Personal Finance Society
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Good Practice Guide

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A practical guide to Advised Pension Income Drawdown

Foreword

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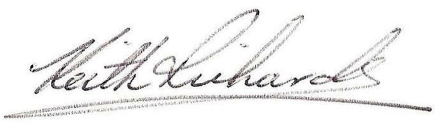
In 2015, the introduction of 'Pension Freedoms' was a game changer for the retirement income market, moving existing pension savings from a source of income in retirement to a financial planning vehicle.

Prior to its implementation approximately 75% of individuals converting their pension fund to an income stream entered into an annuity contract, often without exercising their Open Market Option to secure a competitive annuity rate. Annuity sales were dominant across the market and income drawdown was a much smaller part of the market. But since the introduction of pension freedoms, the situation has reversed, with approximately 75% of individuals now entering into income drawdown.

At the same time, we are starting to see a change in attitude to traditional retirement, with many people now transitioning into retirement (rather than it being marked by a distinct point in time) and looking at their overall assets, including residential property, savings and pensions to fund their changing retirement income needs at different points during later life.

While pension freedoms have provided flexibility such as that inherent in drawdown, it is still the main aim of most people that their pension provides them with an income that lasts through retirement. Indeed, this is one of the reasons the regulator continues to look closely at the retirement income market.

This paper recognised that advice firms want to do the right thing by their clients, but sometimes struggle to identify good practice. Specifically, this paper is in response to members' requests for further commentary and clarification around good practice in the face of increased numbers of income drawdown cases being taken out across the market and the possibility that strong market returns enjoyed since the introduction of freedoms are unlikely to continue unchecked. We hope this guide makes a valuable contribution to suitability and the ongoing delivery of consistently good client outcomes.



Adviser Good Practice

1. Understanding the client's overall financial position

Income Drawdown isn't really a product – it's more a strategy for withdrawing retirement savings from a tax wrapper. Advice on Income Drawdown therefore requires broad context, specifically the wider financial circumstances and needs of clients, given in almost all cases it involves a trade off between risk and reward as well as tax mitigation decisions. If your client has other sources of income, lifetime savings or realisable assets including residential property, these should be considered and, in many cases, might offer up a more tax efficient route compared to withdrawing income from a pension.

2. Understanding the client's starting position

As well as understanding a client's overall financial position, a bespoke approach stemming from establishing a client's starting position is often critical in ensuring a good consumer outcome. For example, some clients are looking for deferred drawdown, wanting to take their tax-free cash with a view to buying another pension product later down the line. Other clients are looking to take the maximum tax efficient income from their pension to bridge the gap until their state retirement pension and/or occupational pensions kick in.

3. Assessing all options

The Taxation of Pensions Act 2014 ('pension freedoms') allows an individual to take as much or as little as they like from their money purchase arrangements on reaching the normal minimum pension age (or earlier in special circumstances). Whilst scheme rules do not have to offer all the flexible options allowable, all available options including a transfer to an alternative arrangement should be considered to arrive at the most suitable client outcome.

Advisers need to demonstrate they have carried out sufficiently broad research on the products available in the market, as well as checking that the product they have selected does 'what it says on the tin'. This should include commentary on why the existing provider (if applicable) is not being considered or chosen.

Advice on drawdown itself is increasingly not a binary choice for many in respect of retirement income products, with good practice involving an assessment of the suitability of a full spectrum of retirement income solutions, including phased drawdown and blended or hybrid solutions so that current and known/unknown future income needs can be best accommodated. Drawdown should also be benchmarked against annuities and, where appropriate, enhanced annuities.

4. Considering all the risks

Drawdown is almost always a balancing act between mitigating risk, receiving returns and retaining some flexibility. A successful drawdown strategy involves the ongoing and effective management of any number of client risks following the establishment of attitude to risk and capacity for loss. Essentially this is about helping clients understand the greater risks associated with drawing down retirement portfolios, compared with the accumulation stage, including:

- **Sequence of returns risk** (also known as reverse pound cost averaging) – where withdrawals during a market downturn can lead to a rapid reduction in the value of a fund.
- **Volatility drag** – the risk inherent where a portfolio falls in value and then needs to work harder to go back to its initial value.
- **Inflation risk** – helping the client appreciate how long their portfolio might need to last and a considered view on the impact of inflation (for example, 5% inflation reduces real income by two thirds over a 20 year period). Even relatively benign rates of inflation can have a huge financial impact over increasing years in later life.
- **Longevity risk** – an assessment of average life expectancy and helping clients understand the probability of living beyond this.

In addition to the above, specific warnings should be given to clients including:

- The capital value of the fund may be eroded
- The investment returns may be less than those shown on the illustrations
- Annuity rates may be better or worse in the future
- High levels of income may not be sustainable.

5. Clarifying all the charges

In the FCA's 2017 Retirement Outcome Review, when commenting on non-advised drawdown the regulator stated:

"Drawdown charges can be complex, opaque and hard to compare…"

It's particularly important that advisers follow good practice in respect of adviser charging and associated disclosure for drawdown, given the added complexity around such things as charges for drawing an income, drawdown set up charges, platform custody charges etc. For further information please see the Personal Finance Society's earlier guide: 'A good practice guide to adviser charging (and associated disclosure)' – March 2015.

6. Establishing an optimal investment strategy

Advisers should consider the need for a different investment approach for clients in the accumulation and decumulation stage. In adverse market environments, volatility combined with withdrawals can result in significant falls in portfolio value so the effective delivery of low volatility growth through a regularly reviewed investment strategy is a crucial objective for most drawdown clients.

7. Establishing a 'prudent' withdrawal rate

Linked to the above, advisers should have a robust framework in place when it comes to advising clients on what commentators often refer to as a Safe Withdrawal Rate (SWR). Drawdown is however not without risk. As such, good practice should also extend to the use of more accurate words such as 'prudent' or 'reasonable' withdrawal rates. Of course, any rule of thumb needs to be adapted to take into account individual client circumstances as well as external factors such as inflation.

Where a withdrawal rate is established to provide a sustainable income, the adviser should of course take account of the key aspects of the FCA PS 18/6 – Advising on Pension Transfers, including the current Transfer Value Analysis (TVA) and the subsequent application of the Appropriate Pension Transfer Analysis framework (effective 1/10/18).

8. Minimising Tax

One of the key ways advisers can demonstrate value (and increase sustainability of income) is in respect of limiting tax on withdrawals. Unless a pension provider holds an up-to-date tax code, lump sum withdrawals from a pension plan will currently be subject to income tax under the emergency rate basis. This will result in an overpayment of tax for a significant majority of individuals making their first withdrawal from their pension.

Whilst this overpaid tax may be reclaimed during the tax year using one of the new HMRC forms specifically designed for this purpose, consideration of strategies to avoid emergency tax including utilising phased income withdrawal when a large tax-free cash amount is not required is good practice where appropriate.

In addition, advisers should always raise the issue and assess the impact of the Lifetime Allowance, both on withdrawals and at age 75 on remaining benefits. Account should be taken of the existence of any 'protection' from the 'lifetime allowance charge' in respect of the value of benefits built up (and future benefits that may accrue) in excess of the LTA.

9. Consideration of other opportunities

Where appropriate, adviser should consider other planning opportunities related to drawdown, including for example, the use of spousal bypass trusts, the recycling of income and the use of excess income to fund pension contributions (e.g. for children or spouse).

10. Creating a defined, repeatable process

Scoping out, documenting and following a defined process that is flexible enough to accommodate all types of clients' current and evolving needs, as well as predictable and unpredictable events will help ensure advice remains suitable and compliant. Such processes should cover onboarding both new clients and a robust review for existing clients.

11. Building a robust review process

Successful drawdown strategies require ongoing monitoring to help ensure they meet changing and evolving client circumstances. This requires a consistent drawdown review process across all clients, regardless of the provider.

Critical questions include:

1. Is it meeting the stated objectives, priorities and expectations of the client?
2. Is the chosen level of income sustainable over the long term?
3. Is the investment strategy still suitable?

Other important questions to be asked include amongst others:

- How will a client's health affect the review and outcomes?
- How do you assess whether the clients' objectives are still realistic?
- Has their capacity for loss/attitude to risk changed?
- How are any changes to strategy and investment portfolio identified and actioned?
- How do you decide if the time has come to consider a partial, phased or full exit from a drawdown plan (for example, to buy an annuity when a client gets older and the impact of mortality drag means their drawdown strategy becomes progressively less effective)?
- Is it clear the clients' minimum income requirements are still being met?
- Has the client's cognitive abilities deteriorated?
- Does the client have a Power of Attorney in place? Or, is the client a Power of Attorney for someone else?
- Advisers should hardwire a review of the nomination/expression of wish into every annual review and following each key life event.
- Changes in relevant legislation?

12. Frequency of Review

It has always been important to review drawdown pension funds with clients on a regular basis but following pension freedoms, and the facility to take large ad hoc withdrawals at any time, reviews have become even more important. Frequency of review should reflect the complexity of any given clients' circumstances, but good practice would suggest this should be at least annually and, in some cases, more frequently.

13. Use of Cash Flow Modelling

A good way of understanding the specific needs of a client surface whether they have any concerns about outliving their retirement savings and help them make decisions (especially where trade offs exist) is the regular use of some form of cash flow modelling. Good practice should include running cash flow modelling beyond average life expectancy and the adviser should have a considered position on what that should be and why. This might also involve further modelling of a clients' overall financial situation to age 75 because at this point it might be better for some individuals to annuitise and remove the risk of outliving their money entirely.

Effective Cash Flow modelling should stress test various scenarios for the client to enable them to decide whether they are able to take the income they require and how it might be affected by certain events such as:

- The need to increase income taken from a portfolio
- The need for any ad hoc withdrawals
- Inflation is higher (or lower) than expected/predicted
- Living longer than expected
- Future returns prove to be lower than expected
- Unpredictable events – a stock market crash, the need to fund long term care etc.

It is good practice for cash flow modelling to be an integral part of the review process.

14. Building Contingency

Its good practice to make sure there is a contingency built in to all retirement planning, and to make sure there is significant provision to cover unforeseen problems (such as a major stock market crash, significant unexpected capital expenditure or the death of a partner). Agreeing to a plan of action in advance will enable action to be taken quickly.

15. Understanding of the impact on Welfare and Social Care Support

It is important that the adviser understands the impact of different choices on drawing down pension funds on current and future entitlement to welfare and social care support. This is especially relevant for those who draw down their pension pot quickly as they may be deemed by authorities to have deliberately deprived themselves of income/assets and in so doing reduce or disqualify entitlement to such support at some future point.

16. Powers of Attorney

As well as increased longevity, the UK will have increasing numbers of people with illnesses, both physical and mental, ranging from mild cognitive decline to dementia. Good practice involves highlighting the possibility of loss of a clients' own ability; for instance if they lose mental capacity, what are the issues that present in terms of the ongoing management of a drawdown strategy. Evidencing that the client has the ongoing capacity to make decisions and outsource decisions to third parties, such as discretionary fund managers and their adviser is increasingly important.

Clearly the time to set up a Lasting Power of Attorney is well before it is needed and adviser firms should highlight this to their clients. Consideration should also be given to a disclaimer being signed at the outset if the client chooses not to elect an LPA.

17. Drawdown legacy planning

Pension freedoms introduced the concept of nominee and successor flexi-access drawdown, which amongst other things allows for pension wealth to be passed down through family generations. Apart from being good practice, it is important that a member nominates and keeps their nominated beneficiaries up to date if they want them to have access to all death benefit options available under drawdown. Advisers should hardwire a review of the nomination/expression of wish into every annual review and following each key life event.

Further consideration to involve family and/or loved ones in drawdown legacy planning can mean the whole experience on death goes smoothly and promptly, often resulting in a far better outcome at what is almost always an emotionally difficult time for family members.

Appendix – The Rules and regulatory source material

Recent FCA communications

Recent Communications	Relevant dates	Content commentary/link
FCA CP 18/17 – 'Retirement Outcomes Review: Proposed changes to our rules & guidance'	Issued 28/6/2018 Closes 6/9/2018 Policy Statement due Q1 2019	This consultation sets out the FCA's proposed package of remedies from their **Retirement Outcomes Review**. Drawdown is where the majority of the review's focus and concern lies. Between October 2015 and September 2017, nearly 350,000 pension pots went into drawdown, and almost a third of these did so without the benefit of any financial advice. In respect of drawdown, the FCA are seeking feedback from stakeholders on proposals that: • providers should offer ready-made drawdown investment solutions, within a simple choice architecture ('investment pathways'), which reflect standardised consumer objectives • new consumers accessing drawdown will have to make an active choice to be in cash. The FCA expects firms to have a strategy for dealing with consumers who have already been defaulted into cash,and who are unlikely to be best served by this investment strategy Once a consumer has entered drawdown the FCA suggest they still need information and support, and... • are consulting on a proposal that providers should send information to their customers in drawdown annually, whether or not they are currently drawing an income from their pot. • are seeking feedback from stakeholders on whether firms should remind their customers annually of their chosen investment pathway and their ability to switch. **www.fca.org.uk/publications/consultation-papers/cp18-17-retirement-outcomes-review**
FCA Non-advised drawdown pension sales review: summary of findings	Issued 28/3/2018	The FCA assessed whether firms are providing necessary information in a way that helps customers make informed decisions when accessing retirement benefits and when reviewing whether their drawdown pension continues to meet their needs. **www.fca.org.uk/publication/multi-firm-reviews/non-advised-drawdown-pension-sales-review.pdf**

Appendix – The Rules and regulatory source material

Further reading

Defaqto: *Professionals' guide to drawdown 2018–19*
The document is accredited by the CII/PFS and CISI for up to 60 minutes of structured CPD.
https://www.defaqto.com/advisers/publications/professionals-guide-to-drawdown-201819/ or https://www.pruadviser.co.uk/pdf/GENM416404.pdf

The Pension Advice Service – *Spotlight on Income Drawdown*
file:///C:/Users/apfstonm/Downloads/https___www.pensionsadvisoryservice.org.uk_content_spotlights-files_uploads_Income_Drawdown_SPOT001_v1.6_Dec_2017_.pdf

Money Advice Service - *What is income drawdown?*
https://www.moneyadviceservice.org.uk/en/articles/income-drawdown

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