HINDSIGHT

Collegiate UNDERWRITING

Winter 2014

Welcome to the latest edition of our Hindsight publication.

Pension transfers from occupational pension schemes are again in the news. In 2011 we looked at these in light of the decline in defined benefit schemes, Trustees were de-risking their pension liabilities by offering enhanced transfer value schemes to members.

This time news has been made because of proposed changes in the last budget:-

- Total flexibility on drawing income from age 55
- Reduced tax on death on pensions
- Proposals to block transfers from public sector schemes

In July 2014 the FCA published their Thematic Review into Enhanced transfer value pension transfers. They stated that their finding would be of interest to financial advisers who provide any pension transfer advice to consumers who are members of defined benefit schemes. We have produced excerpts from these findings.

Financial Advisers may be having their clients targeted by less scrupulous advisers seeking to use the new rules to entice member's of defined benefit schemes to transfer to personal pension arrangements. We believe that in the vast majority of cases this will be judged by the regulator and the FOS as poor advice and could therefore lead to upheld claims against the adviser in later years if there are losses. These are easily measured against the certain benefits of the scheme. The nature and size of compensation awarded by the FOS on upheld pension transfer claims makes this a difficult area to underwrite as no amount of income in increased premiums will cover the potential downside.

We have re-produced sections from the 2011 edition as many of the points raised are still relevant.

Finally we have produced the thoughts of the FCA on advisers who arrange pension transfers with a view to investing pension monies in unregulated products.

You will note that the Collegiate proposal form specifically addresses these areas and our underwriting will reflect the views of the regulator and FOS that these are higher risk areas. This could result in substantially increased premium and excess levels or even refusal to provide terms in some instances

My thanks go to Mark Gibbon, our Managing Director and Martin Archer, our Legal Director for producing this newsletter.

We hope that you will find these articles informative and useful.

If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk.

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New pension proposals

Under unsecured pension rules the level of income that can be taken is either:-

- Unlimited where pension income of £20K per annum has been secured or
- 120% GAD rates (increasing to 150% from beginning of first pension year after 27 March 2014)

Under proposals in the last budget total flexibility in how much pension income can be taken will be given. This means that the whole of the pension fund could be taken in the first year. Tax is payable at the marginal income tax rate. These proposals will come in to effect from April 2015. As a temporary measure the level of secured income required for total flexibility has been reduced to £12,000.

The government have just announced proposals that they will change the level of death tax from April 2015. Currently benefits within the LTA in a personal pension are:-

- Tax free if under 75 and pension funds not accessed
- Otherwise 55% of fund value

The current proposals put forward will change this to

- Tax free if under 75 regardless of whether funds have been accessed
- Marginal tax rate of person receiving pot if over 75

The government also said they would bring in legislation to block the transfer of pension benefits from public sector schemes. Tthere has been some mention of this being extended to private sector schemes. The reasons quoted for this were economic but do highlight the fact that they are concerned that the proposals will have the consequence of large scale transfers.

There is also concern that this increased level of flexibility will be used to bring about a wave of pension transfers out of defined benefit schemes which are not in the interests of the consumer or the IFA industry. We do not believe that the FOS or FCA will regard this as the most suitable course of action in the majority of cases.

For most consumers who have a defined benefit scheme this will be the basis of the majority of their pension savings. They will often have little investment experience and are not considered able to make an informed decision even with advice. History has shown that when things do not turn out as hoped for a number of these consumers will complain and the level of compensation payable will be high.

Pension Transfers

Thematic review Enhanced Transfer Value (ETV) pension transfers

In July 2014 the FCA published their findings on the review of bulk pension transfer advice provided by financial advisers where employers offered an enhancement to the transfer value.

They looked at the period 2008-2012. Prior to 2008 most ETV exercises were done on a direct offer basis. From 2008 onwards financial advisers were engaged by employers to provide individual advice on the suitability of the transfer. From 2012 the FCA stated that the number of such exercises had declined as transfer values became less attractive for employers. They thought recent proposals may cause an increased interest in this type of exercise.

The FCA stated that the findings would be of interest to financial advisers who provide ETV pension transfer advice but also to advisers who provide any pension transfer advice to consumers.

The FCA stated that Pension transfer advice is important to Defined Benefit members:-

- They may not have the skills and experience to make a decision about transferring
- They may not understand the value of
  - existing benefits
  - implications of losing underlying guarantees
  - reliance on annuity rates and investment returns
- Are heavily reliant on advice
- Cannot reverse the decision
- Many years can pass before the wisdom of the decision is known, then it may be too late to improve retirement income

Overall they found that 34% of advice was unsuitable and 14% unclear. Examples of drivers of unsuitable advice were:-

- Outcome focused on critical yield not wider member circumstances
- Inadequate risk assessment
- Fund recommendation not matching risk profile

59% of members within the review were insistent customers.

The FCA expected advisers to look at alternative options to accepting a transfer value, which may not be in the customer's long term interests, solely to gain access to cash.

This provides some insight into what standards will be expected if there is a wave of transfers to take advantage of the new rules particularly

death benefits. The FCA will expect a proper exploration of the alternative means of providing these benefits without recourse to pension transfer which they may consider is too valuable a benefit to give up.

Guidance in the FCA handbook provides that when advising a customer whether to transfer out of a defined benefit scheme the starting assumption is that it will not be suitable. The adviser must obtain sufficient information about the customer to believe the transaction:-

- Meets investment objectives
- Is such that they can financially bear any related investment risk
- Is such that they have the necessary experience and knowledge to understand the risk involved in the transaction

Some other key areas where the FCA found explanations were inadequate:-

- Disclosure of level of funding of scheme and effect on transfer value
- Preferred retirement age comparison
- Capacity for loss and in conjunction with ATR
- Guaranteed benefits under Pension Protection Fund
- Transfer of risk

We have seen in previous FOS cases that the customer should have an opportunity to beat the benefits that are being given up by transferring not just match them.

Chance to win!

What does the Pension Regulator have to say about pension transfers?

The Pensions Regulator issued guidance on pension transfer incentive exercises in December 2010. The Pensions Regulator starts by stating that Trustees should start from the presumption that such exercises and transfers are not in most members' interests. They should therefore approach any exercise cautiously and actively.

In December 2010 David Norgrove, chair of the Pensions Regulator, gave a speech at the NAPF annual conference in which he discussed enhanced transfer values. He reiterated his belief that in the overwhelming majority of situations enhanced transfers were not in the member's interests. He accepts that there will be specific and individual circumstances in which a transfer may be in the member's interests. These were:-

- Limited life expectancy
- No dependents
- Sophisticated investor balancing risks in portfolio of retirement benefits
- Level of benefits significantly higher than the PPF cap and as such would be cut if schemes entered the PPF

His expectation is that there will be a minority of members who fit this bill. The Pensions Regulator pays out approximately 150,000 pensions from the Pension Protection Fund with an average value of £3,800.

Mr. Norgrove acknowledges that it is a simple fact that it is very difficult for members to gauge whether giving up a defined benefit pension promise in exchange for a cash transfer into a defined contribution scheme, will be in the best interests over the long term. But given the gravity of the decision, the difficult financial equation, and potential for detriment if they get the decision wrong he believes the Regulator's stance is reasonable and proportionate.

Cash equivalent transfer values

From 1 October 2008 new transfer regulations were introduced making Trustees of Occupational Pension Schemes responsible for the method of calculating the cash equivalent transfer value ('CETV'). Previously this was certified by the scheme's actuary. The Pension Regulator issued guidance to assist Trustees in fulfilling these duties.

The key points raised were:-

- There is scope for Trustee judgement in producing transfer values appropriate for their scheme.
- Where a member has an option that can be exercised under the scheme and it will increase the value of benefits this has to be taken account of by the Trustees in calculating the 'CETV'. The Trustees can allow for the chance that the member will not take up the option, which can be based on past experience.
- Where discretionary benefits can be awarded but are not automatic the Trustees have to decide to what extent these discretionary benefits are to be included. They must have regard to any established custom for awarding them and any consent requirements.
- Trustees are allowed to reduce the 'CETV' to allow for underfunding although where the employers covenant is judged to be strong and any funding shortfall is being remedied over a reasonably short period trustees should not normally reduce the 'CETV'

An example of an option may be early retirement without consent. Similarly a discretionary benefit might be early retirement with consent of the employer.

Transfer value Analysis System

The transfer value analysis system ('TVAS') was introduced from 1 July 1994. The 'TVAS' should be applied to all transfers from a final salary occupational scheme. The critical yield, calculated by the 'TVAS', is the return required from a receiving personal pension or section 32 policies to match at retirement age the benefits provided by a final salary occupational pension scheme. This can be calculated at normal retirement age and an early retirement age. The reports will also compare tax free cash amounts, death benefits payable and pension income levels at varying rates of return as compared to the existing scheme.

The critical yield is then reviewed together with the risk assessment of the client to determine if the defined contribution scheme that the pension is being transferred to has a fair chance of matching or exceeding the benefits that were payable under the defined benefit scheme and whether this is a risk that the client is prepared to take in the circumstances.

What the transfer is doing is removing risk from the employer scheme onto the shoulders of the employee. The employee has no certainty over what will eventually be paid out as pension in retirement. This will depend on a number of factors namely investment performance, charges, interest rates and life expectancy. If these move against the employee in the time to retirement then they may well face a reduced income. As an example we have seen a number of transfers that were done in 2006 where investment performance has been poor. Annuity rates have also fallen.

Capacity for loss

If a complaint is made in the future, FOS when considering their decision will look at a number of factors, including whether the employee understood that risk and also whether they had the capacity to bear the level of loss. The FOS is very sympathetic to individuals who, in their opinion, did not have the capacity to bear the loss, but were advised to transfer benefits and have then suffered detriment. In January 2011 the FSA produced a Guidance consultation on 'Assessing suitability'. They define capacity for loss as 'the ability to absorb falls in the value of investment. If any loss of capital would have a material detrimental effect on a customer's standard of living, this should be taken into account in assessing the risk they are able to take.' Although this guidance is aimed at investment decisions this must equally apply to an investment decision on pension assets where investment performance is required to match benefits and may not be achieved. This loss can be measured against the alternative option of leaving the benefits with the existing pension scheme.

There are benefits to the deferred member of making a pension transfer, access to greater tax free cash, the opportunity to do better, flexibility and control but it is important that any advice also concentrates on what is being given up. This is not just a question of whether the critical yield is reasonable in light of the overall risk assessment of the client and what might be expected from investment performance but should also cover what will happen if those yields are not achieved. This is particularly important where the deferred member is close to retirement age or the value of the pension benefits forms the majority of the customer's pension provision. It would be very sensible to include an analysis of the downside in any advice to the customer.

What does the Pension Protection Fund provide?

This was established in April 2005 to pay compensation to members of eligible defined benefit pension schemes where there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

Compensation is paid to individuals who have reached schemes normal retirement date or are in receipt of survivors or ill health pensions. This is paid at 100%. Where part of the compensation is derived from service on or after 6 April 1997 the payment will be increased by RPI capped at 2.5%.

For people below normal retirement date compensation is generally 90% of accrued pension at date of assessment revalued at RPI, capped at 5% for service prior April 2009 and 2.5% compound for service post April 2009. This compensation is currently subject to an overall cap of £32,761 after applying 90%. Once in payment that part that derives from service post April 1997 is increased by RPI capped at 2.5%.

When a scheme is in an assessment period, the trustees may only pay a transfer value where, before the assessment date, the member has requested and accepted the transfer value in writing and has designated a scheme willing to accept that transfer value.

Further, the trustees may only pay that transfer value if:

- they are satisfied that to do so is consistent with the objective of ensuring protected liabilities do not exceed assets (or that where they do, the excess is kept to a minimum); and
- they reduce the transfer payment to the extent necessary to ensure that it does not exceed the cost of securing the benefits which correspond to the compensation that would be payable if the Pension Protection Fund were to assume responsibility.

Where the assessment period has come to an end and the Pension Protection Fund has assumed responsibility for a scheme, the member will become entitled to compensation at normal pension age. Once the Pension Protection Fund has assumed responsibility for the scheme, a member would not be entitled to a transfer payment unless pensionable service was ended by the start of the assessment period and at that time the member had less than 3 months' pensionable service in the scheme.

There will be a small number of members who have concerns that they face reduced benefits payable in retirement if the pension scheme entered the Pension Protection Fund. The solvency of an employer scheme is not something we would expect an IFA to advise on. It would be reasonable to point out the critical yield required to match benefits payable under the Pension Protection Fund and the level of those benefits. If we refer back to the guidance to Trustees on 'CETV' they are allowed to reduce transfer values for funding issues. Ultimately any decision based on a scheme's solvency must be for the member to make.

Advising on pension transfers with a view to investing monies into unregulated products through a SIPP

In 2013 the FSA expressed concern that advisers were giving advice to customers on pension transfer and pension switches without assessing the advantages or disadvantages of investments proposed to be held with the new pension.

They made a number of points:-

- The proposed investments were often high risk, highly illiquid unregulated investments such as diamonds, overseas property development, forestry and film schemes.
- Model is based on an introducer to an unregulated firm, marketing of unregulated product. Customer referred to regulated adviser to provide advice on a SIPP capable of holding the unregulated investment.
- Depending on circumstances the customer may not have recourse to the FOS or FSCS should there be a problem with the unregulated product.

FSA's view was that the provision of suitable advice requires consideration of the suitability of the overall proposition and it should be clear to advisers, that where a customer seeks advice on a pension transfer in implementing a wider investment strategy, the advice must take account of the investment strategy being contemplated.

In 2013 the FSA issued guidance on the due diligence procedure SIPP operators used to assess non-standard investments. In 2014 the FCA wrote to all CEOs of SIPP operators following a thematic review which followed up the guidance. The thematic review indicated widespread failings and asked that CEOs review their business and specifically review that

- Where non-standard investment business is undertaken adequate procedures are in place to assess these investments

The key findings of the review were failures by firms to:-

- Understand the nature of the investment
- Check money was paid to legitimate businesses
- Independently verify that assets were real and secure, or that investment schemes operated as claimed.

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