Think piece

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Drawdown reviews: providing valuable at-retirement services to customers

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Summary

- For several years now a variety of factors (principally low gilt yields and improving longevity) have led to low annuity returns which, in turn, have contributed to the growth in the use of drawdown contracts in 'at retirement' planning.
- Unfortunately, a combination of consumer inertia which has benefitted many pension providers and tax rules have resulted in an affinity towards annuities.
- The the Chancellor's pensions reforms announced in Budget 2014 has tried to address the latter issue by liberalising the tax rules, but still consumers need to be connected with the right product in a timely manner.
- It is therefore essential that an effective drawdown review process is in place to ensure continuing suitability.
- The actual requirement for a capped drawdown review comes from HMRC and was introduced as a way of trying to ensure that plan holders did not erode the value of their plan too much to provide an on-going income. That driver will disappear from April 2015, and it will be necessary to consider the possibility of the client accessing their fund (net of tax) in full.
- HMRC sets down specific requirements for when regular reviews must occur, and the already extensive list of options available to customers will increase as a result of the Budget 2014 pensions reforms. An adequate and careful review process is clearly required.
- Research suggests a widespread lack of knowledge among advisers of the full range of options available to clients, and a failure by some firms to include either health questions or relevant personalized annuity rates in the review process.

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PFS Introduction: pensions savings drawdown has grown in popularity as an at-retirement decumulation option in recent years, and the pensions liberalisation reforms announced by the Chancellor in Budget 2014 changes may well accelerate this going forward. It is therefore essential that an effective drawdown review process is in place to ensure continuing suitability. In this Thinkpiece we will look at the current requirements for drawdown reviews and provide insight into how a robust and future-proof process can be developed, and the article provides some relevant support material that will help achieve this.

For several years now a variety of factors (principally low gilt yields and improving longevity) have led to low annuity returns which, in turn, have contributed to the growth in the use of drawdown contracts in 'at retirement' planning.

The failure of many retirees to look further than the annuity offered by their pension provider has meant that a significant number of pensioners have received even lower annuity rates. They have not exploited their right to shop around under the Open Market Options rights, as the Financial Services Consumer Panel reported in Dec 2013, and some of those who have done so have been sold less suitable products on a non-advised basis.[1] The problem of poor value annuities, combined with effectively compulsory annuitisation, for those whose circumstances made drawdown inappropriate, has been recognised by successive governments. The FCA's annuities thematic review also highlighted failings due to issues around the lack of shopping around.

It is against this background that the 2014 Budget proposals should be seen. From April 2015 anyone aged 55 or over, who has not already used their fund to buy an annuity, should be able to access their fund in full, subject to a marginal rate tax charge on any amount over the Pension Commencement Lump Sum.

The size of the market

According to figures published by Money Management in August 2014, there were at least 252,000 capped drawdown contracts in force and at least £29 billion[2] in assets under management within those plans excluding those held by James Hay (who did not disclose their assets held in drawdown).

The 2014 Budget proposals put annuity purchase 'on hold' for many which led to a number of one-year short term annuities. There were written under drawdown rules, taken out as a method of accessing scheme benefits at retirement, within an effective holding action. As of the end of June 2014, 9,500 drawdown contracts had been written with an average pot of £50,000.

The key issue to address is demonstrating ongoing suitability, and finding the right review process to ensure a robust and sustainable model for consumers.

The requirement to review capped drawdown

The actual requirement for a capped drawdown review comes from HM Revenue & Customs (HMRC) and was introduced as a way of trying to ensure that plan holders did not erode the value of their plan too much to provide an on-going income. This driver will disappear from April 2015, since it will then be possible for plan holders to take the whole value of their capped drawdown plan as (taxed) cash.

Nonetheless, the requirement continues as far as the reviews prior to April 2015 are concerned and will still have relevance where advisers undertake reviews after that date if they are to provide plan holders with a proper analysis of their options.

Reviews undertaken from April 2015 will have to consider the possibility of the client accessing their fund (net of tax) in full. Reviews undertaken prior to April 2015 will need to reflect the fact that accessing the fund (net of tax) in full will be a future option and advice must reflect that.

To ensure that the fund within a capped drawdown does not deplete too quickly, a 'formal' HMRC review of the maximum income level must take place every three years for clients under 75 and annually for those over 75 until the whole fund is used to buy a lifetime annuity or the member dies. Box 1 below sets out the actual HMRC requirements and in addition certain events aside from a

[1] See FSCP Press Release, Dec 2013: http://www.fs-cp.org.uk/newsroom/2013/244.shtml

[2] Income drawdown: trouble ahead?, by Charlotte Richards, *FT Adviser*, 26 Aug 2014.

client request can trigger a review. Most of the time it is likely that the maximum income level will change at each review, based on the then current fund value and the client's age and needs. Attitude to Risk, capacity for loss etc are also likely to have changed.

Box 1: HMRC Requirements for Drawdown Reviews

- Every 'reference period' or three-year interval starting from the date income withdrawal commences.
- The review will take place on the 'reference date', which will be either the first date of the reference period, or a 'nominated date' which can be up to 60 days before the reference date (in either case the new level will take effect at the reference date itself).
- Reviews will also be required if part of the fund is moved into an annuity or a scheme pension, or if a pension sharing order takes effect.
- A customer can also request an additional review on a drawdown anniversary, subject to the pension administrator's agreement. In which case, the new income level will apply from the start of the next pension year and a new three-year reference period will be take affect.
- More frequent reviews of the suitability of the drawdown may take place if the planholder's adviser undertakes regular reviews of their other investments.
- There are additional rules for clients who were in income withdrawal before 6 April 2011 (when the rules changed) under a five-yearly review.
- Their next review could take place on or before 4 April 2016, from when the new three-yearly period will apply. Further complications arise for any clients who have transferred drawdown benefits to another provider.
- At capped drawdown review, customers have several options: they can stay in capped drawdown; switch to flexible drawdown (subject to a minimum level of secure pension income of £12,000); convert part or all of their fund to a conventional, enhanced, impaired or guaranteed annuity, or scheme pension; or transfer their fund to another drawdown arrangement.
- Post-April 2015, this options list will expand to include the ability to take as much from their fund as required as (partly) taxed cash.

What are the outcomes of reviews at present?

With all of the options available at review, combined with the changes a plan holder is likely to go through over the three years between reviews, one might expect to see a lot of changes when reviews are undertaken. However, this does not seem to be the case. By far the most common outcome appears to be for capped drawdown policyholders to remain in drawdown.

It should be noted that over 45%[3] of capped drawdown plans are not used to provide any level of income.

Just Retirement undertook some research in 2013 and Q1 of 2014 to try to understand why this should be the case. From initial data from 600 respondents—all practising advisers—they found that 12% of advisers did not consider annuities 'at all' when they undertook a capped drawdown review. In addition, overall, only 33% of advisers considered the plan holder's health when completing the review.

To gain some sense of what is actually happening when capped drawdown contracts are reviewed, the survey was followed by in-depth interviews with ten of the respondent firms[4] known to be active in 'at retirement' planning.

While no firm conclusions can be drawn from this research given its relatively small sample size and its approach, it does nevertheless provide some insight that all available options are not currently being considered at review.

While it is at least theoretically possible for reviews to be undertaken 'remotely' by the product manufacturer or adviser, this survey shows that advisers 'always' or 'usually' undertake the reviews face to face.

Of the reviews undertaken by these firms in the 12 months prior to interview, nearly all (over 97%) resulted in the customer remaining in capped drawdown. In one example (the firm with the largest number of live capped drawdown clients), 100% of cases were reviewed in the period and all remained in capped drawdown.

However, further investigation did raise questions around the processes used by firms when undertaking these reviews.

[3] Money Management review of 50 product providers published August 2014

[4] 10 firms were interviewed covering 1100 individual capped drawdown contracts

As already stated, there is no real guidance as to what should be included in a drawdown review beyond the HMRC requirements. This factor will almost inevitably lead to failings in processes

There is, in any event, evidence of a widespread lack of knowledge of the full range of options available to clients. Specifically health-based annuities which make up two-thirds of the annuities which are written as a result of drawdown reviews.

There appears to be be a failure by some firms to include either health questions or relevant personalized annuity rates in the review process. Only 40% of firms look beyond the GAD rate, even if they have asked health questions – which 80% of firms claimed to have done).

It is important to note that critical yield is not the sole, or even necessarily the most important, factor in a client's decision whether to remain in drawdown; indeed many clients enter drawdown despite the critical yield. However, a process which doesn't include both health questions and the practical use of the answers to those questions is likely to result in more clients remaining in drawdown, possibly to their detriment.

What are the FCA's requirements for capped drawdown reviews?

While there are no specific rules in the FCA Handbook around capped drawdown reviews, this does not mean that the regulator has no expectations on how customers should be treated in this area.

First, the activity of undertaking a drawdown review is an FCA 'regulated activity'. Second, an adviser who gives advice to a client following a review of a capped drawdown contract, even if the advice is to change nothing, will be providing a personal recommendation, and as such be subject to advice rules. The handbook defines a personal recommendation as:

"a recommendation that is advice on investments, or advice on a home finance transaction and is presented as suitable for the person to whom it is made, or is based on a consideration of the circumstances of that person".[5]

Based on this fact, and the absence of specific rules around the review process, the drawdown review must be treated very much in the same way as the original recommendation to utilise a drawdown solution. So the requirements of COBS 9.3.3 would apply. In fact, as a personal recommendation is being made, the adviser should follow the full 'assessing suitability' requirements of COBS 9.2.

The fact that firms appear, for example, not to be considering annuities at all as part of the process, much less considering health based annuities, would seem to breach these requirements in many cases.

Box 2: Consequences of an inadequate drawdown review

- Not considering an annuity at all means that the client is not given the opportunity to consider the advantages of alternatives to drawdown
- The failure to ask health questions at retirement means that other options than drawdown may not be considered properly
- The failure to include enhanced annuity rates in the critical yield calculation means that some clients who could benefit from an annuity are left in drawdown facing lower levels of income and higher levels of risk

The adviser faces:

- Client complaints can cause reputational damage
- Client complaints can result in the need to make compensation payments
- Client complaints may be subject to Financial Ombudsman Service (FOS) review
- The FCA can require firms to undertake prior business reviews (which are expensive)
- The FCA can censure and fine a firm for providing inappropriate advice and having inadequate systems and controls
- Drawdown reviews which do not result in new business may not be subject to the firm's normal compliance processes
- All of the above can impact on PII costs and even availability

Given the new flexibility from April 2015, the need to assess all aspects of a client's financial and other circumstances when undertaking a capped drawdown review even more vital. Customers not drawing an income may well wish to access the net capital value of their fund.

[5] FCA Handbook, Conduct of Business Sourcebook (COBS), Rule 9.3.3 https://fshandbook.info/FS/glossary-html/handbook/Glossary/P?definition=G877

In conclusion

Capped drawdown is a substantial market and the demand for reviews of existing contracts is likely to increase significantly when the full effects of the 2014 Budget work through in April 2015. It is absolutely crucial that firms have a detailed process in place in order to cope effectively with the level of demand and the complexity of possible solutions. A formal process is necessary to ensure that both supervision and compliance departments are aware that advice has been given in a drawdown review which, where no new 'business' is written, is not always the case.

In order to support members in the delivery of best practice we have developed an overview of the Drawdown review process. This looks at the key areas to be considered within the process and includes a 12 point, step by step process.

As further support we have produced a checklist that will enable you to validate that all the key points required by the Drawdown review process have been covered.

These documents are included as an appendix to this Thinkpiece. If you are a Drawdown practitioner, paraplanner or compliance professional we would urge you to review these documents and consider how they may be helpful to the refinement of your own existing Drawdown review process.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk. or by telephone: +44 (0)20 7417 4783.

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The Drawdown Review Process

Introduction

Since pension simplification was first introduced in 2006, and with the 2014 Budget Statement, there have been a number of changes to the drawdown rules. With this in mind, it is important to take a fresh look at the drawdown review process and consider the breadth of options available to your customers.

Key Considerations for defining the drawdown process:

- What does your drawdown review process look like?
- How do you charge for the service you provide?
- Are your fees for on-going advice & reviews clear, fair and not misleading? – Are these mentioned in the customer updates and agreements?
- How frequently do you review your existing customers' drawdown plans? Does this need to change?
- How do you identify those customers who should be reviewed more urgently than others?
- What events should trigger an ad hoc review?
- Are there any current customers who you have identified should consider alternative retirement solutions now, and what are the reasons for this?
- Are there any customers who either no longer have an appetite for investment risk or are seeking an alternative income solution? (This includes those who have a reduced capacity for loss)
- What process do you follow to identify the above customers, bearing in mind that they are ageing?
- How do you segment your customers? Does this process clearly identify capped and flexible, along with hybrid drawdown customers?
- Does your current fact find / customer profiler capture sufficient information to enable you to conduct a review or does this need to be updated?
- How does the minimum secured pension income reduction from £20,000 to £12,000 affect your existing customers?
- Is anyone impacted by the revised triviality rules – increasing from £18,000 up to £30,000?

What else is there to consider?

- What rate & shape of investment return is needed to secure an income level that matches that available from an annuity?
- Does your process support TCF principles?
- Are you fully aware of any fund manager changes / impact on the customer's portfolio?
- Do you need to rebase the existing fund choice?
- What is your strategy/ process for customers who do not respond to requests for a review?

This process or customer journey doesn't have to be' war & peace' if it can evidence the step-by-step guide detailed below then this should be sufficient.

Your review process should at the very minimum be an annual event and consistent across all your Regulated advisers / consultants.

Clearly, there is a cost to these reviews and there should be an explicit fee for the drawdown review. Where trail commission remains payable in respect of pre-RDR business this can, of course, be offset against the fee, or it can be facilitated through an adviser charge. The effect is identical.

- For both face to face and telephone advice you need to update your fact find / KYC data along with any recent changes in health and ATR. Remember to include health questions as part of your pre-appointment letter or telephone contact.
- Identify the current fund value(s) and analyse the underlying performance of the assets held.
- Review performance and investment strategy against your customer objectives / goals and priorities.
- Has your customer's health changed since the last review– does this have an impact? (You can use on line tools to assist you with critical yield calculations such as that available from Just Retirement)
- Complete a set of 5 screening questions that will identify whether you need to complete a common quotation form with your customer re their full information and health disclosure to obtain OMO quotes.
- If your customer does qualify for enhanced /individually underwritten annuity rates then reassess the critical yield calculation using this rate (e.g. using an online tool such as that available from Just Retirement) and identify whether the availability of a higher annuity rate affects their decision to remain in Drawdown.
- Introduce and discuss the relevance of a phased exit from Drawdown into another vehicle, such as annuity purchase, fixed term annuity, partial taxed withdrawal
- Issue draft Suitability Report and quotes to your customer, book follow up meeting.
- Discuss all options with your customer
- Issue your final recommendations and any revised KFI / KFD.
- Process changes and issue any updates to your customer.
- Monitor and diary forward for next review / planning.

Financial intermediary checklist: demonstrating ongoing suitability for drawdown

In line with FCA comments around establishing suitability for Drawdown (based on their webinar of March 2014) the following checklist is designed to prompt an action or check by you prior to submission of the review and/or new business to your Compliance or Business Monitoring teams. Note that this includes any fund switch advice and/or re-balancing.

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Name of Customer	Adviser Name
Date of Review	Date(s) of customer meetings
Date IDD / TOB completed (if applicable):	Date of Customer Service Agreement / Fee Agreement (if applicable):
Customer Date of Birth	Age:
Customer status: Single / Married / Civil Partnership/ Widow / Co-habiting / Separated/ Divorced – altered since last review?	

Fact Find (FF) or 'Know Your Customer (KYC):	✓
Is the FF / KYC up to date? (Should be no older than 12 months since last one completed). For telephone or face-to-face advice.	
Have all relevant sections / boxes been completed in full (IE no blanks– the use of zero or n/a when appropriate)?	
Have you used any form of focused retirement questionnaire and if so has this been fully completed & considered?*	
Do you have full and complete details of any health issues? Has the customer's health changed since your last review? **	
Does this impact on the critical yield you may now need to research/review and have you recalculated the relevant personalised critical yield for the needs of your client? ***	
Has the customer refused to disclose any information? Does this impact on your ability to provide your services and / or advice?	
Is this an 'insistent customer'? – If so have you followed your internal procedures for dealing & documenting this?	
Is this a 'vulnerable' customer? – If so have you followed your internal procedures for dealing with and documenting this?	
Does your updated FF / KYC include the customer's updated attitude to risk (ATR) and their desire to take risk ? (Has an updated Risk Profiling questionnaire been completed?)	
Does your updated FF / KYC include the customer's updated capacity for loss and the way this has been measured? Notes should also include any discussions around loss or minimum income requirements	
Have the desire to take risk, or capacity for loss changed since the last review or meeting, and if so has this been documented in the notes? If having indicated any change in their desire to take risk or capacity for loss does the FF / KYC detail your discussion around any need for considering any alternative income solutions?	
Does any goal require an increase in risk and if so do the FF notes explain why?	
Does the Fact Find / KYC demonstrate the need for income / growth or a combination of the two?	
Have you discussed and documented any changes that may be required as a result of the 2014 Budget, including both the interim changes and the planned changes from April 2015?	
Have you updated the customer's overall objectives and priorities? Have these changed since the last review or meeting, and if so has this been documented in the notes?	
Are the customer goals realistic – do they seem appropriate and are they written in their own words (not generic)	
Have you documented the customer's income & expenditure needs now and in the next 12 months?	
Does the customer have access to an 'emergency fund – does this follow your firm's guidance?	
Does the FF document any debts or other liabilities? (secured and unsecured)	
If any of these need to be repaid has this, been considered in your research & solutions?	
Do you know the customer's tax rate and have you considered the effect of this?	
Is there any requirement for any further Tax Free Cash / Pension Commencemen Lump Sum noted from any other sources not yet crystallised or released?	
Do you have full and complete details of all retrement provision recorded? Inclusive of any other investments , savings or other provision?	
If applicable - Has the customer lost or need to track down any pension or retirement plans before you can consider next steps? (Will need NI number to complete BR19)	
Is the customer entitled to any State Benefits?	
Are any changes in circumstances expected in the next 1–5 years? (This includes leaving the UK)	
Is the customer still UK domiciled?	
Is the customer still UK resident?	
Does the customer have any form of Power of Attorney?	
Have they made a will? Is it up to date?	

Research:	✓
Have you Identified the current fund value(s) and completed an analysis of the underlying performance of the assets held?	
Does this recommendation involve any re-broker / replacement business e.g. pension switch or transfer and if so has each individual policy been researched?	
Consolidation of ANY existing pension funds is not an acceptable reason for going into drawdown and / or SIPP / hybrid plans	
Have you included all funds research to include both performance and investment strategy against the customers objectives, goals & priorities? This includes any rebalancing? (If using software or portfolio reviews do these provide an audit trail of the events leading to the final fund choice?)	
Is there a clear relationship between funds selected and customer ATR?	
If using DFM – does this involve any rebalancing? Have all associated costs & charges been considered & understood by the customer?	
If using DFM – have all associated costs & charges been considered & understood by the customer?	
Have you included research into all relevant charges applicable? E.g. plan charges, AMCs, MVRs, exit penalties, Policy fees, switch charges etc.	
Have you conducted like for like comparison with your recommended solution and is this in evidence? This includes obtaining any OMO quotations and the availability of an enhanced annuity rate, where appropriate.	
Does this include any 'off panel' process – where applicable , and is this on file as evidence of approval?	
Do you have KFI / KFD to match the recommended solution both for the customer and your file? (All funds should match)	
Have you considered all possible alternatives and documented this?	
Have you conducted all necessary Critical yield calculations (particularly important if customers health has changed) and considered whether it is achievable?	
If applicable - Have you checked against the Lifetime Allowance?	
Does any fund value fall into 'small pot' and / or triviality rules ?	
Is your customer close to SPA or their chosen retirement date (eg where they have taken pcls and no income but not yet retired) and has this been factored into the review and on-going advice & recommendations?	

*If using a bespoke post retirement questionnaire please ensure that all relevant questions and notes are fully completed to demonstrate 'KYC'.

** You can complete a set of 5 screening questions that will identify whether you need to complete a common quotation form with your customer re their full information and health disclosure to obtain OMO quotes

*** you may want to consider using a specialist critical yield calculator, such as that available from Just Retirement to assist with this calculation

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Suitability Report (SR) / appendices:	✓
Does the file contain a copy of the final SR?	
Does the SR state if this is a full financial review or limited / focused to income drawdown only? Does the SR match the KFI /KFD by way of product, features, options, funds, charges etc? (*Please include any death benefits*)	
Does the SR state the customer objectives , goals and needs in line with the FF?	
Do the reasons for the advice match the customers objectives / needs and priorities as detailed within the FF?	
Do the reasons for the fund(s) match the research and customer ATR , alongwith any change in this since the last review?	
Is this consistent throughout the audit trail?	
Are all statements factually correct?	
Have you documented why this provider & product is still being recommended where there is no change or a new provider?	
Have you provided sufficient reasons and evidence to support the level of income / cash being taken ?	
If immediate income is being taken have all the consequences been included (including property fund warnings)?	
Have all appropriate warnings & risk been documented clearly?	
If relevant - Have the reasons for any re-broke / replacement business been clearly documented?	
If relevant - If re-broke / replacement have the advantages, disadvantages and any increase in costs in cash terms confirmed to the customer?	
Does the SR explain next steps, including on-going review process and charges?	
Have you considered all possible alternatives – including 'do nothing'?	
Have you documented remuneration in line with customer agreement? (Is this clear, fair and not misleading?)	
Is it clear how the customer's minimum income requirement is being met? If not secured, how will the customer cope if their income were to drop below this minimum level of income required?	
Depending on the level of income being taken and any associated volatility in the underlying investments have you clearly defined and explained when / if the income might run out, particularly before they die?	
Cancellation rights detailed where appropriate ?	
Have you included all relevant appendices?	
Is the SR signed by the FI?	

Other	✓
Have you updated your customer records post sale to indicate next agreed review and new business?	
Is up to date Verification of Identity / AML needed?	