

## **"DO-IT-YOURSELF" PIVOTAL AGES**

### **Introduction**

For many years, it has been the practice of pension providers to publish pivotal ages to assist financial advisers in giving recommendations on contracting out of the earnings related part of the State pension scheme (formerly SERPS; now the State Second Pension - S2P). 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. Different pension providers publish different pivotal ages, not only because charges vary but, more importantly, because companies can make different assumptions with regard to future investment returns and annuity rates: there is no formal guidance on what these should be. It follows that Independent Financial Advisers who rely on the pivotal age guidelines provided by the companies with whom they place contracting-out business may not be acting truly independently, because the investment assumptions underlying their advice may not be consistent.

Our Pensions Information Number 97 explains the concept of 'critical yield', and attempts to encourage Independent Financial Advisers who were not already doing so to set their own criteria for contracting out. To do this, you must first make judgements (1) of what investment return a contracted-out pension policy might reasonably be expected to achieve, and (2) of the annuity rate basis which could apply at retirement. Having made these judgements, you will then be in a position to test product-specific critical yield tables against your criteria. In practice, not all companies publish critical yields, but it is sufficient to know a product's charging structure, because critical yields can be determined from that information. NPI has made critical yield calculations across a range of charging structures (fixed charges excluded, e.g. policy fees), compared them with a selection of possible advice criteria, and converted the results, for ease of use, into pivotal age tables. These tables are independent of any company's product, and can be used in both new business and annual review situations.

### **Investment returns and annuity rates**

If you intend to make practical use of the pivotal age tables which follow, you must first formulate a view of the long-term prospects for future investment returns and annuity rates.

First, what return is it reasonable to expect an investment to achieve between now and the client's retirement date? As contributors' entitlements to the earnings-related State pension are revalued in line with the index of National Average Earnings (NAE) each year, contracted-out investments must beat the increase in NAE by a margin, but what margin is attainable? The Government Actuary, in calculating the latest rebate tables, assumed NAE + 2% pa. The illustration basis prescribed by the Financial Services Authority uses NAE + 1% pa and NAE + 3% pa. Recent actual experience (not necessarily of any help given the current unpredictability of markets) has been as follows:

Year	Increase in NAE	Monetary returns pa		Returns pa in excess of NAE	
		UK equity	UK fixed int	UK equity	UK fixed int
2003	3.4%	20.9%	1.2%	16.9%	-2.1%
2002	3.5%	-22.7%	9.9%	-25.3%	6.2%
2001	2.3%	-13.3%	-0.9%	-15.2%	-3.1%
2000	4.8%	-5.9%	8.0%	-10.2%	3.1%
1999	6.2%	24.2%	-0.4%	16.9%	-6.2%
1998	4.2%	13.8%	29.8%	9.2%	24.6%

(These figures are related, e.g. 2003 equity:  $1.169 = 1.209$  divided by  $1.034$ )

Annual averages over 5 year periods fluctuate less wildly:

Year	Increase in NAE	Monetary returns pa		Returns pa in excess of NAE	
		UK equity	UK fixed int	UK equity	UK fixed int
1999 - 03	4.0%	-1.1%	3.5%	-4.9%	-0.5%
1998 - 02	4.2%	-2.3%	8.7%	-6.2%	4.4%
1993 - 97	3.7%	15.8%	9.7%	11.7%	5.8%
1988 - 92	7.8%	13.4%	11.9%	5.2%	3.8%

Past returns are not necessarily a guide to future returns.  
Investment returns include net income reinvested.

Your criterion for investment returns is NAE plus ..... (you complete)

The rate at which the fund can be converted to annuity at retirement is also relevant. As protected rights annuities must include Limited Price Indexation (LPI - annual increases at the lower of RPI and 5% pa), the most appropriate investments to back these annuities are Index-Linked Gilts (ILG), which were devised to provide a return in excess of RPI. The criterion should be: what yield in excess of RPI is it reasonable to expect? The Government Actuary, in calculating the latest rebate tables, assumed an eventual return to a historic investment return of RPI + 3.5% pa, but this basis has attracted criticism on the grounds that it is well in excess of the return available now. The illustration basis prescribed by the FSA uses RPI + 2% pa and RPI + 4% pa. Recent Index-Linked Gilt yields relative to the RPI (again, not necessarily a guide to the future) have been as follows:

As at date:	5-15 year ILG (zero inflation)	>15 year ILG (zero inflation)	5-15 year ILG (inflation at 5%)	>15 year ILG (inflation at 5%)	Average of the four
24 Mar 2004	1.9%	1.8%	1.6%	1.6%	1.7%
31 Dec 2003	2.1%	2.1%	1.8%	1.9%	2.0%
31 Dec 2002	2.3%	2.2%	2.0%	2.0%	2.1%
31 Dec 2001	2.7%	2.4%	2.4%	2.2%	2.4%
31 Dec 2000	2.4%	1.9%	2.1%	1.8%	2.0%

Your criterion for annuity rate basis: Index-Linked Gilts to earn RPI plus ..... (you complete).

Our calculations have been revised 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.

Once you have set your criteria for investment return and annuity rate basis, you will be in a position to consult the relevant pivotal age table below (use the table which assumes charges closest to the actual contract charges). However, there may be some client-specific factors which should be considered first:

#### Client-specific factors which may influence contracting-out advice

1. Attitude to risk: Contracting out should not normally be recommended to any client who is not prepared to invest the greater part of his contribution in equity-based investments, because without the higher potential returns possible from equities and property there is little chance of a rebate policy improving on the S2P benefits given up.
2. Marital status at retirement: If the individual is not married when the Protected Rights fund is converted to annuity, he/she will have the option of purchasing a single life pension. A single life pension would be higher than the normal joint pension (which must include a 50% widow(er)'s pension), but the difference is not great. For example: for a male retiring at 65, it is equivalent to increasing the annuity yield criterion by 0.4%, and for a female retiring at 60, by 0.3%. For a client in this situation, you could increase your annuity rate basis criterion.
3. A high expectation of death before retirement: A Protected Rights fund would give some benefit, where the State would give none.
4. A desire to take benefits at age 60: A Protected Rights fund would meet this objective, but consider whether the reduction in benefit would be too great a price to pay.
5. An intention to emigrate: The full benefit of UK State pensions (in particular, indexation) may not be available to people who choose to emigrate and live in certain countries outside the European Union (most notably Canada, Australia, New Zealand and South Africa). Where this benefit restriction is applicable, the case for contracting out would be strengthened.

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6. Cynicism towards State pension 'promises': The value of SERPS benefits is now much less than the basis originally announced. Devaluation of State benefits could happen again, if not by reducing the amount of S2P, then possibly by redefining State pension age.
7. Consideration of proposals included in the Government's recent Pensions Green Paper. 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.

### A PRACTICAL EXAMPLE

**Suppose you decide** that it is reasonable to make contracting-out recommendations based on the following assumptions:

1. Investment returns in deferment will exceed NAE by 2% per annum.
2. In the medium to long term, index-linked gilts will yield 2% per annum in real terms.

The tables which follow provide the pivotal ages you require. You need to know the type of contract and its charging structure, in order to decide which table is most appropriate to use.

Look along the line defined by NAE + 2%, RPI + 2% . The six tables give these pivotal ages: (These are ages attained on 5 April 2004.)

<b>Contract type and full charging structure</b>	<b>Contract out at ages (male)</b>	<b>Contract out at ages (female)</b>
PP, 0.5% AMC only	up to 24, also 51 to 55	up to 25
PP, 0.75% AMC only	51 to 55	none
PP, 1.0% AMC only	52 to 54	none
PP, 1.25% AMC only	52 to 54	none
PP, 96%/99% allocation, 5% bid/offer, 1.0% AMC	none	none
COMP, 5% bid/offer, 1.0% AMC	none	none

Any pivotal ages you determine in this way may be used in both new business and annual review situations.

**PIVOTAL AGE TABLE 1**

Personal Pension / Stakeholder. Annual Management Charge = 0.5% and no other charges.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	And for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	up to 59	up to 53
2.5%	3.0%	up to 58	up to 52
2.5%	2.5%	up to 57	up to 50
2.5%	2.0%	up to 40*, 50 to 56	up to 44*
2.5%	1.5%	up to 35*, 51 to 55	up to 39*
2.25%	3.25%	up to 58	up to 52
2.25%	2.75%	up to 57	up to 52
2.25%	2.25%	up to 39*, 49 to 56	up to 40*
2.25%	1.75%	up to 30*, 51 to 55	up to 35*
2.0%	3.0%	up to 58	up to 52
2.0%	2.5%	up to 35*, 50 to 57	up to 40*
2.0%	2.0%	up to 24*, 51 to 55	up to 25*
2.0%	1.5%	52 to 54	none
1.75%	2.75%	up to 57	up to 25
1.75%	2.25%	51 to 56	none
1.75%	1.75%	52 to 55	none
1.5%	2.5%	up to 56	none
1.5%	2.0%	51 to 55	none
1.5%	1.5%	52 to 53	none
1.0%	2.0%	52 to 53	none
1.0%	1.5%	none	none

\* Several ages centred on this age can be considered borderline. Within this band, contracting out may favour those whose earnings are high in the Lower Earnings Limit - Upper Earnings Limit band, but not those with lower earnings.

## PIVOTAL AGE TABLE 2

Personal Pension / Stakeholder. Annual Management Charge = 0.75% and no other charges.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	And for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	up to 59	up to 53
2.5%	3.0%	up to 58	up to 52
2.5%	2.5%	up to 44, 50 to 57	up to 47
2.5%	2.0%	up to 36*, 50 to 56	up to 40*
2.5%	1.5%	up to 25*, 51 to 54	up to 30*
2.25%	3.25%	up to 59	up to 52
2.25%	2.75%	up to 39*, 50 to 57	up to 40*
2.25%	2.25%	up to 25*, 51 to 56	up to 30*
2.25%	1.75%	51 to 55	none
2.0%	3.0%	up to 25*, 50 to 58	up to 35*
2.0%	2.5%	50 to 56	none
2.0%	2.0%	51 to 55	none
2.0%	1.5%	52 to 53	none
1.75%	2.75%	51 to 57	none
1.75%	2.25%	50 to 55	none
1.75%	1.75%	52 to 54	none
1.5%	2.5%	51 to 56	none
1.5%	2.0%	52 to 54	none
1.5%	1.5%	none	none
1.0%	2.0%	none	none
1.0%	1.5%	none	none

\* Several ages centred on this age can be considered borderline. Within this band, contracting out may favour those whose earnings are high in the Lower Earnings Limit - Upper Earnings Limit band, but not those with lower earnings.

### PIVOTAL AGE TABLE 3

Personal Pension / Stakeholder. Annual Management Charge = 1.00% and no other charges.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	And for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	up to 59	up to 53
2.5%	3.0%	up to 43*, 49 to 58	up to 52
2.5%	2.5%	up to 28*, 50 to 57	up to 37*
2.5%	2.0%	51 to 55	up to 24*
2.5%	1.5%	52 to 54	none
2.25%	3.25%	up to 36* 49 to 59	up to 47*, 51 to 52
2.25%	2.75%	50 to 57	none
2.25%	2.25%	51 to 56	none
2.25%	1.75%	52 to 54	none
2.0%	3.0%	50 to 58	none
2.0%	2.5%	51 to 56	none
2.0%	2.0%	52 to 54	none
2.0%	1.5%	none	none
1.75%	2.75%	51 to 56	none
1.75%	2.25%	52 to 55	none
1.75%	1.75%	52 to 53	none
1.5%	2.5%	52 to 55	none
1.5%	2.0%	52 to 53	none
1.5%	1.5%	none	none
1.0%	2.0%	none	none
1.0%	1.5%	none	none

\* Several ages centred on this age can be considered borderline. Within this band, contracting out may favour those whose earnings are high in the Lower Earnings Limit - Upper Earnings Limit band, but not those with lower earnings.

**PIVOTAL AGE TABLE 4**

Personal Pension. Annual Management Charge = 1.25% and no other charges.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	And for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	up to 40, 49 to 59	up to 52
2.5%	3.0%	50 to 58	up to 37*
2.5%	2.5%	51 to 56	none
2.5%	2.0%	51 to 55	none
2.5%	1.5%	52 to 53	none
2.25%	3.25%	50 to 58	52 only
2.25%	2.75%	51 to 57	none
2.25%	2.25%	51 to 55	none
2.25%	1.75%	52 to 53	none
2.0%	3.0%	51 to 57	none
2.0%	2.5%	51 to 55	none
2.0%	2.0%	52 to 54	none
2.0%	1.5%	none	none
1.75%	2.75%	51 to 56	none
1.75%	2.25%	52 to 54	none
1.75%	1.75%	none	none
1.5%	2.5%	52 to 55	none
1.5%	2.0%	none	none
1.5%	1.5%	none	none
1.0%	2.0%	none	none
1.0%	1.5%	none	none

\* Several ages centred on this age can be considered borderline. Within this band, contracting out may favour those whose earnings are high in the Lower Earnings Limit - Upper Earnings Limit band, but not those with lower earnings.

**PIVOTAL AGE TABLE 5**

Personal Pension. Allocation: First £500 at 96%, balance at 99%. Bid/offer spread 5% and Annual Management Charge = 1.00%.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	And for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	up to 58	up to (40 - 52)£
2.5%	3.0%	up to 27*, 50 to 56	up to 33*
2.5%	2.5%	51 to 55	none
2.5%	2.0%	52 to 53	none
2.5%	1.5%	none	none
2.25%	3.25%	50 to 57	none
2.25%	2.75%	51 to 55	none
2.25%	2.25%	52 to 54	none
2.25%	1.75%	none	none
2.0%	3.0%	51 to 55	none
2.0%	2.5%	52 to 54	none
2.0%	2.0%	none	none
2.0%	1.5%	none	none
1.75%	2.75%	52 to 54	none
1.75%	2.25%	none	none
1.75%	1.75%	none	none
1.5%	2.5%	none	none
1.5%	2.0%	none	none
1.5%	1.5%	none	none
1.0%	2.0%	none	none

\* Several ages centred on this age can be considered borderline. Within this band, contracting out may favour those whose earnings are high in the Lower Earnings Limit - Upper Earnings Limit band, but not those with lower earnings.

£ Salary dependent: £20,000pa or more, pivotal age is 52. Under £20,000pa, pivotal age is 40.

**PIVOTAL AGE TABLE 6**

**Contracted out Money Purchase.** Initial charge from nil to 5% and Annual Management Charge = 1.00%. This table does not allow for fixed charges.

Your view on future investment returns: <b>NAE plus ...</b>	Your (adjusted) view on future indexed gilt yields: <b>RPI plus ...</b>	Then, for <b>males</b> , contracting out may be favourable at ages:	and for <b>females</b> , contracting out may be favourable at ages:
2.5%	3.5%	51 to 58	none
2.5%	3.0%	52 to 56	none
2.5%	2.5%	52 to 55	none
2.5%	2.0%	only 53	none
2.5%	1.5%	none	none
2.25%	3.25%	52 to 57	none
2.25%	2.75%	52 to 55	none
2.25%	2.25%	53 to 54	none
2.25%	1.75%	none	none
2.0%	3.0%	52 to 55	none
2.0%	2.5%	53 to 54	none
2.0%	2.0%	none	none
2.0%	1.5%	none	none
1.75%	2.75%	53 to 54	none
1.75%	2.25%	none	none
1.75%	1.75%	none	none
1.5%	2.5%	none	none
1.5%	2.0%	none	none
1.5%	1.5%	none	none
1.0%	2.0%	none	none
1.0%	1.5%	none	none

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