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TECHNICAL

BULLETIN

CRITICAL YIELD

What role does a critical yield now play in deciding on the suitability of drawdown for your client, at outset and throughout the drawdown review process?

With increased pension flexibilities a greater number of clients are likely to find themselves considering some form of income withdrawal solution for their retirement income needs. With the availability of flexi-access drawdown (FAD) and its removal of the need to consider maximum GAD limits, the opportunity to take large, irregular and ad-hoc income payments creates further complexity in ensuring the sustainability of a client's pension income. These changes will have an impact on the role of critical yields when assessing your clients' circumstances.

As a quick recap, the critical yield calculation assumes that a guaranteed income for life (GIfL), provided by a pension annuity, will be purchased at a certain point in the future. If the solution you recommended to your client might still involve future annuitisation, then the critical yield calculation will still play a vital role when considering if the income level being taken is sustainable in the long term.

If your recommendation no longer includes future annuitisation, the critical yield calculation is still relevant, but the assumptions made within the calculation may need to change.

It's worth noting there is no requirement to include critical yields in an illustration, but where they appear it's not possible to provide a Critical Yield B without also showing a Critical Yield A (these are explained in more detail below).

Most drawdown providers choose to offer these as a matter of best practice. However, there's variation in the annuity rates used to underpin the calculation (either FCA prescribed or company's own rates), and just because something has been adopted as a 'norm' doesn't necessarily mean it's always useful in the client advice journey. So let's consider their relevance in more detail.

Relevance?

With pension freedoms firmly embedded, the obvious question that arises is "what relevance does a critical yield now have for my client?" This is a reasonable question to ask, particularly if the intention is to completely empty the pension pot immediately, perhaps by taking an Uncrystallised Fund Pension Lump Sum (UFPLS) or the strategy is to strip out the entire pension tax efficiently over a few tax years through flexi-access drawdown. In this context there's a question as to how relevant any critical yield might be in understanding the implications of the recommendation made.

Where the client is seeking to draw a structured income from their drawdown over a number of years, having an understanding as to how sustainable this income stream will be is still important and critical yields can be used to help assess this.

Being able to recognise when a critical yield can enhance the client discussion and support the advice recommendation is key.

When considering whether, or how, to use critical yields it's worth identifying if there's another way of commenting on the drawdown income's sustainability. Examples of alternatives might include using a cash flow modelling tool or by identifying and commenting on the number of years before the pension funds are likely to be exhausted, for example, by using an illustration.

Why critical yield remains important

Where a client is reliant on the drawdown fund to provide an ongoing income stream, failure to consistently achieve the investment returns required to meet the critical yield would mean the income level selected is unsustainable, and may result in fund depletion and lower income. Ultimately this leaves your client with a difficult decision to make: do they reduce their income, or do they take on more investment risk and move to a more aggressive asset allocation? If they're not comfortable with this, do they remain in drawdown at all?

In these circumstances, as the critical yield is a key component in this decision making process, it's essential that the calculation used is as accurate as possible and tailored to your client's individual circumstances. The annuity assumption used in the calculation should accurately reflect the annuity your client would purchase in reality.

If the critical yield is incorrect, your client's investment portfolio may be aiming to achieve an investment return that would not match their future income objectives.

As a result, this will often mean recalculating the critical yield used in your client's drawdown quotation to tailor it to their individual circumstances.

Please see the tools section of justadviser.com for a critical yield calculator which can be used to provide a personalised figure for clients.

Critical yields

A critical yield is an indicative investment return which – if met – would achieve a fund value capable of supporting a certain level of income in the future.

There are two types of critical yields in use:

Type A: the return required to match the annuity that could have been purchased at outset.

Type B: the return required to maintain a selected income level.

Type A critical yields will assume that your client is taking the same level of income from their drawdown arrangement as they could have secured through an annuity purchase. In reality, your client may opt to take a different level of income to this. In these situations, a Type A critical yield would be irrelevant and a Type B critical yield would be the more accurate yield to consider.

The problem with critical yields

On most drawdown illustrations, providers will show a Type A critical yield often based on a standard level annuity, with no dependant's pension included.

Is this the correct annuity type and shape for my client? – this is the key question to consider when looking at these illustrations. If the answer to this question is "no" then your client's critical yield will not be specific to their individual circumstances and considering a more personalised approach would provide a more relevant yield.

Three steps to a personalised critical yield

The trigger point for calculating a critical yield can be at any point during your client's drawdown period. However, in reality this tends to happen at the outset of drawdown or where a phased or drip feed strategy is employed, at the next crystallisation event.

With the removal of the triannual and annual GAD reviews (which were associated with capped drawdown) any advice process will need to consider when to conduct a drawdown review. The review may occur as part of any ongoing service agreed with the client – perhaps annually. It could be driven by events, for example, reaching state pension age, or it could be triggered by a desire for different levels of income withdrawal.

Regardless of when this review takes place, obtaining an up to date accurate critical yield should be considered.

There are three simple steps that can be taken to ensure that your client's critical yield is personalised:

Step 1 – Underwrite

We believe that everyone should be individually underwritten, in order to achieve a personalised income that's tailored to their circumstances. For a mild condition a client could receive an income of up to 15% more, whilst a severe condition could mean up to a 30% uplift to your client's income. Underwriting will help establish the correct level of enhanced annuity rate uplift. This uplifted rate should be factored into the calculation.

Step 2 – Shape

Look at the required annuity shape compared to the standard annuity shape assumption used in drawdown packs and quotes. Consideration should be given to the frequency, escalation, guarantee period and dependant's/nominee benefits that your client would actually wish to have built into any annuity purchase. Depending on the options chosen, the critical yield may then be lower than before, as the starting income will be lower.

Step 3 – Income

Your client should consider how much income they wish to take now and in the future; there can be a temptation to take more now simply because it's available. If you establish that your client is likely to annuitise in the future, thought should also be given to when they may wish to consider this. These income levels should then be used in conjunction with the annuity shape and enhancement established in steps 1 and 2 to recalculate your client's personalised critical yield.

A personalised critical yield calculation in practice

If we apply this process to a 65 year old with a crystallised pension pot of £100,000 who decides they want to draw an income of £7,650 per annum:

The drawdown quote from their provider shows a Type A critical yield and confirms a yield of 4.36%.

To recalculate this critical yield using our three steps:

Step 1 – Underwrite

Through underwriting it's confirmed your client qualifies for a moderate enhancement on their annuity. This should be built into the annuity assumptions used.

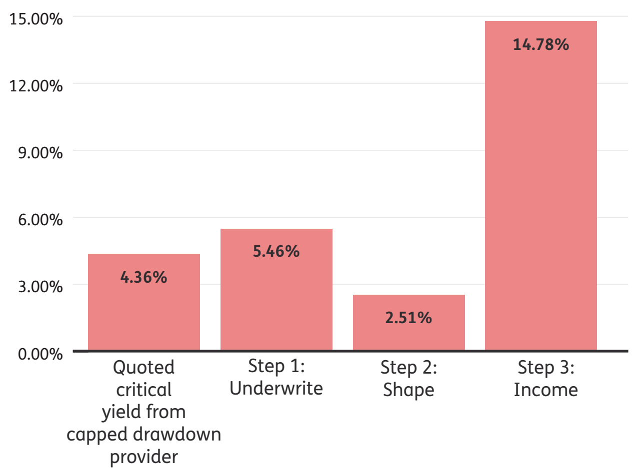
Step 2 – Shape

You establish that your client would actually want to purchase an annuity with:

- 50% dependant's pension
- 3.0% escalation
- 10-year guarantee period

Instead of the standard annuity assumptions used in the drawdown provider's critical yield – these revised options should be built into your new calculations.

These assumptions are then fed into the personalised critical yield calculation and the impact is shown below:



Step 3 – Income

Your client indicates that they would like to take £7,650 income initially, with a view to sustaining this income when they eventually annuitise. You establish they foresee doing this by age 75.

You can see that by following our three steps the critical yield rises from 4.36% to 14.78% once personalised – approximately 339% higher. Had you built an investment portfolio to achieve the quoted critical yield in your client illustration they would have dramatically undershot their income target.

As can be seen, the biggest impact is a result of step three, where the income is selected. We have assumed the client wishes to take an income of £7,650 (which coincidentally is what could have been provided based on 150% GAD) and sustain this throughout their retirement. This is clearly a significant sum and many clients will choose less income, which will lower the critical yield accordingly.

To sustain their income they would either need to scale back their initial income or take on more investment risk, something they might not be comfortable with.

Summary

In the absence of an alternative method of commenting on how sustainable the income source is, a critical yield can be used to help support the recommendation made to a client.

Whilst suitability should not be solely determined with reference to the critical yield, it does help to frame the advice considerations and discussions.

Where a critical yield is used to support the recommendation, this comparison demonstrates that underwriting and annuity shaping are crucial to providing a personalised critical yield figure at outset or review.

Although it can be argued that circumstances could change in the future, and that annuity shaping or enhanced and standard annuity rates may alter, utilising underwriting can help provide a more informative discussion around realistic drawdown investment aims, and also how a GIfL, provided by a pension annuity, can be considered as a valuable alternative and benchmark.

FOR MORE INFORMATION

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