HINDSIGHT

Pension Transfer Special Autumn 2015

Welcome to the latest edition of our Hindsight publication.

The Chancellor has been busy in the 'pension's arena'. There have been significant well publicised changes to the UK pension system that presents some challenges and opportunities to the IFA market. Non-age restrictions on how customers can access their pensions have been removed.

Following the last budget the Government issued a Green Paper consulting on simplification of the pension tax relief system. They estimated the cost of the relief at £21.2bn per annum. The Green Paper asks a number of questions including 'To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?' and 'Do respondents believe that a simpler system is likely to result in greater engagement with pension savings?' Responses have to be made by the end of September. Given the level of the deficit and the criticisms that pension tax relief has received, it seems likely there will be change if not abolition.

However in this edition of Hindsight we are going to look at the issues presented by the pension reforms that have been legislated.

My thanks go to Mark Gibbon, our Managing Director, Martin Archer, our Legal Director and Tyson Oladokun 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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Pension reforms

1. New Rules

Flexible drawdown allows 25% of consumer's pension funds to be taken as a tax free lump sum and any further withdrawals taxed at their marginal rate of income tax, but there is no limit on how much can be withdrawn each year. There is no requirement to buy an annuity at 75 and any balance in the pension fund can be passed to beneficiaries on death. A similar model has been used in Australia and Canada with different results. The concern is consumers will spend all their money and leave themselves dependent on state handouts, Australia or will spend at too low a rate, Canada.

Previously most consumers had two options at retirement. They could buy an annuity or they could go into drawdown. Drawdown could be flexible or capped. Flexible required secured income of £20,000 per annum, reduced to £12,000 from 6 April 2014. Once this level of income was secured withdrawals were unlimited but taxed at the marginal rate of income tax. Capped drawdown was based on 150% of an equivalent annuity. Where the consumer takes income from a flexible drawdown the money purchase annual allowance is reduced to £10,000. If a consumer only takes their tax free lump sum then the allowance remains at the current level of £40,000. If income is taken from a capped drawdown within the prescribed limits the full allowance remains available.

The changes have removed the ten year restriction on guarantees in annuities. This means an annuity can continue to be paid to an individual's estate for any defined period. Annuities can go down as well as up but this level of flexibility would restrict the money purchase annual allowance to £10,000.

One of the most notable changes brought in on 6 April 2015 was the introduction of a new authorised payment called an 'uncrystallised funds pension lump sum' (UFPLS). An UFPLS can be paid from uncrystallised

money purchase funds as a lump sum. There is a 25% tax-free element and the balance is taxed at the member's marginal rate of tax. This effectively gives flexibility over how tax free cash can be taken. Previously if a customer wanted to access an income from the whole of the fund they needed to take the whole of their tax free cash.

Members, if their scheme allows, can take their entire money purchase pot as an UFPLS in one go, or take a series of smaller UFPLS's, each of which will have a 25% tax-free element.

However, as with flexible drawdown above, taking any UFPLS will result in the individual's annual allowance being reduced to £10,000.

On death before age 75, nominated beneficiaries can receive the whole of the pension fund as a lump sum tax free if paid out within 2 years. Money can be paid from a drawdown or annuity tax free if designated within two years. It no longer makes any difference whether the fund has been accessed or not.

This does remove one area of claims where tax free cash had been taken and death occurred prior age 75. Previously this would have attracted a tax charge but this is no longer the case.

If death comes after 75 then this is subject to 45% tax (unless paid as income) for payments made between 6 April 2015 and 6 April 2016. It is taxed as income, at the beneficiary's rate of income tax, on payments after 6 April 2016. Previously a dependents pension could be bought but otherwise any lump sum paid would be taxed at 55%.

Input periods have been aligned with the tax year. All open input periods were closed on 8 July 2015. A new input period then runs from 9 July 2015 to 5 April 2016. Consumers can have three input periods that end in 2015/16. Transitional rules have been introduced that allow £80,000 annual allowance for 2015/6 split between the two periods. The period to 8 July 2015 the 'pre alignment year' has an annual allowance of £80,000, plus any carry forward, for pension input periods ending between 6 April 2015 and 8 July 2015. It is possible for consumers to have two such periods.

The period 9 July 2015 to 5 April 2016 is the 'post alignment' period. The annual allowance is £80,000 less used in 'pre alignment period' but a maximum of £40,000 plus carry forward.

Details can be found at https://www.gov.uk/government/publications/pensions-technical-note-transitional-provisions-for-aligning-pension-input-periods/pensions-technical-note-transitional-provisions-for-aligning-pension-input-periods

2. FCA Policy Statement

FCA issued Policy Statement PS15/4 'Retirement reforms and the guidance guarantee: retirement risk warnings' in February 2015. This introduced new rules to cover the risks associated with the new pension flexibilities. These include:-

- Appropriate risk warnings where consumers access pension savings.
- Requirement to ask consumers questions to identify if a risk factor is present and therefore if a risk warning must be given.

The purpose of these rules is to help consumers:-

- Understand the importance and implications of decisions they are making.
- Seek regulated advice or guidance from Pensions Wise to help understand risks.
- Ensure Firms understand what they should do to warn consumers re risk.

Para 3.34 deals with the subjects that firms should ask questions on. These include:-

- State of health.
- Guarantees.
- Partner or dependants.
- Inflation.
- Sustainability of retirement income.
- Tax implications.
- Charges.
- Mean tested benefits.
- Debt.
- Investment scams.

3. Risks and potential claims

Small pots

One of the issues facing IFA's is what advice they should give to individuals with small pension pots. The traditional route for clients with smaller pension pots was to purchase an annuity, however the new reforms offer more choice.

Before these pension reforms came in, around 80% of annuities purchased were by savers with pots of less than £200,000 and almost 50% were less than £50,000. It is likely investors with smaller pots will seek to capitalise on the wider freedoms with the new pension changes. They may not feel the certainty of income provided by an annuity is worth the modest income and so may seek to access their whole fund at once at their marginal rate of income. If this is done then the rate of tax paid on this pot will be important. With a promised personal allowance of £12,000 and a new state pension at circa £7,000 can a small pot be taken tax free rather than incurring tax charges if taken in one go? If the pension fund is not taken in one go what is the fund going to be invested in? We have seen previous claims where customers should have accessed their pensions and bought an annuity but remained invested and lost money. If advice would be to take the pot as a series of small sums to avoid tax charges and spread the sum over a number of years what investment risk should the consumer be taking. Not much if any is the likely answer.

Pension transfers

An old favourite in professional indemnity risks! How many individuals are going to transfer Defined Benefit (DB) pension schemes to Defined Contribution (DC) in order to access their fund under the new reforms? The Pensions Regulator has anticipated 100,000 transfers from DB to DC following the changes in April 2015.

The Pensions Regulator has already advised (http://www.thepensionsregulator.gov.uk/docs/db-dc-transfers-conversions-regulatory-guidance.pdf) that there should be no transfers of more than £30,000 from a DB scheme to a DC scheme without appropriate independent advice and for the relevant adviser to have specific 'transfer specialist qualification'.

In the 12 months preceding the introduction of the 2015 pension reforms, there were a number of Enhanced Transfer Value cases deemed unsuitable by the FCA. Under the old rules, the FCA found 34% of advice unsuitable, 14% uncertain whether advice was suitable and 74% where disclosure was unacceptable. Where there are grounds for believing unsuitable advice has been given the FCA can make an order under Section 166 FSMA requiring an IFA to appoint a skilled person to review the suitability of work. This has the potential to be very expensive and has serious implications for those firms affected.

The FCA will be watching this space and so will insurers. Giving up a defined benefit scheme with all the built in guarantees is not something that should be done lightly and we would not expect to see many transfers just to take advantage of the pension liberation reforms. We can think of circumstances where this might be appropriate. As an example, someone who had other income may want to transfer pension benefits so they can be passed onto beneficiaries rather than lost on death. In this case we would expect the level of income being taken from the money purchase fund would be substantially less than that available under the defined benefit pension scheme. We would not expect to see transfers where a similar level of income was being withdrawn. We would also expect alternative solutions to have been investigated.

Pension Fraud

As individuals can now access their whole pension pot, the risk of pension scams has been heightened. As a general rule, a pension cannot be accessed under age 55 unless there are exceptional circumstances. Most fraudsters will attempt to lure individuals into making one-off investments by withdrawing their whole fund. The Pensions Regulator advises that members with DB schemes must take appropriate independent advice from an FCA-authorised adviser before transferring their benefits.

What responsibilities does the IFA owe to the customer where they arrange for the pension fund to be paid out? This is an interesting question and we can compare this to some of the decisions that have been made on SIPP transfers organised by IFA's that were then invested in unregulated collective investments e.g. Harlequin without advice from the IFA.

FOS ask some questions that help them decide if an IFA is liable for losses on an investment into a SIPP where the IFA arranged the transfer but did not advise on the investment:-

- Did the IFA know the investment was going to take place?
- What investment experience did the customer have?
- What was the customer's attitude to risk?

If the IFA knew the investment was going to be made, FOS's view is COBS 9 requires the IFA to consider the suitability of the transaction and this cannot be done without looking at the investment objectives or specific investment type being proposed. FOS will not accept a statement in the suitability report that the IFA is not considering the proposed investment. Our view would be that where no investment was determined the IFA has a problem as the transfer would be unsuitable due to the higher costs associated with running a SIPP. FOS would then look at the suitability of the investment and compare that against the investment experience and attitude to risk of the customer. Invariably the complaint then succeeds although we have seen complaints where FOS were convinced that the customer would have accessed the pension fund anyway and in these circumstances rejected the complaint.

Where does that leave the IFA advising someone to access their pension fund? If the IFA has documented the reason is to provide income rather than investment then this would seem to fall outside of comparison with the SIPP example. However if the IFA is aware of a proposed investment, the suitability of that investment needs to be included within the advice on the proposed transfer. Reference should be made to the questions identified in Policy Statement PS15/4, see details above.

In order to safeguard against individuals being victims of pension fraud, the Pensions Regulator has advice to help combat pension scamming. This can be found at:-

http://www.thepensionsregulator.gov.uk/trustees/pension-scams-trustees.aspx

http://www.combatingpensionscams.org.uk/

Some of the questions asked here are familiar to historic investment claims we have seen.
These include:-

- Connection to unregulated investment.
- Allude to overseas investment.
- Hint at unusual, creative or new investment techniques.
- Access pre age 55.
- Transfer is after cold calls, unsolicited emails or texts.
- Mention loan, savings advance, loophole, government endorsement.

What to do with insistent customers?

"Just say No"

There has been a lively debate around the issue of "insistent clients", triggered by the new pension freedoms. "Just say No" was the conclusion that the Personal Finance Society reached having engaged with the FCA and FOS on the matter. This contrasts with the comments attributed to Rory Percival, technical specialist at the FCA, who has proffered the view that if you document the process well, in 3 steps you ought not to have a problem.

1. provide your advice in a concise and clear way ensuring the clients understanding.
2. if the client wants to take another course make clear to the clients the risks involved.
3. if the client still wants to proceed against your advice make it very clear that the transaction is being arranged against advice.

COBS Rule 10.3.3 states 'If a client asks a firm to go ahead with a transaction, despite being given a warning by the firm, it is for the firm to consider whether to do so having regard to the circumstances'. The FCA has also now issued their Factsheet No.035 setting out in some detail their position on the issue.

Although there have been few "insistent customer" claims pursued through FOS a comparison of two such complaints where Final Decisions have been issued provide some useful points. Both related to final salary pension transfers to personal pensions. In one case an award was made against the firm and in the other no liability was found.

It is possible to discern a distinct rationale for the contrasting fortunes of the firms concerned. Both cases were viewed as unsuitable by the advising firms essentially for the same reason. The critical yield required to match the benefits being given up were considered to be too demanding for the customers recorded attitude to risk.

In the first case the driver for the client to proceed was his concern about the deficit in the funding of the ceding scheme. In the other case the driver was the clients wish to select his own investments

In the first case the ombudsman accepted that the customer was concerned about the security of the final salary scheme but thought him relatively unsophisticated. FOS found that whilst the adviser advised against the transfer, the adviser did not sufficiently explain to the client from available information, the steps the scheme was taking to reduce the deficit nor did he sufficiently highlight the protection afforded by the PPF.

Had the adviser taken more care on the above issues the Ombudsman was of the view that the customer would not have proceeded with the transaction. The firm was ordered to make redress.

In the other case the Ombudsman was satisfied that the advisor had covered the risks associated with

the transaction. FOS was satisfied the customer had investment experience and was independent minded (having not followed unrelated advice previously). In the circumstances the Ombudsman was satisfied that the client would have proceeded with the transaction in any event and no award was appropriate.

In the former case there was an email between the adviser and the firms compliance function discussing how the transaction could be proceeded with, in which the compliance function advised it could only be transacted as insistent or execution only. This exchange could have been read as a "how to" discussion with the advisor being keen to arrange it, rather than exhibiting any real reluctance to do so.

FOS is generally hostile to disclaimers, on the basis that you can't disclaim bad advice. It therefore follows that if FOS believes (rightly or wrongly) that there has been no genuine attempt by the adviser to dissuade the customer from the folly of proceeding then you should expect a hard time of it before them.

Clearly the greater the folly of the clients proposed course of action in terms of the risk of detriment, the more sceptical FOS may be of the motive for facilitating the transaction. This is particularly so where the driver is weak and there are obvious alternative solutions available.

The reason that the insistent customer issue has come to the fore recently are the choices customers are going to face between taking advantage of the new pension freedom reforms or using the old solutions (annuities). The expectation is that there are going to be a greater number of customers who wish to act against the advice given by the IFA.

What are IFA's going to do when they are faced with this situation? There are two possibilities if the IFA is to minimise the risk of future claim;

- Just say No.
- Make a genuine attempt to dissuade thecustomer and have close regard to the FCA 035 Factsheet and the documentationrequirements stated therein.

Despite the fact the pension reforms have only been in force a matter of months, we have already received some claims from 'insistent customers' who have been refused transfers from DB to DC schemes. In one case, the client wished to transfer out of his DB scheme soon after the April 2015 changes were effected, but this was refused by the IFA on the grounds that their compliance team deemed the recommendation to transfer benefits out of his occupational scheme unsuitable. The complaint has been rejected and to date has not been referred to FOS.

In another case, a client wished to withdraw all of his pension funds under the new pension rules. He was advised against by his IFA. He did not agree with this advice and chose to go ahead with it anyway dealing directly with the relevant provider. The IFA (rightly in our opinion) advised the client they could not support the transaction, accessing the whole pension, but referred him to the provider.

The difficulty in both of these scenarios is that the customer purports to understand the implications of the advice whether this is transferring out of a DB scheme or accessing their whole fund. IFA's will need to disregard insistent clients if they feel the advice will be unsuitable. The best way forward in these cases will be to simply refuse to provide any advice. External referrals may be possible, but IFA's will need to heavily document that they are not providing advice but simply introducing the customer to someone who can advise them on the suitability of their proposals.

If the IFA is going to process the transaction we recommend obtaining a signed letter from the customer setting out why they are going against advice.

Impact

The number of annuities sold will decline but the budget may encourage long term savings.

Currently 75% of people reaching retirement with pension savings purchase an annuity. With annuities no longer being a 'forced purchase', demand will fall. Currently around 50% of annuities purchased by volume have pension pots of less than £20,000 and almost 80% are less than £50,000. Many of those with smaller pension pots may decide not to annuitise. They may feel that the certainty of income provided by an annuity is not worthwhile, given the modest income provided and the additional tax payable on withdrawing from the pension fund may not appear significant. The impact on those with larger pension savings is less clear. The majority of the money flowing into annuity sales comes from larger pots, with purchases over £50,000 accounting for almost 60% of total annuity sales by value. Many of these individuals do not have to annuitise today, yet more than half of people who are not obliged to purchase an annuity currently do. They might continue to see annuities as worthwhile, given the guaranteed income levels can be more meaningful to those needing certainty.

Our experience is that many IFA's have successfully dealt with RDR moving their business model from transaction based to asset management based with recurring fee income. With an increased encouragement to saving and wealth managers increasing minimum portfolio sizes IFA's will consolidate in this area to help manage those savings which will increasingly be the responsibility of the individual.

With a successful business model IFA's will seek to manage risk to protect their businesses.
That will mean

- Restricting Execution Only to experienced customers.
- Providing different advice levels for different customers.
  Making sure the terms of advice are clearly explained.
- Complying with Policy statement PS15/4.
- Extra care when dealing with pension transfers where valuable guarantees are being sacrificed. Nothing has changed here but consumers have an extra reason that can be used to persuade them into doing something that may not be in their interests.
- Watch Insistent customers.

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