Financial Conduct Authority

FCA
FINANCIAL CONDUCT AUTHORITY

Thematic Review TR14/12

Enhanced transfer value pension transfers

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Contents

	Executive summary	3
1	Overview and scope	4
	1.1 What is the scope?	4
	1.2 Who will be interested in this report?	4
	1.3 What is an ETV pension transfer?	5
	1.4 Why did we carry out this review?	6
	1.5 What did we do?	6
	1.6 What did we find?	7
	1.7 Our expectations and next steps	9
2	Key findings	11
	2.1 Terms of contract between the financial adviser and the employer	11
	2.2 Company offer (member communication)	12
	2.3 Information gathering	14
	2.4 Supporting evidence for advice	16
	2.5 Employer insolvency risk	17
	2.6 Recommendation	18
	2.7 Tax and benefit implications	21
	2.8 Insistent members	22
	2.9 Method of communication	24

Executive summary

What did we review?

We (the FCA) reviewed suitability of bulk pension transfer advice provided by financial advisers where employers offered an enhancement to the transfer value (ETV).

What did we find?

The results from the review showed that some financial advisers appear to have provided ETV pension transfer advice without complying with the requirements and guidance in force at the time.

What happens next?

We will work with individual financial advisory firms to address unfair outcomes.

All financial advisers who provide pension transfer advice, including where ETVs are offered, should consider:

- the FCA Handbook requirements;
- the relevant guidance;
- findings in this paper and the examples of good and poor practice provided below;

and review their arrangements accordingly.

We would expect firms to ensure that any pension transfer advice is sufficiently robust to meet our requirements.

Senior management of authorised financial advisory firms should satisfy themselves that their firms' practices in relation to pension transfer advice deliver fair customer outcomes.

We recommend that consumers who have immediate concerns should contact the financial advisory firm that gave them the advice. This is a complex area of financial advice and there is not necessarily any immediate risk to many of the affected consumers; they received the pension transfer advice during rather than towards the end of their working lives and many of them will not yet have reached their intended retirement age. That is why we intend to work with the financial advisory firms to identify affected consumers and address any concerns.

1. Overview and scope

1.1 What is the scope?

In this report, we present the findings from our ETV project. We looked into suitability of bulk pension transfer advice[1] provided by financial advisers where employers offered an enhancement to the transfer value[2] available to incentivise current and former employees to leave their existing defined benefit (DB) pension schemes.

We considered the period from 2008 to 2012. We understand that before 2008 many bulk transfer ETV exercises were done on a direct offer basis, i.e. a personal recommendation was not given to the member and the employer was making an offer directly to the member typically by a broad communication giving generic benefits and disadvantages of transferring. By mid-2008, the Financial Services Authority (FSA) – our predecessor regulator – had issued two statements about the complexities of doing ETV exercises on a direct offer basis. Financial advisers were therefore engaged by employers to provide individual advice to their members on the suitability of the ETV transfer. From 2012, we understand that the number of employers offering bulk ETV transfers decreased mainly because market conditions for such exercises became less favourable, i.e. transfer values became less attractive for employers. However, emerging developments in the pension environment, including the recent Budget announcements and the Government's response to the DB aspects of the consultation, may cause employers and employees to show increased interest in this type of exercise.

1.2 Who will be interested in this report?

This report summarises our recent thematic research on pension transfer advice processes where ETVs were offered. It is not general guidance on the operation of our rules.

This review is primarily aimed at financial advisers who provide ETV pension transfer advice and their senior management. Our findings will also be of interest to financial advisers who provide any pension transfer advice to consumers who are DB pension scheme members, and to pension trustees, and employers with DB schemes.

1 For the avoidance of doubt, the advice was provided to members individually.

2 A pension transfer value represents the capital cost of meeting the future pension liability. This is a complex calculation which takes into account a number of factors including the scheme benefits, market conditions, mortality assumptions and the financial position of the scheme.

1.3 What is an ETV pension transfer?

DB schemes provide a pension income based on the period of membership, pensionable earnings and the accrual rate, which is the rate at which the pension accumulates for each year of service completed. The deferred pension is then revalued in the period to retirement. The employer is responsible for ensuring sufficient financial resources are available to pay the promised pension. Employers undertake bulk transfer exercises from their DB pension schemes to manage their own pension liabilities because, when a member transfers from the DB scheme, the employer has no further obligation to the employee in relation to the DB scheme.

These transfers are normally made to a personal arrangement in the employee's own name such as a personal pension established to receive the transfer value or to an existing pension arrangement including a current employer's pension scheme. The first option will usually be a defined contribution (DC) arrangement and, given the limited availability of DB schemes, any existing pension arrangements are likely to be arranged on a 'money purchase' or DC basis. Even if a DB scheme is available, transfers in are often dealt with on a DC basis.

When a transfer is made the risk is transferred from the employer to the individual if the transfer is made on a DC basis. The member loses the underlying guarantees of the DB scheme and has to take personal responsibility for investment decisions. The member also bears the annuity risk if a 'traditional' pension income is required.

ETVs are offered to incentivise members to transfer out of the DB schemes. The enhancement offered takes the form of an increase in the pension transfer value and could include a direct cash payment[3] which is subject to deduction for income tax and National Insurance (NI).

In the ETV pension transfer process, we regulate the pension transfer advice given by financial advisers to members of pension schemes who are seeking to transfer benefits into an FCA-regulated pension scheme.[4]

Pension transfer advice is important as DB scheme members:

- may not have the skills and experience to make a decision about transferring;
- may not understand the value of their existing benefits, the cost of providing these benefits and the implications of losing the underlying guarantees of a DB scheme and being reliant on annuity rates and investment returns; and
- may have also been influenced by the cash incentive which was usually available immediately rather than at retirement age.[5]

Members are therefore likely to be heavily reliant on the advice provided. Further, once a transfer from a DB scheme is made, members will not be able to reconsider their decision and transfer back to the scheme. It might take many years before the prudence or imprudence of the transfer becomes evident to the member. For those who may have expected the DC scheme to match or improve upon the DB benefits, if returns are not as expected, it may then be too late to improve the member's retirement income.

3 We note that, under the Incentive Exercises for Pensions – A Code of Good Practice of June 2012, no cash incentives should be offered that are contingent on the member's decision to accept the offer.

4 See the definition of 'pension transfer' in the FCA Handbook Glossary of definitions.

5 Please see footnote 3.

1.4 Why did we carry out this review?

During the course of firm-specific supervision, we came across ETV pension transfer advice business. A sample of case files were reviewed, which gave reason for some concern. Given the importance of pension transfer advice (as outlined in section 1.3 above), we decided to undertake some research to assess the extent of potential detriment to consumers.

1.5 What did we do?

To review the suitability of the ETV advice, we engaged an independent statistician to draw a sample of 300 case files from a significant proportion of the firms known to have provided bulk ETV pension transfer advice in the period from 2008 to 2012.

These files were reviewed by an independent consultant based on a review methodology developed jointly between the FCA and the consultant. We selected the independent consultant following a tender process.

The review assessed two areas for each case file in line with the current FCA approach to file reviews. The first area assessed was whether the recommendation provided, and the advice process that the member was put through, resulted in a suitable outcome in the member's individual circumstances ('suitability'). The second area assessed was 'disclosure' (i.e. the way the financial adviser communicated with the member), where we considered whether the process that was followed was appropriate relative to the guidance in place at the time, whether the appropriate rules had been followed, and whether the information provided to the member was clear, fair and not misleading, such that the member could make an informed decision about their options in relation to the ETV offer.

Factors which were used to assess the 'suitability' finding included:

- Has the member been recommended a product that matches their investment horizon? Factors such as, is there enough time to achieve the anticipated returns required, does the product allow benefits to be taken at the preferred retirement age, and does life-styling start too early/too late to be of benefit to the member, were considered.
- Has the member been recommended a product that matches their financial circumstances?
- Has the member been recommended a product that matches their needs and objectives?
- If the member has been recommended a product where there is a need for on-going reviews, has this been explained, offered or put into place?
- Has the member been exposed to a level of risk that they are willing and able to take?
- Has the member been recommended a product that does not take into account their tax position (without good reason)?
- Has the member incurred additional costs without good reason?
- Has the member lost benefits or guarantees without good reason or sufficient justification?

Factors which were used to assess the 'disclosure' finding included:

- Has the firm provided the required product disclosure for the member to be able to make an informed decision?
- Has the suitability report provided the member with sufficient information about their personal recommendation?

1.6 What did we find?

The overall results of the review are set out in the tables below.

Suitability finding across review population	Frequency	% of Population
Suitable	153	52%
Unsuitable	98	34%
Unclear	41	14%
Grand Total	292[6]	100%

Disclosure finding across review population	Frequency	% of Population
Acceptable	62	21%
Unacceptable	216	74%
Uncertain	14	5%
Grand Total	292[6]	100%

The review showed a large variance in advice approaches and in the quality of advice provided by financial advisers. The volume of transfers undertaken by different financial advisory firms also varied greatly. So, the above results should not be applied directly to provide a relevant comparison of the whole ETV market.

Given that we have concerns about some of the results, we will work with individual financial advisory firms to address unfair outcomes.

Regarding disclosure failings (74% unacceptable), a disclosure failing would typically arise from some form of process or information provision failing. While we would expect firms to ensure that they make the correct disclosures, a disclosure failing would not necessarily result in a suitability failing where there is no material impact on the outcome for the member. The main underlying causes of disclosure failings appeared to be the use of a rigid advice process that did not always allow for consideration of individual member circumstances or information needs, and the absence of clear contemporaneous records.

We found that in the majority of cases the employers met the cost of the advice. Limited budgets provided by the employers, and the numbers of employees advised in a relatively short time, meant that the advice was often 'process driven', creating a risk that not all the members' circumstances were considered in all cases. This also meant that advice was generally 'limited

6 Although the independent statistician drew a sample of 300 case files, only 292 of those files fell within the scope of this review.

scope'[7] and solely in respect of whether to take the ETV offer. While in principle it is possible to limit the scope of advice, given the complexity of ETV advice in this review we saw specific examples where placing limits on the scope of advice became a driver of unfair customer outcomes.

Drivers of suitability failings included:

- generic templates which were inadequately 'tailored' so the advice did not reflect specific member circumstances or give sufficient priority to the members' own requirements;
- advice where the outcome focused solely on critical yield[8] analysis without full consideration of wider member circumstances;
- not establishing adequately the level of risk a member is willing and able to take;
- fund recommendations which did not match the assessed risk profile of the member;
- the use of default receiving schemes (in some cases with uncompetitive charging structures) and limited consideration of the suitability of a member's other existing pension arrangements; and
- limited consideration of the tax and in a small number of cases 'means tested benefit' implications of accepting the offer.

Drivers of disclosure failings included:

- incomplete record keeping;
- limited information capture and documentation of the insistency[9] process;
- the 'annuity risk' of transfer from DB to DC not being fully explained;
- over emphasis on the possible 'flexibility' under a DC scheme in undertaking the transfer analysis;
- offers being structured against a reduced transfer value and therefore appearing artificially generous; and
- no consideration of the members' Additional Voluntary Contribution (AVC) funds as part of the advice process.

59% of members within the review population were insistent clients. Where members were insistent and took the enhancement as cash, the case files showed that only a small minority of the financial advisers considered alternative options to accepting a transfer, which may not be in the members' long term interests, solely to gain access to cash. While this advice would typically be outside the 'limited scope' of the advice given (as the engagement typically would

7 The financial adviser did not consider all aspects of the member's circumstances (e.g. current assets/liabilities, existing pension arrangements, including AVCs).

8 The critical yield is the investment return which is required to match the existing scheme benefits. This also makes a number of assumptions about factors which will impact on both the pension received from the DB scheme and the cost of matching the benefits. This will include assumptions made about the various indices which will impact on the revaluation of the pension and also factors such as gilt yields which will impact on the conversion of the pension fund to an income.

9 Many of the transfers were made on an insistent client basis, where the member acted against some element of the advice received. Typically the advice was to remain in the DB scheme but the member transferred despite this recommendation.

be to cover pension advice), when the availability of immediate cash was the sole reason for making a transfer it would have been relatively straightforward to highlight this matter to the member.

1.7 Our expectations and next steps

Our rules require that a firm must ensure that a communication by the firm to a client is fair, clear and not misleading.[10] A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.[11] Whereas guidance in the FCA Handbook provides that when advising a retail client who is, or is eligible to be, a member of a DB occupational pension scheme whether to transfer or opt-out, a firm should start by assuming that a transfer or opt-out will not be suitable. A firm should only then consider a transfer or opt-out to be suitable if it can clearly demonstrate, on contemporaneous evidence, that the transfer or opt-out is in the client's best interests.[12]

A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about them and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

a. meets their investment objectives;

b. is such that they are able financially to bear any related investment risks consistent with their investment objectives; and

c. is such that they have the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of their portfolio.[13]

Pension transfer specific provisions are provided in the Conduct of Business Sourcebook (COBS) 19. The FSA issued guidance on how to comply with the rules (e.g. FSA and the Pensions Regulator joint statement 'Enhanced Transfer Value Exercises', July 2010[14], and FSA final guidance on 'Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection', March 2011[15]). The Pensions Regulator has issued guidance on several occasions. 'The Incentive Exercises for Pensions – A Code of Good Practice'[16] of June 2012 (voluntary code) also outlines principles to follow when providing ETV advice (e.g. no cash incentives should be offered that are contingent on the member's decision to accept the offer).

Based on the results from the review and poor practice examples (see below), some financial advisers appear to have provided advice about pension transfers where ETVs were offered without complying with the requirements and guidance in force at the time. We will therefore engage with those financial advisory firms where we have specific concerns about the suitability of their ETV pension transfer advice. We will discuss the file review results with the relevant financial advisory firms and seek to agree a proportionate and tailored set of actions. Where

10 COBS 4.2.1R(1)
11 COBS 9.2.1R(1)
12 COBS 19.1.6G
13 COBS 9.2.2R(1)
14 www.thepensionsregulator.gov.uk/docs/transfer-values-joint-statement-july-2010.pdf
15 www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg11-05
16 www.site-fusion.co.uk/files/writeable/uploads/webfusion47278/file/thecode.pdf

appropriate we will ask the financial advisory firms to undertake past business reviews and put things right for consumers who have been adversely affected. It is important to note that in two thirds of the cases we reviewed we found no evidence of unfair customer outcomes.

All financial advisers who provide pension transfer advice, including where ETVs are offered, should consider:

- the FCA Handbook requirements;
- the relevant guidance;
- findings in this paper and the examples of good and poor practice provided below; and

review their arrangements accordingly.

We would expect firms to ensure that any pension transfer advice is sufficiently robust to meet our requirements.

Senior management of authorised financial advisory firms should satisfy themselves that their firms' practices in relation to pension transfer advice deliver fair customer outcomes.

We recommend that consumers who have immediate concerns should contact the financial advisory firm that gave them the advice. This is a complex area of financial advice and there is not necessarily any immediate risk to many of the affected consumers; they received the pension transfer advice during rather than towards the end of their working lives and many of them will not yet have reached their intended retirement age. That is why we intend to work with the financial advisory firms to identify affected consumers and address any concerns.

2. Key findings

The review showed a large variance in advice approaches and in the quality of advice provided by financial advisers. Here, we summarise our findings and provide examples of the good and poor practice identified in the review.

2.1 Terms of contract between the financial adviser and the employer

In most cases, the employer paid the financial adviser for the advice to the member in relation to the ETV pension transfer (typically on a flat fee basis). The cost and thus scope of the advice varied significantly between financial advisers and schemes.

In some cases, initial and trail commission was also charged on the receiving scheme. The commission varied greatly, ranging from £24 to £2,400, and was often a percentage of the fund value.

It is clear from this review that some employers understood the complex issues likely to be involved and were prepared to match this in terms of remuneration to the financial adviser. However, where financial advisers had limited budgets and timescales, it meant that often the information gathering was limited and pension transfer advice was 'process driven' rather than aimed at considering member's specific circumstances. The advice was generally also of 'limited scope', and so it did not consider all aspects of the member's circumstances, or was only paid for by the employer up to a fixed amount. While some limits may be placed on cost and, thus, the scope of advice, given the complexity of ETV advice, in some cases even basic details were not captured within the process.

A common theme throughout the review was that the consideration of AVCs appeared to be out of scope for the financial adviser and, thus, not taken into account when making a recommendation. For members who have an AVC fund within the ceding DB scheme, if taking a transfer, typically it is a requirement that the AVC fund also transfers. So, for certain AVC fund types (e.g. with profits, guaranteed annuity rates), the member could incur detriment in respect of transferring these AVCs without having received any advice.

Good practice	• The financial adviser was remunerated for the work undertaken, regardless of the outcome. • The terms of engagement between the employer and the financial adviser allowed for the advice to cover members' existing pension arrangements, including as possible vehicles for the ETV payment. • Where members acted on an insistent basis, and the key driver for this was identified as the cash enhancement, the financial adviser explored the members' real need for the cash (and, if driven by the need for debt repayment, considered alternative means of repaying debt). • Members were given clear disclosure on whether the advice paid for by the employer included advice in relation to the funds in the receiving scheme and any subsequent reviews and the need for life-styling[17] or rebalancing.[18]
Poor practice	• Due to limited scope, advice was purely in respect of the suitability of the transfer (i.e. no consideration was given to the member's wider financial circumstances and transfers had to be to a default DC arrangement with no consideration of existing pension arrangements). • The financial adviser's fee per member was capped up to a fixed cost of £250 and for transferring pension benefits only. Any further advice would have had to be met by the member. Such a structure created a significant risk that the scope of advice was very limited. • The financial adviser's fee structure incentivised making positive recommendations to transfer (e.g. the financial adviser's fees were linked to 250 members transferring: if no members transferred, the financial adviser would reduce its total costs by 25% and, for every 10 members that did transfer, the discount would reduce by 1%). • The financial adviser's remuneration was deducted from the transferring funds.

2.2 Company offer (member communication)

Initial communications to members play an important role in shaping members' decisions and views on the offer. The review showed that, mainly, initial communications were produced by the employer and its corporate adviser. However, there were instances where the financial adviser supported the employer in structuring the offer.

Good practice	• Care was taken in communications to avoid members reaching irrational conclusions (e.g. balanced information was provided about the employer's financial position).
Poor practice	• There was over-emphasis of the risk that the sponsoring employer of the DB scheme might become insolvent. • The offer documents the employers issued were not kept as part of the record of the advice.

17 Life-styling provides automatic switching of pension savings into another fund, or funds, as a member gets closer to their planned retirement age.

18 Please see section 2.6.3 on rebalancing.

2.2.1 Requirement to take financial advice

In section 1.3 we outlined the reasons why advice is important before members make decisions about transferring out of DB schemes. This was generally addressed in member communications and ETV offer structures.

The review shows that generally the practice in this area was robust, so members were required to take or strongly advised to take advice prior to accepting the offer. However, this was not always the case.

Good practice	• The employer's communications about and terms of the ETV offer stated that it was a requirement to take advice from a financial adviser before the offer could be accepted by the member, making it clear that it is essential that members take advice. • The member was cautioned against making a decision about accepting the ETV offer before seeking advice. • Advice was given to the member before they could select their preferred form of enhancement (relevant where cash was offered).
Poor practice	• The employer's communications allowed the member to engage in the offer before taking advice. • The employer's communications required the member to select the basis on which they wanted to accept the offer (if at all) before receiving any advice and the advice was provided on that basis. If the member had stated that they wanted to take the enhancement as cash, they were not given analysis of the benefits of taking the enhancement to another pension arrangement.

2.2.2 Offer structure

A deferred member of a DB pension scheme (who is not receiving a pension and is more than one year from their Normal Retirement Date) has the right to transfer their pension transfer value to another suitable pension arrangement. This Cash Equivalent Transfer Value (CETV) should represent the best estimate of the expected cost to the scheme of providing the member's accrued benefit entitlement under the scheme, based on a number of assumptions.[19]

If the scheme was to have insufficient assets at the time of the transfer to be able to pay the full amount of the CETV for all members, then paying this for a transferring member could potentially reduce the security of the benefits for the remaining members. As a result of this, the trustees of a DB scheme may decide to pay transfer values at a reduced level to protect the security of the benefits for the remaining members (to ensure that each member is treated equitably).

During the period of this review many DB pension schemes were in a deficit. An actuarial reduction was applied to the CETV to reflect the level of underfunding, resulting in 'reduced' transfer values being offered.

The review highlighted that ETV offers were frequently structured with the enhancement shown relative to the 'reduced' transfer value without full disclosure of this to the member. Thus, the enhancement appeared more generous when compared to CETV.

19 See footnote 2.

Good practice	• The employer's communications made it clear that transfer values were reduced to reflect underfunding and also explained the reasons for this. The offered enhancement was then set out clearly to show: - the enhancement to increase the 'reduced' transfer value up to the CETV; and - the enhancement to the CETV. • The employer's communications made it clear if the scheme was underfunded and whether the ETV offer was expressed as a CETV or 'reduced' value.
Poor practice	• ETV offers were structured with the enhancement shown relative to the 'reduced' transfer value which reflected the underfunding without full disclosure of this point to the member. The enhancement would therefore appear to be more generous. • Members were provided with an additional cash incentive if they took the financial adviser's advice and then transferred. This additional cash incentive was described by the employer as a 'gesture of goodwill to cover the time [the member] spent considering and receiving advice' but the additional payment was only payable if the member took the transfer.

2.2.3 Timing of offer

Timing of the offer could have an impact on members' decision making. The proportion of exercises in this review that were undertaken in November/December with the enhancement paid in the New Year seemed higher than would be expected if the exercises were spread out evenly throughout the year. However, this could have been due to employers having financial year ends on 31 December.

Good practice	• Members were given sufficient time to consider the ETV offer and take financial advice. • The offer timeline was designed to avoid members having to make decisions at financial pressure points such as Christmas (although end of year often coincides with the end of financial year).
Poor practice	• The offer included statements which may have put members under pressure to make quick decisions by, for example, indicating limited employer finances to fund the offer.

2.3 Information gathering

Our rules require that, when making a personal recommendation or managing their investments, a firm must obtain the necessary information regarding the client's:

- knowledge and experience in the investment field relevant to the specific type of designated investment or service;
- financial situation; and

- investment objectives;

so as to enable the firm to make the recommendation, or take the decision, which is suitable for them.[20]

The review showed that the information held on file relating to the member's retirement provision varied considerably between firms, and the validity of the information also varied. Most files captured member information, but there was little evidence to suggest that unrealistic information provided by a member was assessed for credibility or challenged.

Good practice	• The information gathering process was broad enough to support the personal recommendation regarding pension transfers and was not limited simply because the advice focus was on the ETV offer (e.g. it included questions about customers' assets, liabilities, preferred retirement age and other retirement provision). • Information gathering was bespoke for the customer, and not restricted by the limitations of a narrow process or template-approach. • Omissions, inconsistencies and anomalies were followed up, resolved and documented to create a full record of the facts on which the personal recommendation was based. • Contemporaneous records of discussions with members were made and retained and used to check the member's understanding of the risks and implications of transferring from the DB scheme (including for example call recordings); and the rationale for the transfer was captured in their own words.
Poor practice	• Key information relevant to a personal recommendation about a pension transfer was not obtained or recorded on file (e.g. preferred retirement age and other pension provision). • The information gathering process was limited (e.g. it did not allow sufficient time, or any time, for a discussion with the member) and as a result not all relevant information about the member was captured. • Omissions, inconsistencies and anomalies were not followed up, challenged and resolved.

2.3.1 Preferred retirement age

The member's preferred retirement age is fundamental to making a suitable personal recommendation about pension transfer and achieving a fair outcome for the member.

In almost all cases, the member's preferred retirement age was visible on the file. However, in almost a third of those cases, it was not possible to tell if the estimated income required would be achievable at the preferred retirement age.

20 COBS 9.2.1R(2)

Good practice	• The member's preferred retirement age was recorded on file. • The financial adviser gathered sufficient information to explain whether and how the preferred retirement age would be achievable as a result of their personal recommendation.
Poor practice	• The member's preferred retirement age was not recorded on file. • Information recorded on file was not sufficient to assess whether the member would be in a position to retire at their required level of income at their preferred retirement age.

2.3.2 Attitude to risk (ATR)

In the majority of cases, the member's ATR was established through a list of ATR descriptions. Members were expected to choose the description that most closely aligned to their understanding of the risk they were prepared to take. The level of support/challenge from the financial advisers in this process was not always clear from the reviewed case files.

Poor practice	• Risk descriptions used highly subjective or vague terminology or descriptions were so similar as to undermine the value of the exercise (for example: 'happy' to take on investment risk and 'willing' to take on investment risk as differentiators).

2.3.3 Capacity for loss

Most case files did not contain sufficient information to support an objective exploration of a member's capacity for loss.

In a significant proportion of the cases, there was insufficient evidence to suggest that the member's capacity for loss had been considered in conjunction with the member's ATR. However, there is some evidence that this improved following the publication of the 'Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection' by the FSA in March 2011.[21]

2.4 Supporting evidence for advice

The aim of the transfer value analysis system (TVAS) report is to illustrate the rate of return that would be required in a DC pension arrangement to match the benefits being given up in the ceding scheme (the critical yield). The key features illustration (KFI) provides an illustration of the possible benefits which the member could receive from the DC scheme at retirement based on prescribed assumptions and reflecting the member's actual fund choice.

The review showed that the illustration was not always prepared in line with COBS and that the TVAS and the KFI were not always aligned. It was often unclear, based on the file content alone, if the relevant requirements had been met. In some cases there was no KFI on the file.

21 www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg11-05

Good practice	• The TVAS reflected accurately the scheme and the member's circumstances. • Where assumptions were made about the member and the scheme (e.g. preferred retirement age, fund charges), the member was made aware of the impact this may have had on the critical yield. • Critical yields were shown to the member with and without the enhancement and with and without the pension commencement lump sum (PCLS)[22] and Pension Protection Fund (PPF)[23] yield. • The relevant TVAS report and KFI were aligned and discussed with the member and retained as part of the record of the advice.
Poor practice	• The TVAS did not reflect all of the benefits provided by the scheme (e.g. the spouse's benefits, increases to the pension in payment). • The TVAS and KFI were not tailored to the member's specific circumstances (i.e. spouses' age, preferred retirement age, actual fund, annual management charges) and this was not explained to the member. • Because the assumptions were incorrect, this significantly understated the critical yield, leaving members with a false impression of the return required to match the benefits of the ceding scheme. • The inputted TVAS data (e.g. fund charges) was incorrect which led to materially misleading reports. • It was unclear if the illustration comparison was conducted in line with COBS 19.1.4R. • The Annuity Interest Rate was not consistent across the TVAS and KFI. • Where the investment selection changed during the advice process, the ability to achieve the critical yield was not reconsidered. In some cases where cautious investments were selected (including 100% cash) the member may not have been made aware of the low probability of the critical yield being met and the material impact on their retirement income if they transferred from the DB scheme. • For members who were nearing their preferred retirement age, the impact of life-styling on the critical yield was not considered in the personal recommendation, i.e. reducing the equity content of the investment fund leading to potentially lower returns on the fund.

2.5 Employer insolvency risk

Across the review population, a broad theme was that employers' and financial advisers' communications made reference to the role of the PPF, the level of benefits the member would receive under the PPF and the risks of employer insolvency if the member does not transfer their benefits out of the ceding scheme.

22 PCLS, before 6 April 2011, is a lump sum benefit paid to a member of a registered pension scheme (aged under 75) in connection with an arising entitlement to a pension benefit (other than a short-term annuity contract), and which meets the conditions detailed in paragraphs 1 to 3 of Schedule 29 to the Finance Act 2004. From 6 April 2011, PCLS is a lump sum benefit paid to a member of a registered pension scheme in connection with an arising entitlement to a pension benefit (other than a short-term annuity contract), and which meets the conditions detailed in paragraphs 1 to 3 of Schedule 29 to the Finance Act 2004. (HM Revenue & Customs Glossary)

23 PPF was established to pay compensation to members of eligible DB pension schemes, whose sponsoring employers become insolvent. PPF is funded by a levy on all eligible DB schemes. PPF became operational on 6 April 2005. (The Pensions Regulator Glossary)

Not all financial advisers were fully transparent in respect of the 'guaranteed benefits' and 'security' of the ceding scheme. A regular fact find question was 'do you value security of benefits?'. In light of this, some members stated that they had 'distrust' in the employer and therefore believed that a DC scheme would be more 'secure' than the DB scheme. A member's views on the employer's insolvency risk were rarely challenged. In response, some financial advisers said that DB benefits are not guaranteed (due to the insolvency risk) and if the member believes there is a real risk of employer insolvency then the DC scheme could be more secure (while not commenting on the risk transfer or considering the implication of the critical yield in relation to PPF benefits).

Despite making reference to the risk of employer insolvency, there were a number of cases where the PPF critical yield was not considered as part of analysis.

Good practice	• The suitability letter included a summary of the Dun & Bradstreet[24] scores for the employer that reflected the insolvency probability of the employer and are currently used by the PPF to determine insolvency probabilities. This section of the suitability report provided further details on the security of the scheme sponsor, which stated that the firm is in 'good' condition.
Poor practice	• The financial adviser stated in the suitability report that the scheme was not guaranteed, described the role of the PPF, and explained the current deficit of the scheme. During the phone call with the adviser, the member had to challenge the information relating to the PPF explaining that the scheme was ultimately underwritten by the state and therefore would not be subject to the PPF. The member stated their belief that the report overplayed the risk of employer insolvency.

2.6 Recommendation

2.6.1 Consideration of wider benefits

There may be circumstances in which the advantages of a transfer to a personal pension outweigh the value of the defined benefits, where for example the DB scheme is restrictive in terms of format and timing of the benefits. Alternatively, the member may have the need for wider benefits offered by the ceding scheme.

In the review, there was a lot of focus on the timing of benefits e.g. the possibility to retire early. The review saw no evidence that firms were considering the ceding scheme benefits in the event of ill-health which could have been important to the member.

Where wider benefits under the ceding scheme were subject to trustee consent/ discretion (e.g. pension increase, early retirement, ill-health retirement), across the review population there was limited evidence of consideration by the financial advisers of this matter or checking of precedents for this with the trustees.

24 http://www.dnb.co.uk/

Good practice	• The personal recommendation reflected the member's individual circumstances. Among other things, in addition to critical yields, wider benefits, such as AVCs, tax, NI, and benefit implications were taken into account when making a personal recommendation. • A full assessment of the benefits of the ceding scheme was made before making a personal recommendation. For example, a member could have placed great importance on generous early retirement terms, or ill health benefits, so that suitable advice was not to transfer even if the critical yield was achievable.
Poor practice	• Over-emphasis of the possible 'flexibility' under a DC scheme was given when undertaking the transfer analysis, while not adequately reflecting the downside.

2.6.2 Receiving scheme

As part of the advice process, when recommending a transfer, financial advisers are required to recommend a receiving scheme and fund for the transfer value.

In almost all cases in this review, the recommended receiving scheme was the default scheme chosen for all members included in the pension transfer exercise and was not demonstrably based on the member's specific circumstances or preferences. For most members, this approach would result in a product that was suitable for the member's needs. However, there were exceptions, e.g. the member may have had a reason for requiring the transfer to go to an existing scheme, albeit that it would then have been possible to make an onward transfer.

Examples of circumstances where the member may have wished to consider their existing scheme could include an existing DB scheme with more favourable benefits or more security than the ceding scheme, a DC scheme with lower charges, or a scheme with a large fund discount whereby the transfer value could move the total fund over the relevant threshold. However, some firms explicitly excluded the review of existing products from the scope of the advice paid for under the ETV exercise.

Good practice	• The member's other existing pension schemes were taken into account when recommending a product. • There was clear evidence of the suitability of the receiving product and funds based on the member's circumstances.
Poor practice	• The product charge was described as competitive, but there was no evidence on the files to support this, as the annual management charge (AMC) appeared higher than for the receiving schemes in the majority of files that we reviewed. • Immediate-vesting members were placed in a standard annuity when they may have been eligible for enhanced rates.

2.6.3 Fund selection

In most cases, the selected fund was an internally managed fund (i.e. fund managed by the selected scheme provider) selected with reference to the member's stated ATR. While most transfer funds within the sample population would not have required rebalancing, where this was required, it was not always described clearly (e.g. why this would be needed, what would be required in order to re-review the funds and the cost of any on-going reviews).

Good practice	• Where ongoing reviews of fund performance and potentially rebalancing of the portfolio were required, this was explained to the member in clear terms, including how and when it would need to be done, and the cost of ongoing reviews.
Poor practice	• The selected fund was too cautious to meet the critical yield and the financial adviser did not explain that ongoing reviews of fund performance would be necessary. • Advice was provided on the basis that the member would take an annuity at their preferred retirement age, but no consideration was given to alternative methods of securing retirement income (i.e. phased retirement or drawdown).

2.6.4 Language of the recommendation

The clarity of financial advisers' recommendations varied considerably across the review population. There were examples of very clear recommendations but also examples of weak and ambiguous wording. For example wording included phrases such as 'the transfer will not be more appropriate' or 'the transfer may not be appropriate'.

Good practice	• The personal recommendation was expressed in clear and unambiguous terms in relation to both the advice on whether or not to transfer and, if the member transferred, the receiving product and the funds into which the member was advised to invest.
Poor practice	• Template paragraphs were used in the personal recommendation, which did not relate to the member's specific circumstances. • The language used to describe the recommendation left the member to decide between various options. For example, the suitability report recommended that the member should stay in the scheme, but that, the member should transfer if any other objectives were of greater importance to the member than maximising their income at retirement.

2.6.4.1 Transfer of risk

Given the complexity of the issues involved in transferring out of a DB scheme, the clarity and quality of explanations about the risks and key issues is very important.

In the review population, some files explained in strong terms the transfer of risk, using for example bold text and underlining to help members understand the key details. Others explained this transfer of risk in ways that could be open to more than one interpretation.

Good practice	• The suitability reports recommended that the member should not accept the transfer offer and stated: 'The critical yield demonstrates that you would need to take too high a risk and then be rewarded for taking that risk. Our opinion is that this is extremely unlikely, and if you transfer, your retirement income will be lower than if you stayed with the [employer's] scheme'. The report continued to explain the transfer of risk and the impact of accepting the cash enhancement.
Poor practice	• There was a statement in the suitability report that played down the risk ('you will be taking on risk you don't have to worry about now').

2.7 Tax and benefit implications

The tax and NI treatment of the enhancement differed for the member depending on whether the enhancement was taken as cash or taken as an enhancement to the transfer value to the receiving scheme. The cash enhancement element may also have a detrimental effect on a member's financial situation in relation to state benefits and conditional allowances such as age allowance. In some circumstances, there was an increased likelihood of benefits and allowances being reduced especially where the member was unemployed or on a very low income.

The review showed that the tax implications of taking the enhancement as cash were generally disclosed by both the employer and the financial adviser to the member. This principally involved a statement noting that if the enhancement was taken as cash it would be subject to deductions for tax and NI. However, the amount (and thus the net cash payment) was rarely disclosed in an explicit way. There were also some cases where potential detriment in relation to state benefits and conditional allowances was not explained at all, or was described in generic terms as opposed to explaining the real impact in relation to the member's situation.

Good practice	• The amount of tax and the NI implications (and thus the net cash payment) was disclosed to the member.
Poor practice	• The potential detriment in relation to state benefits and conditional allowances was not explained at all, or was described in general terms. • For members who were approaching retirement age, wider tax points were not covered by the financial advisers as part of the advice process, in particular where the member wished to take the enhancement as cash. Some examples were: – where the key driver for taking the ETV was to access the cash enhancement, limited or no consideration was given to whether taking the enhancement to a DC scheme and then releasing the cash through payment of a PCLS would have been more tax efficient; – limited or no consideration was given to the member taking the PCLS (to access cash tax free) and then using a draw down, instead of taking the enhancement as cash; and – limited or no consideration was given to a reduction in the member's marginal rate of tax if the member had taken the remainder as cash through a pension/ draw down product when the member stopped working.

There was evidence that tax treatment of the enhancement, when taken as cash, differed between current and former employees of the employer. Current employees would have been taxed at their marginal rate through the employers' payroll, and members would have been advised that the cash enhancement could have moved them into the higher rate tax band. Members who were no longer working for the employer were often set up on an OT tax code (this is an 'override tax code' which is used when full income details for all employment sources are unknown). As a result, the member was likely to pay a higher level of tax than would otherwise be required.

2.8 Insistent members

In 59% of the files reviewed, the transfers took place on an insistent basis after a personal recommendation had been made (members acted against financial advisers' advice). The 'unsuitable' outcomes arose in two main ways:

- the personal recommendation was not to leave the DB scheme but the presentation of the recommendation was unclear, lacking relevant facts or with incorrect information (and so it could not be relied upon); and
- the financial adviser advised the member not to transfer out of the DB scheme but then recommended a product that was not suitable (with reference to the outcome of and assessment of the information gathered about the member).

A significant proportion of files did not record the reasons for the member's decision to act on an insistent basis.

Good practice	• For an insistent member, their reasons and the risks of not accepting the personal recommendation were discussed with the client. The reasons, the discussion and its outcome were documented in a separate document to the original personal recommendation. • Robust warnings were given and documented. • Insistent members wrote, in their own words, why they decided to proceed on an insistent basis. • After the member rejected the advice to transfer the full value to the pension and opted to take the enhancement as cash, the financial adviser recommended a product and fund based on the member's proposed approach to the transfer.
Poor practice	• Communications with an insistent member did not contain sufficiently strong warnings about the risks of transferring against professional advice. • The file did not indicate why an insistent member decided to act against professional advice not to transfer. • There was no documented process to show how the member was treated as an insistent client. • TVAS/critical yields were not recalculated to show the effect of proceeding on an insistent basis (e.g. the effect of taking part of the enhancement as cash).

2.8.1 Reasons for opting for cash enhancement

Where members acted on an insistent basis and the key driver for this was the cash enhancement, only a limited number of financial advisers considered alternative options to accepting a transfer, which may not be in their long term interests, solely to gain access to cash. While this advice would typically be outside the 'limited scope' of the advice given (as the engagement typically would be to cover pension advice), when the availability of immediate cash was the sole reason for making a transfer it would have been relatively straightforward to highlight this to the member.

Good practice	• The financial adviser recommended that the member made an appointment with the Citizens Advice Bureau to provide support with non-cleared debts and to ensure that he was receiving all benefits for which he was eligible. • A debt advice fact-sheet was provided to a member whose cash enhancement was not sufficient to clear all the member's debts.
Poor practice	• Although, from the fact find, it seemed likely that the member's liabilities were a key element in them opting to act against advice to obtain the cash enhancement, it appears that this was not discussed in any way and alternative options for repayment of debts were not considered.

We note that under the 'Incentive Exercises for Pensions – A Code of Good Practice'[25] of June 2012, no cash incentives should be offered that are contingent on the member's decision to accept the offer.

25 www.site-fusion.co.uk/files/writeable/uploads/webfusion47278/file/thecode.pdf

2.9 Method of communication

Methods of communication with members during the advice process varied across the population of firms in the review. Some firms posted fact finds to members for completion before advice was given. Some firms completed the fact find process by telephone, and others through the combination of post and follow-up telephone calls or meetings. Some firms also used online information gathering. The risks associated with the member completing the fact find at home or on-line are that the member may not have understood the importance of accurately recording information, and the member may not have understood the questions and/or failed to complete all relevant sections of the questionnaire.

Poor practice	• Group presentations were used to explain the transfer to members, which is highly unlikely to be an appropriate basis for providing individual advice. It appeared that members made their decision to transfer between attending the presentation and receiving the advice not to transfer. • The fact find was undertaken by using an online questionnaire which produced 'problem' messages when inconsistent inputs were made and 'warning' messages if the information could indicate that the ETV was not suitable. Those alerts were not obviously followed up by the financial adviser.

Recordings of telephone calls between the member and the financial adviser provided contemporaneous records of the advice process and insight into the extent that the member understood the issues. Without detailed contemporaneous records, it is difficult to assess the member's level of understanding of the risk they are taking on, the exploration of all of the relevant issues, and the weight the financial adviser attached to individual facts.

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