

CONTRACTING OUT - NPI's CRITICAL YIELDS

A more transparent approach to contracting-out advice, replacing 'Pivotal Ages'

The State Second Pension (S2P) and contracting out

Since 6 April 2002, when the State Second Pension (S2P) superseded SERPS, National Insurance contributions have earned S2P benefits. Employed persons have the option of contracting out. By contracting out of S2P, they will not necessarily give up all their S2P entitlement: the enhancement (S2P top-up benefit) which the State will provide to those on lower earnings will be given regardless of whether the individual is contracted in or contracted out. Therefore the decision whether or not to contract out does not have to take into account the S2P top-up; the amount of S2P given up by contracting out will just be the amount of S2P attributable to the actual National Insurance contribution rebated.

Pivotal ages

Prior to March 2002 NPI, like most other pension providers, published pivotal ages to assist financial advisers in giving recommendations on contracting out. A pivotal age is the expected age from which the value of the earnings-related pension benefit being given up begins to exceed the value of the pension that the rebate is expected to provide, i.e. the age at which the transition is made from being better off contracted out to being better off contracted in.

The calculation of pivotal ages is dependent upon the assumptions used in the projection of the rebate premium, including contract charges. Pivotal ages may therefore differ between products, and they may also differ between one pension provider and another, not only because of charges but also because companies can make different assumptions with regard to investment returns: there is no formal guidance on what these should be.

All pivotal ages published by NPI prior to March 2002 were based upon a comparison of projected contracted-out policy benefits with the SERPS benefits given up, considering each year's rebate contribution separately. They assumed investment returns would outstrip National Average Earnings by 3% each year, coupled with the Financial Services Authority's unisex annuity basis for conversion of the fund to annuity and, the relevant contract charges.

The only guidance readily available to financial advisers on contracting out has been that published by the product providers themselves. If Independent Financial Advisers rely on the pivotal age guidelines provided by the companies with whom they place contracting-out business, the investment assumptions underlying their advice may not be consistent. However, if companies were to publish critical yields instead of pivotal ages, this would give Independent Financial Advisers more freedom to use their own judgement as to what is a reasonable investment return to hope for from a contracted-out pension policy, and hence to exercise greater control over their advice on contracting out.

Critical yields (CY)

A critical yield is the investment return which would need to be earned, over and above the increase in the index of National Average Earnings (NAE) each year, to provide a benefit at least equal to the amount of the earnings-related State pension given up.

It is not, however, sufficient just to consider the investment return earned before retirement. The rate at which the fund can be converted to annuity at retirement must also form part of the calculation. NPI changed its calculations last year to reflect the new annuity mortality basis specified by the Financial Services Authority which must be used in benefit illustrations from 6 April 2003. This basis incorporates an allowance for future improvements in mortality. While this is a significant step in the right direction, there is no guarantee that the allowance will match the full improvement in mortality encountered in practice. The interest rate underlying the annuity is linked to the pre-retirement investment return in the same way that the FSA stipulates for use in contracting-out policy illustrations: pre-retirement return plus 1% pa, but based upon RPI rather than NAE. The effect of using the new mortality basis is to increase critical yields.

Because the State Second Pension benefit accrual formula allows for the revaluation of earnings in line with increases in the National Average Earnings (NAE) index, contracted-out benefit illustrations and the critical yields published by NPI are expressed in real (NAE-related) terms. Critical yields also make full allowance for contract charges, so that a high charging contract will show a higher critical yield than a low charging contract. All calculations assume Protected Rights benefits are taken from State Pension Age (SPA).

Below are tables of critical yields applicable to NPI's contracting out products in 2004/5. But first, some questions arising:

1Q. Why are critical yields similar for males and females until age 49, but then diverge?

1A. Males and females currently aged 49 and below all have a state pension age of 65. Use of unisex annuity rates results in the same critical yields for these people. Older females have a lower state pension age and therefore the state earnings-related pension accrues more quickly (due to a shorter working life) while the contracted out pension reduces because of the shorter period of investment and lower annuity rates (because the pension will start at a younger age).

2Q. Why do the critical yields for males dip between the ages of 49 and 58?

2A. This appears to be a consequence of the Government Actuary's aim of producing a smoothly increasing unisex table of contracted-out rebates. He had to choose between using a uniform investment assumption either for males or for females; clearly he decided that using females gave a more acceptable result.

3Q. For Protected Rights benefits built up since 6 April 1997, if the individual is not married when the Protected Rights fund is converted to annuity, he/she will have the option of a single life pension. As a single life pension would be higher than the normal joint pension (which must include a 50% widow(er) s pension), would this not reduce the critical yield? Should this possibility be taken into account when giving advice on contracting out?

3A. Yes, it is relevant if the individual is likely to be unmarried on the date the pension is taken. However, our calculations show that the critical yield would not be greatly affected. For example:

For males aged 58, 59 and 60 the critical yield reduces by 0.3%

For females aged 51, 52 and 53 the critical yield reduces by 0.2%

In pivotal age terms, these reductions are equivalent to a pivotal age shift of less than one year.

4Q. How have investment returns compared with the NAE Index in the past?

4A. Period	Average incr p.a. in NAE	Average REAL returns p.a. over the 5 year period		
		UK equities	UK fixed interest	75% Eq + 25% FI
1998 - 2002	4.4%	-6.4%	3.1%	-3.7%
1993 - 1997	3.7%	11.7%	5.8%	10.2%
1988 - 1992	7.8%	5.2%	3.8%	5.1%
1983 - 1987	7.8%	12.8%	4.0%	10.7%
1978 - 1982	13.9%	2.6%	-0.8%	1.8%

These figures include income reinvested.

Past investment returns are not necessarily a guide to future investment returns.

5Q. How might the proposals in the Pensions Green Paper affect the contracting-out decision?

5A. As it is proposed that the value of contracted-out benefits will be included when assessing the lifetime limit, whereas State pension scheme benefits will be paid in addition, any individual who has prospects of breaching the limit at any time should almost certainly prefer to be contracted in to the State Second Pension. However, those who are unlikely to breach the limit should note the possibility that protected rights may in future be 25% commutable for tax-free cash.

TABLES OF CRITICAL YIELDS

For an explanation of the basis on which these figures have been calculated, please refer to the section "Critical yields" above.

CRITICAL YIELD TABLE 1

- Annual Management Charge (AMC) only contracts
- Applicable to:
 - Group Personal Pension Plan (AMC only - refer to appropriate column)
 - Individual Stakeholder (refer to 1.0% AMC columns)
 - Group Stakeholder (refer to columns up to 1.0% AMC, as appropriate)
- For salaries of less than £15,000, increase asterisked figures by 0.1%

MALES					FEMALES			
0.4% AMC	0.75% AMC	1.0% AMC	1.25% AMC	Age attained on 5th April 2004	0.4% AMC	0.75% AMC	1.0% AMC	1.25% AMC
1.7%	2.0%*	2.2%*	2.4%*	16 - 25	1.6%	1.9%*	2.1%*	2.3%*
1.8%*	2.0%*	2.2%	2.4%	26 - 35	1.7%*	1.9%*	2.1%	2.3%
1.8%	2.1%	2.2%*	2.4%	36 - 40	1.7%	2.0%	2.1%*	2.3%
1.8%	2.2%*	2.3%	2.5%*	41 - 45	1.8%	2.0%*	2.2%	2.4%*
2.0%*	2.2%*	2.3%	2.5%*	46	1.8%*	2.1%*	2.2%	2.4%*
2.0%*	2.2%*	2.3%	2.5%*	47	1.9%*	2.1%*	2.2%	2.4%*
2.0%	2.2%	2.4%*	2.5%	48	1.9%	2.1%	2.2%*	2.4%
1.8%	2.0%	2.2%	2.3%*	49	1.9%	2.1%	2.2%*	2.4%
1.6%	1.8%*	1.9%	2.0%	50	1.9%	2.1%*	2.2%*	2.4%
1.3%*	1.4%	1.6%*	1.7%	51	1.9%*	2.0%	2.2%	2.3%
0.9%*	1.1%	1.2%*	1.3%	52	1.9%	2.0%	2.1%	2.2%
0.9%	1.0%*	1.1%	1.3%	53	2.3%*	2.4%*	2.5%	2.5%
1.0%*	1.2%	1.3%	1.4%	54	2.7%	2.7%	2.8%	2.9%*
1.2%	1.3%*	1.4%*	1.5%	55	3.2%	3.3%	3.3%*	3.4%
1.4%	1.5%*	1.6%*	1.7%*	56				
1.6%*	1.7%*	1.8%*	1.9%*	57				
1.8%	1.9%	2.0%	2.1%*	58				
2.1%*	2.2%*	2.2%*	2.3%	59				
2.6%*	2.7%	2.7%*	2.8%	60				

Depending on the precise salary in a specific case, this table may overstate a critical yield by up to 0.15%. In all cases, the maximum understatement is that implied by rounding to 0.1% (i.e. 0.05%).

CRITICAL YIELD TABLE 2

- Applicable to NPI's standard terms PPP
- Contract terms: Allocation 96% on first £500, 99% thereafter
5% bid-offer spread
1.0% Annual Management Charge

MALES					FEMALES			
Salary £ under 10,000	Salary £ 10,000 to 14,999	Salary £ 15,000 to 19,999	Salary £ 20,000 and over	Age attained on 5th April 2004	Salary £ under 10,000	Salary £ 10,000 to 14,999	Salary £ 15,000 to 19,999	Salary £ 20,000 and over
2.3%	2.3%	2.3%	2.3%	16 - 20	2.3%	2.3%	2.2%	2.2%
2.4%	2.4%	2.3%	2.3%	21 - 30	2.4%	2.4%	2.3%	2.3%
2.5%	2.4%	2.4%	2.4%	31 - 35	2.4%	2.4%	2.3%	2.3%
2.5%	2.5%	2.5%	2.4%	36 - 40	2.5%	2.4%	2.4%	2.3%
2.7%	2.6%	2.6%	2.5%	41 - 45	2.6%	2.5%	2.5%	2.4%
2.7%	2.7%	2.6%	2.5%	46	2.6%	2.5%	2.5%	2.4%
2.7%	2.7%	2.6%	2.6%	47	2.6%	2.6%	2.5%	2.5%
2.8%	2.7%	2.7%	2.6%	48	2.6%	2.6%	2.5%	2.5%
2.6%	2.5%	2.5%	2.4%	49	2.7%	2.6%	2.5%	2.5%
2.3%	2.2%	2.2%	2.1%	50	2.7%	2.6%	2.5%	2.5%
2.0%	1.9%	1.9%	1.8%	51	2.6%	2.6%	2.5%	2.4%
1.6%	1.5%	1.5%	1.5%	52	2.6%	2.5%	2.5%	2.4%
1.6%	1.6%	1.5%	1.4%	53	3.0%	2.9%	2.9%	2.8%
1.7%	1.7%	1.6%	1.6%	54	3.4%	3.3%	3.3%	3.2%
1.9%	1.8%	1.8%	1.7%	55	4.0%	3.9%	3.8%	3.8%
2.1%	2.0%	2.0%	1.9%	56				
2.3%	2.2%	2.2%	2.1%	57				
2.6%	2.5%	2.4%	2.4%	58				
2.9%	2.8%	2.7%	2.7%	59				
3.5%	3.3%	3.2%	3.2%	60				

Depending on the precise salary in a specific case, this table may overstate a critical yield by up to 0.15%. In all cases, the maximum understatement is that implied by rounding to 0.1% (i.e. 0.05%).

Group Money Purchase (new product)

Where contracting out is through the now preferred route of a Rebate Only Personal Pension (ROPP) while remaining contracted in to the GMP scheme, the critical yields will be those shown in the preceding tables.

Group Money Purchase (old products), EPP and Variable Group PPP

This section covers NPI contracts which apply an ongoing policy fee to contracted-out benefits. The relevant contracts are VGPPP and GMP schemes, where the member is contracted out through the GMP scheme itself.

It is often stated that contracting out is not beneficial where the salary is below a given level, due to the effect of charges. This is true for contracts with fixed policy charges. The higher the fixed policy charge, the higher will be the critical yield.

Both NPI's VGPPP and GMP contracts have an annual member charge within their charging structure. This charge is levied annually (VGPPP) or monthly (GMP) regardless of whether the policyholder has contracted out in that particular tax year. Therefore, guidance regarding ages at which it is beneficial to contract out will need to take into account whether or not the policyholder has contracted out already through the relevant VGPPP/ GMP product with NPI.

For "existing" policyholders (i.e. those who already have a rebate VGPPP/GMP policy and hence have contracted out in the past via this route with NPI), a decision to contract out or to remain contracted out will not increase the existing member charge liability. The following critical yields, independent of salary, would apply:

VGPPP: Deduct 0.1% from the critical yields shown in table 2.

CRITICAL YIELD TABLE 3: GMP and EPP existing policyholders
Contract terms: Allocation 100% 5% bid-offer spread 1.0% Annual Management Charge

Age at 5.4.2004	16 - 39	40 - 46	47	48	49	50	51	52
Critical yield (M)	3.2%	3.3%	3.3%	3.3%	3.1%	2.8%	2.4%	1.9%
Critical yield (F)	3.2%	3.2%	3.2%	3.2%	3.3%	3.2%	3.1%	3.0%

Age at 5.4.2004	53	54	55	56	57	58	59	60
Critical yield (M)	1.5%	1.7%	1.8%	2.0%	2.2%	2.5%	2.8%	3.3%
Critical yield (F)	2.9%	3.3%	3.9%					

These figures are independent of salary and are calculated to the nearest 0.1%.

Contracting out through a GMP scheme is, clearly, the least attractive of the options considered.

For "potential" policyholders (i.e. those who do not currently have a rebate VGPPP/GMP policy and hence have not contracted out in the past via this route with NPI), the critical yields are higher than those quoted above because of the additional liability for future annual member charges. Those on lower incomes and those who would contract out only for a short period would be particularly hard hit by the charges. In general, where contracting out can be achieved through a separate Rebate Only Personal Pension (see above), that route is likely to be the preferred one.

Annual reviews

There is a regulatory requirement that we review contracted-out arrangements each year, and advise the investor if our calculations indicate that he/she should consider contracting back in. Communication may be made either via annual statements or by separate letter. NPI expects most of its review processes to continue much as before. Although critical yields will become the new criterion, the practical consequence of choosing a critical yield upon which to base our annual review will be to define a pivotal age.

The decision to contract out/in is made on a year by year basis, and can be made at any time up to the end of the tax year. Hence the policyholder's decision for the 2004/05 tax year does not have to be made until the end of the 2004/05 tax year, and for most products we shall conduct our annual review mailing during the last three months of the tax year.

For those policyholders whose future rebates will be invested predominantly in equity type funds or property, we estimate the future expected real rate of return relative to growth in the National Average Earnings Index to be 2.35% per annum. This estimate has been set in relation to the FSA real rates of return of 1% and 3% per annum used in new business illustrations.

Where Critical Yields exceed this estimate, those policyholders affected may wish to review the contracted out position with a view to contracting back into the State scheme. This criterion leads to the following policyholders being included in our 2004/5 review:

Critical Yield Table 1:	Males aged 60 and over on 5 April 2004 Females aged 53 and over on 5 April 2004
Critical Yield Table 2: plus VGPP	Males aged 57 and over on 5 April 2004 Females: All
GMP / EPP	Males aged 57 and over on 5 April 2004 All females

The CY tables are fairly sensitive to each product's charges. For CY Table 2, the actual pivotal ages are 58 for males, and, for females, either 36 where the salary is at least £15,000pa or else 21. However, our review mailings will use the ages shown above for consistency and practical considerations. For GMP and EPP products, males aged 51 and under should also consider contracting back into the State scheme.

The change in 2003 to the investment mix for With Profits and the Capital Account from mainly equity and property to predominately fixed interest has a significant impact on expected future investment returns from these funds. The pivotal ages discussed above are not applicable to those policyholders whose future rebates are wholly or partly invested in either fund; such policyholders should consider these possible options:

- Redirect future rebates into equity type funds or property if aged below the pivotal age
- Contract Out of the State scheme via another pension provider
- Contract back into the State scheme

Other pension providers may well use different assumptions, not only in terms of real rates of return but also in terms of annuity interest rates and mortality rates.

NPI's Technical Advisory Services Pensions Number 132 "Do it yourself pivotal ages" allows financial advisers to use their own judgement with regards to the growth potential of equity type investments relative to NAE and index-linked gilt yields for annuity rates (with the aid of past performance figures) in determining the pivotal ages.

The value of equity type investments and property can go down as well as up. There is no guarantee that, for those below the estimated pivotal ages, the pension provided by the Protected Rights fund will exceed the pension otherwise provided by the State scheme.

This Technical Advisory Services Bulletin represents NPI's understanding of English law (unless provisions relating to other countries are expressly stated) and Inland Revenue practice in April 2004. Whilst every effort has been made to ensure that the information presented here is correct, nothing in this bulletin should be construed specifically as advice to contract out or to contract back in, and NPI cannot accept any legal responsibility for any advice given relying on the content of this bulletin.