Good Practice Guide

Personal Finance Society
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PFS

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Pension transfers from defined benefit to defined contribution

This paper is in response to member's requests to provide a summary of good practice within one source document and is based upon the Personal Finance Society's understanding of the regulators rules and current stance. Whilst a summary, it is not intended to be inclusive and should not be relied upon at the exclusion of other sources of information.

Keith Richards

Chief Executive Officer,
the Personal Finance Society

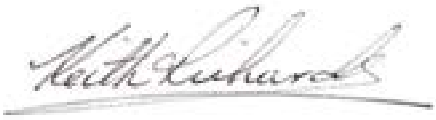
Foreword

In most cases transferring pension benefits is irreversible and in some cases the merits or otherwise of the transfer may only become apparent years into the future. So it is particularly important that firms advising on pension transfers ensure that their clients understand fully the implications of a proposed transfer before deciding whether or not to proceed.

Whilst the insistent client debate has focused attention on a lack of appetite from many financial advisers to carry out pension transfers from defined benefit to defined contribution schemes, specialist pension transfer firms are seeing record levels of enquiries, fuelled by the consumers desire to benefit from pension freedoms alongside historically attractive transfer values given continuing low interest rates and gilt yields.

This has not escaped the attention of the Financial Conduct Authority, who on 24/1/2017 reiterated their expectations on advice on pension transfer, including transfer from a defined benefit (DB) scheme or other scheme with safeguarded benefits. Whilst transferring a DB Pension to a DC Pension can offer a more flexible retirement income, the possibility of extra tax free cash and an easier inheritance (given transferred funds can be passed on to heirs), retaining a DB Pension can also provide certainty, a risk-free income and degrees of inflation protection.

The following sections of this paper are in response to member's requests for further commentary and clarification around good practice, leaving it ultimately to firms to ensure they comply with both the detail and the spirit of the regulators rules. No-one should be in any doubt that the regulator will continue to scrutinise DB transfers as it considers a future thematic review on this market.



The rules and regulatory source material

Date (last updated)	Nature of FCA communication	Content	Link
24/1/2017	Firm	Highlights FCA requirements when providing advice on pension transfers, including advice in particular circumstances	https://www.fca.org.uk/news/news-stories/advising-pension-transfers-our-expectations
17/1/2017	Firm	The FCA expects to consult during Q1 2017 on updating the pension transfer redress methodology	https://www.fca.org.uk/news/statements/fca-statement-redress-methodology-pension-transfers
4/12/2016	Firm	What the FCA considers' to be good and poor practice when advising insistent clients	https://www.fca.org.uk/firms/pension-reforms-insistent-clients/good-poor-practice
3/8/2016	Alert	FCA alert - Advising on pension transfers with a view to investing pension monies into unregulated products through a SIPP	https://www.fca.org.uk/publication/archive/alert-pension-transfers.pdf
10/6/2016	Consumer	FCA consumer guidance on what to consider if thinking about transferring a defined benefit pension, or if you moving or combining a defined contribution pension.	https://www.fca.org.uk/consumers/pension-transfer
9/6/2016	Firm	Help in understanding the FCA's position on insistent clients, following the pension reforms in 2015.	https://www.fca.org.uk/firms/pension-reforms-insistent-clients
8/6/2015	COBS 19.1	Pension transfers, conversions, and opt-outs	https://www.handbook.fca.org.uk/handbook/COBS/19/1.html
June 2015	Policy Statement PS 15/12	Proposed changes to FCA pension transfer rules , feedback on CP15/7 and final rules	https://www.fca.org.uk/publications/policy-statements/ps15-12-proposed-changes-our-pension-transfer-rules-feedback-cp15-7

Advice requirements

(This section covers the basic requirements from governments and regulator)

Section 48 of the Pension Schemes Act 2015

This requires that trustees or scheme managers check that regulated financial advice has been taken before allowing a transfer to proceed, where the proposed transfer involves a DB pension, or other safeguarded benefits, worth more than £30,000.

FCA's guidance for providing advice on a DB transfer

The FCA's guidance for providing advice on a DB transfer continues to be that firms should start by assuming that the transfer is not suitable. A recommendation to transfer should only be made if this can be clearly shown to be demonstrably suitable and in the client's best interests.

Specifically the FCA says (COBS 19.1.6G08/06/2015):

- When advising a retail client... whether to transfer... a firm should start by assuming that a transfer, conversion or opt-out will not be suitable. A firm should only then consider a transfer, conversion or opt-out if it can clearly demonstrate, on contemporary evidence, that the transfer, conversion or opt-out if it is in the client's best interests. (COBS 19.1.7G08/06/2015)
- When a firm advises a retail client on a pension transfer, it should consider the client's attitude to risk including, where relevant, in relation to the rate of investment growth that would have to be achieved to replicate the benefits being given up
- When giving a personal recommendation about a pension transfer, a firm should clearly inform the retail client about... the consequent transfer of risk from the defined benefits pension scheme ... to the retail client
- Including the extent to which benefits may fall short of replicating those in the defined benefits pension scheme...
- In considering whether to make a personal recommendation, a firm should not regard a rate of return which may replicate the benefits being given up from the defined benefits pension scheme or other scheme with safeguarded benefits as sufficient in itself.

Whilst this may feel a little outdated in the post-pension freedoms market and at a time when many DB schemes are in deficit, until such time as a review of this assumption takes place, it should remain the starting point for any advice.

FCA permission and responsibility for advice

Only firms with the FCA permission to advise on pension transfers may do so. It is not acceptable for a firm without the permission to outsource the transfer analysis to a pension transfer specialist or to a firm with the permission, and claim to be advising on the pension transfer.

A firm without the permission may refer a client needing pension transfer advice to a firm with the permission. However, it is not acceptable for that second firm to claim to be advising on the pension transfer without taking into account the assets in which the client's funds will be invested as well as the specific receiving scheme. Where both firms may be responsible for different elements of advice given to the client, firms are expected to liaise for consistency.

For a firm with the permission, FCA rules permit an individual who is not a pension transfer specialist to advise on pension transfers. However, the firm must ensure that the advice is checked by a pension transfer specialist. The firm advising on the transfer remains responsible for the advice, including the advice checked by the pension transfer specialist, even where the pension transfer specialist is not employed by the firm.

FCA position on 'Insistent Client'

An insistent client is a client who wishes to take a different course of action from the one you recommend and wants you to facilitate the transaction against your advice. Where clients are required to take advice (for example in relation to DB pensions and other safeguarded benefits) then some may decide to disregard that advice.

The FCA highlights 3 key steps to take when advising an insistent client:

1. You must provide advice that is suitable for the individual client and this advice must be clear to the client. Advice on pension transfers should follow the normal advice process for pension transfers
2. You should be clear with the client what the risks of the alternative course of action are
3. You should be clear with the client that their actions are against your advice.

The Personal Finance Society has urged the government and regulator to introduce new rules which safeguard advisers against future misselling claims from "insistent clients". Currently, it remains our view that those advisers that facilitate a transfer against their own advice, will be party to arranging an unsuitable solution and as such, might be deemed liable in the event of a future complaint in the absence of any guarantees or input from the regulator on how the Financial Ombudsman Service will interpret such claims.

Recommendations based solely on critical yield

The FCA's supervisory work has revealed that some firms have been recommending pension transfers based solely on whether or not the critical yield is below a certain rate set by the firm for assessing transfers generally. This does not meet the regulators expectations.

The FCA expects a firm to consider the likely expected returns of the assets in which the client's funds will be invested relative to the critical yield.

FCA expectations re consideration of assets

The FCA expect a firm advising on a pension transfer from a defined benefit (DB) scheme or other scheme with safeguarded benefits to consider the assets in which the client's funds will be invested as well as the specific receiving scheme. It is the responsibility of the firm advising on the transfer to take into account the characteristics of these assets.

FCA rules set out what a firm must do in preparing and providing a transfer analysis. In particular, their rules (COBS 19.1.2R(1)) require a comparison between the benefits likely (on reasonable assumptions) to be paid under a DB scheme or other scheme with safeguarded benefits and the benefits afforded by a personal pension scheme, stakeholder scheme or other pension scheme with flexible benefits.

The comparison should explain the rates of return that would have to be achieved to replicate the benefits being given up and should be illustrated on rates of return which take into account the likely expected returns of the assets in which the client's funds will be invested. Unless the advice has taken into account the likely expected returns of the assets, as well as the associated risks and all costs and charges that will be borne by the client, it is unlikely that the advice will meet FCA expectations (see guidance at COBS 19.1.2 and 19.1.6-19.1.8).

What this means is that a firm advising on a pension transfer should not undertake a comparison using generic assumptions for hypothetical receiving schemes. The firm must take into account the likely expected returns of the assets in which the client's funds will be invested as well as the specific receiving scheme.

Personal recommendations

In making personal recommendations, the firm will need to comply with FCA requirements regarding the suitability of the advice provided. The firm should make clear the loss of any safeguarded benefits and the consequent transfer of risk to the client, including:

- investment risk
- longevity risk, and
- the risk that products may not be available or cost effective to meet the client's needs in retirement.

FCA guidance on the suitability of pension transfers (COBS 19.1.7(G)) clearly states that when a firm advises a retail client on a pension transfer it should consider the client's attitude to risk including, where relevant, in relation to the rate of investment growth that would have to be achieved to replicate the benefits being given up.

Adviser Good Practice

(This section looks at suggested good practice in respect of key advice considerations)

1. **Understand the DB Scheme.**
Advisers should be familiar with and seek to fully understand the DB Schemes from which a transfer is being made, their benefit structures and variances. In extreme cases where a scheme is in danger of entering the Pension Protection Fund is the protected amount under the PPF much lower than the amount of the transfer value?

2. **Fully assess both 'harder' and 'softer' facts.**
Some reasons why a member might wish to transfer relate to lifestyle factors rather than whether the DB or DC alternative will pay a comparable or higher income. As such, analysis of 'softer' factors such as risk appetite, health, marital status and dependants need to be considered alongside 'harder' facts such as income levels, TVAS analysis, cash flow modelling etc.

3. **Consider the wider tax issues of the client.**
A common reason to transfer benefits from a DB to DC scheme is to defer income, often to avoid paying unnecessary income tax. However, a DB transfer can result in taxation issues for the client, particularly where high transfer values are involved. For example, the assessment against the lifetime allowance is often more favourable for a DB scheme pension than for crystallised or uncrystallised personal pension.

   In addition, any potential impact on IHT will need to be taken into account, not just in terms of where PCLS is taken or is planned to be taken, but also where an individual dies within two years of making a transfer. In such circumstances, the executors of the persons Will are required to report this to HMRC and where the person was in normal health, HMRC deems there no loss to the estate. However, if the person knew they were seriously ill when the transfer took place (for example, expecting to live for less than two years) then an IHT charge can arise. So if death benefits are a key driver due to the ill health of a member, being aware of the IHT position is critical (albeit that transferring could still be the best outcome even after an IHT charge).

4. **Ensure DB transfer matches client's attitude to risk**
A transfer from a DB scheme to a DC pension usually involves a higher amount of risk for the client. DB pension schemes place no personal investment risk on the client, whereas all of the risk is borne by the client under a DC arrangement. It is not possible to set a minimum attitude to risk for which a DB transfer would appropriate, but it is important that risk is taken fully into account when making a recommendation.

5. **Analysis of client's retirement income needs.**
It is critical that a client's income need in retirement (and the income needs of their spouse/partner) are taken into account. When advising on potential DB transfers, the file should record an analysis of the client's income needs in retirement, and show whether this is likely to be achievable following a transfer. If a transfer analysis suggests that the client's income needs cannot be met, then it is probable that the transfer will not be suitable.

6. **Analysis of sustainability of income.**
Some clients may underestimate both the level of income they will need in retirement, the effects of inflation and their own life expectancy. The value of a DB pension which is guaranteed for life, and which offers a degree of inflation proofing, is one which can be underestimated by clients. Before any recommendation to transfer from a DB scheme is made, it is important that the file can show that clients, and their spouse/partner, will have sufficient income, taking into account inflation, for life. Consideration of the level of secure income a client is likely to need to meet essential living expenses and advice to ensure these are covered as far as possible with secure income should be made.

   There are a number of online tools which can assist advisers in demonstrating the sustainability of income.

7. **Clear capital requirements.**
Where a client has a need for capital, and where a transfer from a DB scheme taking immediate PCLS are being considered, it is important that the reason/s for wanting capital is/are made clear, and that a full breakdown is provided on the file. It is also important that the file shows that all available options for raising capital have been considered.

8. **Consideration of using life assurance as an alternative to transferring when death benefits are required.**
If one of the client's drivers for a transfer of a DB scheme is to leave a legacy behind for beneficiaries, then it is important to consider and research life assurance options as an alternative to meet this need. Files should show that the life assurance market has been researched to obtain the best available rates, and that these have been presented to and discussed with the client. It could certainly be the case that clients may not wish to pay what could be a high premium for cover, but consideration should be given to the relative attraction of taking income from the DB scheme and using this to pay for a life assurance product.

9. **Correct information and the Transfer Value Analysis Service (TVAS).**
Whilst critical yields and hurdle rates should help frame the advice considerations and discussion, the TVAS report uses a series of assumptions to calculate the critical yields, and though these yields are still an important part of the advice process, the suitability shouldn't be framed solely on the basis of "will this beat a critical yield?" Also, if the data entered onto the report is incorrect, then the outcomes will also be incorrect so care should be taken to verify data used.

   Advisers should understand the TVAS calculation process and its shortcomings, especially for those who want to use drawdown post a transfer and avoid annuitisation.

   Advisers should also understand variables that will influence transfer values in years to come and whether this should be a consideration in terms of the timing of a transfer.

10. **Comparison of benefits in suitability report.**
The Suitability Report (SR) should include the retirement benefits available from the existing scheme, in monetary terms. This should then be compared against the likely benefits available via the recommended pension. If a client is being advised to transfer and purchase an annuity, then the annuity income should be recorded. If the client is being advised to transfer to a personal pension, then the SR should record the projected income taken from the illustration, based on mid-rate (although a lower rate may be more appropriate for clients with a lower attitude to risk). If the client is being advised to transfer to drawdown then the SR should record the annuity income, taken from the drawdown illustration, based on the mid-rate.

11. **No over reliance on standard terms and lack of personalisation.**
Where a client's objectives are to achieve "flexibility" of retirement income, or "control" of their pension, it is important to determine what the client is actually trying to achieve, and to investigate what they may mean by "flexibility", or "control", as well as their reasons for wanting this. Whilst it is true to say that DB pensions do not offer flexibility or control, when compared to a personal pension, they do offer guaranteed incomes for life, which will keep pace with inflation. For this reason, it is important that client objectives are fully established and personalised.

12. **Advice should be clearly stated (file mustn't appear to show "order taking").**
The requirement for clients to receive advice on DB transfers can mean that some clients will approach advisers with a clear idea of what they are looking to achieve, and may perceive the advice process as an obstacle, rather than a valued service. This does not mean, however, that the requirement to demonstrate suitability is any different to a case for an established client, where the advice is valued.

    In all cases, the adviser should be able to communicate the key costs, risks, potential consequences and benefits of the transfer, along with bespoke member suitability within a concise report. Reference to 'unknowns' should also be made, such as future changes in legislation.

13. **Part of a wider, full financial planning service**
Where practical, advice on a DB transfer should be done in the context of a full financial planning service that:

    - takes account of all a client's assets, liabilities, income and expenditure
    - tests outcome with reference to cashflow modelling
    - is subject to ongoing review.