TECHNICAL NOTE
CRITICAL YIELDS

Scottish Widows Platform

For Professional Advisers only

Background

In August 1998, Regulatory Update 55 was issued as part of the 'Continuous Professional Development Guidance Notes'. These notes covered what was then called Pension Fund Withdrawals – now called drawdown pension and, amongst other things, set out the requirement for critical yields.

Since that date, critical yields have remained a key factor in assessing the suitability of drawdown pension for clients, both at the outset and at the review (so drawdown pension review packs containing critical yields should be a key requirement of any provider you choose).

Critical yields will not be entirely relevant to every individual. Where decisions are being driven by the need for flexibility or other factors such as death benefits, comparing a drawdown pension income stream with a conventional annuity may not always be the major comparison to be made.

However, explaining a critical yield illustration to a customer should help them better understand the commitment they are making when choosing drawdown pension over an annuity, irrespective of the drivers for that decision.

What do critical yields do?

There are two types of critical yield:

Type A

In a Type A critical yield analysis, a comparison is made between the drawdown pension fund and a conventional annuity.

This is based on the role of investment return required on the drawdown pension fund to provide and maintain an income equal to that obtainable from an annuity purchased with that fund at the outset.

Clearly, the figure that is calculated takes no account of rises and falls in the stockmarket during the period. It simply gives the rate of return that, if achieved smoothly over the term of the plan, will lead to a maturity fund that will buy the same income level at maturity as you'd have bought at the start of the plan.

In theory, if the return exceeds this, you'll get a better income than by buying an annuity in the first place.

Unfortunately the theory's imperfect. If the average return over the period is exceeded but income is withdrawn at a time when market values are depressed, you can beat the critical yield and end up with lower benefits. The opposite is also true.

The yields reflect the effect of charges and mortality drag. Should the main driver for effecting a drawdown pension plan be to maximise income, along the way the drawdown pension fund will need to outperform an annuity. The critical yield will indicate the required rate of return. The critical yield may be so high that the attitude to risk may need to be at least balanced or perhaps even moderately adventurous, to support the equity exposure generally required for such a return. But remember, this higher equity content will increase volatility and volatility means that there will be greater divergence from the average return on a day-by-day basis.

A critical yield analysis takes into account two further key factors:

- **Charges**

  Charges under a drawdown pension plan are much higher than under an annuity, due mainly to the costs of ongoing servicing of the plan, to its more complex nature compared to an annuity and to the remuneration paid to advisers – particularly in view of the requirement to provide ongoing advice. As charges reduce the impact of any investment growth, the higher the charges, the greater is the investment performance required to maintain the drawdown pension fund.

- **Mortality drag**

  When calculating annuity rates, actuaries effectively assume an average life expectancy and those clients purchasing an annuity and fortunate enough to live beyond this are generally gaining at the expense of those dying younger, something commonly referred to as mortality cross-subsidy.

  Those clients who go into drawdown pension and defer annuity purchase lose out on this cross-subsidy and, the longer annuity purchase is deferred, the harder the drawdown pension fund has

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to work (or the more the fund has to grow) to compensate, as life expectancy reduces with age. This has the effect of increasing the critical yield.

In theory, the absence of the mortality cross-subsidy on a drawdown pension fund indicates a higher value of death benefit. However, this is difficult to explain and, towards older ages, the mortality cross-subsidy could be a substantial amount to forego irrespective of the value of any death benefit.

As a result of low interest rates and increased longevity, annuity rates have been relatively low in recent years, with this trend set to continue. Therefore, the critical yield required to beat an annuity would be much lower.

The type of annuity required will also be an important factor – for example, if a spouse's pension is included this reduces the starting annuity and therefore the critical yield required.

Critical yields are also higher for older clients as annuity rates increase with age (i.e. the amount of mortality across-subsidy grows).

Type B

This is the rate of investment return necessary to provide and maintain a selected level of income, both in drawdown pension and in subsequent annuity purchase. Again, the higher the selected level of income the harder the fund has to work to match this and the client's attitude to risk is therefore again a key factor.

What do drawdown pension illustrations have to show?

Ironically, illustrations do not have to show critical yields (although it is unusual not to). However where they are shown, then Type A critical yields must be shown. Type B critical yields can be shown in addition Type A, but cannot be shown in isolation.

Critical yields are generally quoted at ages 65, 70 and 75 but may also be illustrated at other ages. Similarly, at least two of the following must be provided:

1. the total critical yield
2. the additional yield i.e. the difference between the total critical yield and the underlying rate of investment return
3. the underlying rate of investment return

Summary

Critical yields have an important part to play in explaining the costs and risks of drawdown pension to your clients. It could be argued that, if critical yields do not look achievable, particularly taking into account the client's attitude to risk, an annuity should be purchased; otherwise there is a real risk that the fund will be depleted and that the eventual annuity purchased will be a lot less than expected.

However, there are other factors to consider – not least the fact that the client may not be using drawdown pension to counter low annuity rates, and may therefore have no issue with the fact that critical yields may be so high that the investment returns required cannot be achieved.

It is also worth bearing in mind that providers have the choice of using either their own annuity rates or FCA prescribed ones, so there is no level playing field. Therefore, should a provider offer competitive (high) annuity rates, it would not be in their interests to base their critical yields on this as the resulting yields would be higher than had they used FCA prescribed rates.

By the same token, should the provider offer uncompetitive (low) annuity rates, it would be in their interest to use their own rates rather than FCA prescribed ones, as the resulting critical yields will be lower. As they may use different assumptions, critical yields produced by different providers should not be used as a basis for making product comparisons – critical yields may be helpful in explaining the costs and risks to customers but their use should not extend beyond this point.

For more information on the Scottish Widows Platform, please contact your consultant.
We may record or monitor calls to improve our service.

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SWP TN 0007 (0723 IH)