A pension fund withdrawal is defined in the glossary to PIA's Rule Book as:

in relation to a decision of a *customer*, in respect of a *personal pension scheme*, to defer the purchase of an annuity and to take

- (a) income withdrawals within the meaning of section 630 of the Income and Corporation Taxes Act 1988, as amended by section 58 and Schedule II of the Finance Act 1995, and any provisions amending or replacing it; or
- (b) payments made under interim arrangements in accordance with section 28A of the Pension Schemes Act 1993, as inserted by section 143 of the Pensions Act 1995, and any provisions amending or replacing it;

and, in respect of an election to make pension fund withdrawals, a reference in the Rules to a customer, an investor or a policyholder includes, after that person's death, his surviving spouse and/or anyone who is, at that time, his dependant.

2.2 *Use of terms in the guidance notes*

This guidance makes use of the following phrases:

Advisers should be aware of:

This means that the adviser should have a sufficient breadth of knowledge to be able to place PFW advice in the correct context.

Advisers should understand:

This means that the adviser should have a greater depth of knowledge for that particular aspect (for example, death benefit options available to spouses under PFW). An adviser should be **aware** of the inheritance tax rule but would also need to fully **understand** the various death benefit options available to a spouse.

3. The core knowledge and its application

3.1 *The reasons why an investor may consider pension fund withdrawal*

The reasons why an investor may consider PFW may include, for example:

- income flexibility in retirement
- delayed commitment to a guaranteed annuity
- flexibility to take advantage of fluctuating annuity rates
- investment of accumulated fund whilst still withdrawing an income
- provision of flexible benefits in the event of death
- tax free cash withdrawal without purchasing an annuity.

3.2 *The risk factors*

The risk factors which need to be taken into account include the fact that:

- high income withdrawals may not be sustainable during the deferral period
- taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income when the annuity is eventually purchased
- the investment returns may be less than those shown in the illustrations
- annuity rates may be at a worse level when purchase annuity takes place.

3.3 *Investment linking*

The choice of investment link will be based on factors which include:

- the investor's attitude to risk
- the purpose of the plan
- the relative importance of the plan given the investor's financial circumstances.

3.4 *Scope of financial advice*

The investor may expect advice which includes the following:

- an analysis of the investor's retirement needs – taking into account the investor's financial circumstances and all financial arrangements including any accumulated pension fund, the investor's objectives and his attitude to risk
- an analysis of the financial options and solutions available – including a comparison of the relative advantages and disadvantages of the PFW plan and immediate annuity purchase, including (where appropriate) the income immediately payable from any Occupational Scheme the transfer value of which could be used to fund the PFW arrangement. The analysis should also take into account the investor's other means and resources for providing income
- recommendations and the reasons why those recommendations are considered suitable – covering how the recommendation would meet the investor's needs and objectives, and explaining the product detail, the choice of investment fund, and the risk factors, such as critical yield and the cost of PFW plan flexibility
- ongoing advice on the investor's financial arrangements – the investor may expect to receive regular ongoing advice including information on performance against the objectives which the investor has set.

3.5 *Advantages and disadvantages of PFW*

Advisers should understand the advantage and disadvantages of pension fund withdrawals, and how these relate to individual investors.

4. Core Knowledge Requirements

4.1 *Annuities*

Advisers should **understand** the structure of annuities, including an awareness of mortality tables, underpinning investments (gilts etc), and the type and cost of options available (guarantees, escalation, widows etc).

Advisers should be **aware** of the issue of financial strength.

Advisers should also be **aware** of the types of annuity available in the marketplace (with profit, unit linked, impaired health etc).

4.2 *Occupational pension schemes*

Advisers should be **aware** of the advantages that may be associated with maintenance of scheme membership (security, inflation, protection, tax free cash, discretionary increases, death benefits etc). Whilst typically these would cover high quality defined benefit schemes the adviser must also be **aware** of the issues for money purchase schemes, including section 32's.

In addition, advisers should be aware of the special annuity deferral provisions applying to SSASs (Small Self Administered Schemes) and those proposed for insured money purchase, AVC and other arrangements.

4.3 *PFW (Drawdown) and related products*

Advisers should **understand** the concept of PFW.

4.3.1 *Advisers should*

- be able to calculate the maximum and minimum pensions available using the Government Actuary Tables
- **understand** how the movement on long term gilt prices can affect income
- **understand** the need for the adviser to hold annual reviews and for the product provider to carry out tri-annual reviews
- **understand** the death benefit options available.

4.3.2 *Developments affecting the market*

Advisers should be **aware** of developments affecting the market, for example, products and Government regulations.

4.3.3 *Phased Retirement (Staggered Vesting)*

Advisers should **understand** the concept of phased retirement including the advantages and disadvantages of this route and how it can be used in conjunction with PFW.

4.3.4 *Self Investment (SIPP)*

Advisers should be **aware** of the advantages that can be available from self investment.

4.3.5 *Charges/Commission*

Advisers should **understand** the effect of charges on the contract.

4.4 *Investment Considerations*

4.4.1 *Client investment profile*

Advisers should **understand** the need to match investments to client needs.

4.4.2 *Types of investment fund*

Advisers should be **aware** of the structure of different types of investment funds (cash, guaranteed equity, with profit, non profit, managed, unit linked funds etc).

4.4.3 *Critical Yield*

Advisers should **understand** the calculation of critical yield and the impact that different investment strategies can have on the critical yield.

4.4.4 *Mortality Drag*

Advisers should **understand** the concept of mortality drag and mortality gain and how it impacts on the advice given.

4.4.5 *Investor's complete investment portfolio*

Advisers should also be **aware** of the wider investment issues. For example, as an alternative to taking an income from the drawdown, an investor could provide income from periodic encashment of direct equity holdings or other investments.

Members should keep copies of Regulatory Updates issued by the Personal Investment Authority

Illustrating Critical Yields for the Purposes of Pension Fund Withdrawals

PIA has identified two bases for the illustration of critical yields which may be supplied to investors. These are:-

- **type A**
the growth rate needed on the “drawdown” investment sufficient to provide and maintain an income equal to that obtainable under an equivalent immediate annuity
- **type B**
the growth rates necessary to provide and maintain a selected level of income.

PIA has decided that such illustrations of critical yields may only be provided to an investor if they are calculated and presented in accordance with this guidance note. If a type B illustration of critical yield is provided to the investor it must be accompanied by a type A illustration of critical yield.

Type A illustration of critical yield – comparison with purchase of immediate annuity

Alternative Approaches

Yields may be calculated and presented on either of two formats. They may be investor specific; or the firm may publish standard tables containing sufficient values for a potential investor to be able to deduce the critical yield which would apply to him. In general terms, the yields reflect the effect of charges/expenses and mortality.

Investor specific calculations should show the total returns needed using current interest rates. PIA prefers this approach, but recognises that standard tables with appropriate explanations may be of value to investors, particularly when inserted in standard literature.

Critical yields should be shown assuming annuity purchase at each of ages 75, 70 and 65, but may in addition show other ages.

If standard tables are used these should be based on whole years and commencement ages of 55, 60 and 65.

Basis of Calculations

To provide a fair comparison with the purchase of an immediate annuity, the calculations should ignore any application of the GAD limits on drawdown. However, any payment outside the limits should be highlighted as being constrained if the assumptions are borne out.

The critical yield should be calculated in a similar manner to the calculation of reduction in yield – including the effect of appropriate charges whilst ensuring that the effect of mortality is included. The annuity rate at eventual purchase should use the same basis (in particular for rates of investment return) as the alternative immediate annuity.

Analysis has shown that the additional yield over and above the yield underlying the annuity rate does not vary significantly with the underlying assumed rate of investment return. Firms may therefore publish a standard table which is based on immediate annuity rates which incorporate an investment return of the mid-rate (currently 7½%) or the investment return underlying current immediate annuity rates to calculate the additional yields required.

In order to set the critical yield in context, the investor should be given details of at least two of the following:

- a) the total critical yield
- b) the additional yield i.e. the effect of appropriate charges and mortality
- c) the underlying rate of investment return.

Where a standard table is used, it may show either a) or b). The higher of the current GAD interest rate and, if available, the rate underlying the firm's annuity rates may be used as the underlying rate of investment return. Where the figures are investor specific, the rates of return used in the calculation should be disclosed.

Other details

Where standard tables are produced, firms should include a table for both a single life annuity payable monthly in advance for five years' certain and an annuity with at least a 50% spouse's contingent annuity unless the selected table takes account of marital status.

Accompanying wording

The illustration of critical yield should be accompanied by an explanation which is clear, fair and not misleading and which should in particular:-

- include a risk warning concerning the volatility of investment returns and the consequences of that volatility
- give an example using a sample figure from the above table and the underlying rate of investment return so that the investor understands the total investment return needed.

Type B illustration of critical yield – selected income level

Such an illustration of critical yield shows the total underlying rates of investment return necessary to provide the income flow selected by the investor both in drawdown and subsequent annuity purchase.

Circumstances where a type B illustration of critical yield may be issued

Investor specific type B illustrations of critical yield are permitted but should:-

- only be given if accompanied by a type A illustration of critical yield
- use the same commencement age and annuity purchase dates as the type A figures or which can be deduced from the Type A table.

Basis of calculation

The basis of calculation of yields should be as follows:-

- income taken in drawdown must be constrained by the GAD limits
- the critical yield should comprise two rates, namely pre and post the purchase of an annuity. They should assume a consistent investment scenario over the whole period to the death of the investor so that the annuity rate at eventual purchase should be based on the PIA standard annuity tables using an interest rate equivalent to (i.e. 5/6ths of*) the growth rate during the period of pension fund withdrawal
- the annuity purchased should include a contingent spouse's pension of at least 50% of the investor's pension if the investor is currently married.

**Note: 5/6ths is the current ratio between pre and post vesting (e.g. 7% is 5/6 of 9%). In certain circumstances, this method can result in interest rates post retirement significantly above current levels. Where this occurs, then either:*

- *the calculations should be performed imposing a limit on the interest rate post retirement 2% above the current GAD rate, or*
- *the risks associated with the contract should be explained, namely, that interest rates may not rise to the rate required.*

Accompanying wording

The illustration of critical yield should include an explanation which is clear, fair and not misleading and which should in particular:

- state the critical yields necessary to meet the benefits selected by the investor
- include a risk warning concerning the volatility of future investment returns and the consequences of that volatility.

Additional guidance (applicable to both type A and type B illustrations of critical yields)

In addition to the critical yields, the firm may disclose to the investor schedules showing the progression of the fund on a year by year basis.

For both types, regulated firms should make allowance:

- where appropriate, for increases in benefits whilst in payment, both from annuities purchased or from drawdown. It is suggested that a default rate of increase of 3% be used
- for the frequency of income payable.

Phased retirement

The above principles apply to arrangements involving phased retirement.

Existing business

Firms should also follow the principles set out in this guidance in producing illustrations of critical yields for existing business.

