HINDSIGHT

Collegiate UNDERWRITING

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Welcome to the latest edition of our Hindsight publication.

In previous editions of Hindsight we have looked at pension transfers, investment bonds, Unregulated Collective Investment Schemes and our response to the proposed changes to the Ombudsman limits and complaints handling rules. In this edition we have concentrated on reviewing recent Ombudsman cases and highlighting issues raised by the Adjudicator/Ombudsman on the advice given to the customer. In many cases the key to a successful outcome of a complaint at the Ombudsman is a well documented file with an accurate fact find and a well produced reason why letter that clearly explains the rationale for the advice given and deals with the potential risks faced by the customer if things do not go as planned.

There are a number of issues that repeat. Income drawdown and pension transfers are areas where the Ombudsman will look at the ability of the customer to replace lost benefits in their assessment of the case. Investment diversification is a continuing theme. Whole of life plans have raised their heads again where clients are going through a review process which is forcing them to re-examine the advice that was given to them many years ago as they are now being required to provide additional premiums or face much reduced terms.

A similar process will be under way on income drawdown plans as these are scheduled for review. Not only may the funds under management not have performed as expected when they were taken out but the client is now faced with lower GAD rates and a maximum pension limit of 100% not 120% of those rates.

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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Income Drawdown

(a) General cases

(i) The initial complaint was about the level of commission on an income drawdown contract. This was extended by FOS to cover the whole of the advice given to transfer pension plans into a SIPP, giving up GARs, and then placing pension funds into income drawdown rather than an annuity utilising GARs.

Comments by the Adjudicator

- The adviser has a duty to appropriately assess attitude to risk not just rely on the clients selection of it
- Financial circumstances indicate the client was not prepared to accept a great deal of risk

- The decision to transfer did not need to be made until point of retirement if the intention was to enter an income drawdown arrangement
- Consolidation of pension plans prior to retirement was not an objective reason for transferring pensions particularly when valuable GARs were lost
- Income drawdown entails multiple risks and should only be recommended to investors who are able to understand and tolerate those risks
- The customer had little in the way of other assets to fall back on in the event the fund and income were reduced. It was, therefore, inappropriate to subject the limited means of pension provision to risk

Compensation was ordered based on the difference between the purchase of an annuity using GARs at pension date using notional fund values, against what the client secured when the balance on the income drawdown fund was converted to an annuity. Any difference between the historic receipts and payments between the annuity and the income from drawdown from the pension date to date of compensation was also adjusted for.

(ii) A customer was advised at age 58 to transfer three personal pension investments into a SIPP. These were invested into a UK closed ended property fund. Three years later benefits started being paid via income drawdown. Income was subsequently stopped as no income was being received from the property fund to fund withdrawals.

Comments by Ombudsman

- High risk strategy to take benefits via income drawdown given the low value of the fund
- With two years to go to retirement he would expect benefits accumulated to be safeguarded
- Investment held a degree of risk higher than the clients circumstances could accept

Compensation was ordered based on cancelling the income drawdown contract and setting up an annuity for what could have been acquired if the original policies had been used to acquire an annuity at retirement age.

(b) Dependants

The customer was planning on living with a new partner. The customer had existing pension income from previously arranged annuities and their state pension. The Adviser wrote stating they were prepared to accept a medium level of risk. The Adviser noted that one of the options was an annuity that could include provision for a spouse's pension. This required some irrevocable decisions about the structure of the annuity and those options might not be appropriate or desired in the future. They recommended an income withdrawal facility. The Adviser also wrote concerning the level of withdrawal which the customer wanted to take advising that this was not sustainable and if investments did not grow there would be capital erosion. They calculated the critical yield required for the level of planned withdrawals and disclosed this to the customer.

The HMRC definition of dependant is 'A person who was not married to the member or was not in a civil partnership with the member at the date of the member's death is a dependant of the member if, in the opinion of the scheme administrator, at the date of the member's death the person was financially dependant on the member, the person's financial relationship with the member was one of mutual dependence, or the person was dependant on the member because of physical or mental impairment.'

The dependent must be named when purchasing an annuity and cannot be changed later.

The Ombudsman rejected the complaint. He considered that a reasonable body of competent advisers would have advised against locking the pension fund into an irrevocable arrangement that allowed for an income after death which could have no value if the new partner was not a dependent of the customer.

(c) Serious ill health

A customer with a terminal medical condition was advised to take tax free cash and maximum income under an income drawdown arrangement. They subsequently died and the spouse complained about the advice and the imposition of the tax charge of 35% if they took the remaining benefits as a lump sum. Documentary evidence was supplied that the serious ill health lump sum had been considered but could not be used as life expectancy was greater than one year. If this had been available the whole of the pension rights could have been paid as a lump sum provided they did not result in lifetime limits being exceeded, there was written medical evidence from a medical practitioner and it was from an uncrystallised arrangement. The tax charge had also been explained.

The complaint was rejected. The advice was appropriate to the circumstances. Income drawdown was the only way to access the tax free lump sum prior to death and this would allow the spouse to continue with the income drawdown arrangement or purchase an annuity.

Pension Transfers

(i) The customer was advised to transfer final salary pension benefits built up over 20 years of service in a previous employment. The scheme retirement age was 65 but the customer expressed a desire to retire at 60. The Ombudsman stated this was not a justifiable reason for the transfer. The current level of salary and nature of the new employment would not allow the securing of an adequate additional personal pension. There were no other investments or pension provision to supplement any losses and therefore the guarantees of the occupational scheme were too beneficial to forego. A pension annuity could be arranged at age 60, if really required, avoiding risk in the interim.

(ii) A customer, with pension benefits close to the lifetime limit and substantial other assets, was advised to transfer pension benefits out of a defined benefit scheme into a SIPP and income drawdown arrangement. There was a substantial loss, albeit this was capped at £100K by the Ombudsman regime. The complaint was upheld and the Ombudsman made the following points;-

- Critical yields can demonstrate many things but at the same time do not give a clear picture of exactly what is being lost on transferring out of the scheme.
- A comparison of what was payable from the scheme against an annuity that could be purchased with transferred funds gave a considerable immediate loss
- The fact the customer was unsure about income requirements was little justification for exposure to this potentially considerable loss
- The possibility of the scheme becoming insolvent would not have made a significant difference. The customer could have taken income immediately from the scheme and used it to build assets outside of the scheme, albeit after tax. The compensation cap was closer to the annuity than the annuity was to the pension payable from the defined benefit scheme
- None of the issues surrounding greater flexibility, death benefits were as insurmountable as a permanent loss of pension benefits that was highly likely without astounding investment returns

Low to Medium Investor

The customer was advised to surrender a 'with profits' investment bond in favour of another investment bond placed in trust with her son for IHT purposes. The Ombudsman stated that he could decide the adviser was negligent in the management of an investment portfolio if:-

- Investment decisions were not those of a reasonably competent professional investment manager or
- The portfolio was outside the level of risk that the client was willing to take with their investments.

The investment bond was invested 25% each in UK Distribution Fund, UK Fixed Interest Fund, Global Fund and International Equity.

The Ombudsman's assessment of this was that the weighting to fixed interest was too low and the portfolio was not correctly positioned in terms of diversification between fixed interest, equity growth and income at the outset. The UK Distribution fund was 33% equity. The Global Fund and International Equity were 100% equity. This meant that the overall equity weighting was 58%. The Ombudsman viewed this as inappropriate and too high for a low to medium investor risk profile. The complaint was upheld and compensation ordered based on a comparison between the actual investment performance and the return of a portfolio comprising 40% FTSE 100 and 60% UK Index linked gilts.

Another customer was assessed as low to medium attitude to risk. They were advised to invest pension fund assets 50% in equities and 50% in property and cash. Although the customer had reached retirement age the pension fund assets were not required to provide an income and the intention was to leave the funds invested until age 75. The adviser took account of the whole of the customer's assets, which were substantial and mostly invested in cash, in determining the appropriate level of equity investment for the customer. These points had been clearly made to the customer in the reason why letter. The Ombudsman agreed that the asset allocation advised on was not inappropriate to the customer's circumstances and rejected the complaint.

Whole of Life Funds

A single premium whole of life policy was set up to mitigate an IHT liability. A complaint was received when an increase in premium was required to maintain the plan. A previous review had taken place where it was decided that cover could be maintained for a further 10 years assuming a growth rate of 10%.

Life assurance is purchased by deductions from the fund. Investment performance of the fund has a significant effect on whether the life assurance can be maintained in future. A typical plan will have review dates where the product provider can ask for additional contributions or reduce the sum assured.

Ombudsman comments

- The adviser has a responsibility to provide an explanation of the policy and to ensure it was suited to the circumstances and requirements of the client.
- Nature of the policy reviews should be clearly explained at the outset and the potential effects disclosed. This should include a discussion about how any increased premiums would be affordable and the effect on the mitigation of IHT if the sum assured had to be reduced.

The complaint was upheld. There was no documentary evidence of any explanation of the review process that was fundamental to this type of plan and the customer maintained they had not been informed about this part of the plan.

Assignment of Illiquid Fund Investment

(i) The customer was advised to invest in an illiquid property fund. They were not made aware of the restrictions on access to funds nor were they an experienced investor as this was an Unregulated Collective Investment Scheme. There was no certainty about what they would have been invested in so compensation was ordered as return of capital plus base rate plus 1% less the surrender value of the bond and any withdrawals. Where the investment was illiquid then the surrender value should be £nil and the adviser should make arrangements to take ownership of the investment.

(ii) The customer had sold their business for £1m. They were advised to invest £100K into an illiquid property fund. Although they had run a business for many years they were not an experienced investor. No loss but not in a position to liquidate the investment. Compensation was ordered based on a return of capital plus interest. It was left to the adviser to sort out the illiquid property fund. Where no value could be obtained the surrender value was to be shown as £nil in determining the level of compensation.

Risk Categorisation

These are two cases with an identical result from the Ombudsman involving the investment of substantial sums of money recently acquired by the customer.

The first involved the investment of a capital settlement received on divorce where the portfolio had substantial equity content. The second was the investment of the proceeds from the sale of a business into an overseas property fund. This was a UCIS where gearing, lack of diversification and potential illiquidity made the investment inconsistent with the customer's attitude to risk.

In both of these cases the Ombudsman was dissatisfied with the risk assessment carried out by the adviser. In this situation the Ombudsman will look at the investment experience and circumstances of the customer and make a decision as to what an appropriate risk assessment was and apply this to the advice given to determine if it was suitable.

In both cases the assessment by the Ombudsman provided a lower attitude to risk than that assessed by the adviser. Compensation was ordered based on a return of capital plus interest less the surrender value of the investment.

The Ombudsman commented that it was the adviser's role to ensure that attitude to risk was correctly categorised and that the investor understood the level of risk. The provision of product literature or risk warnings cannot make unsuitable advice suitable.

Pension Switching

The customer was advised to transfer a number of pensions into a SIPP which was then over concentrated in property. The complaint was upheld in two respects. The investment in property was too high and failing to advise a transfer of the other pension funds into the existing stakeholder pension. Compensation was ordered based on the difference in values between what the funds would have been worth had they been transferred into the stakeholder pension and the value of the SIPP. The FSA report on pension switching was quoted and used to support why the switch was unsuitable:-

- Pension more expensive than stakeholder but stakeholder would have met customer's needs
- More expensive pension to consolidate but extra cost not explained or justified to customer
- Pension did not match attitude to risk and personal circumstances
- Pension incurring extra cost without good reason

The other reasons quoted in the FSA report on why a pension switch can be unsuitable are:-

- New pension but customer lost benefits from ceding pension without these being explained or justified
- Pension where ongoing advice needed but this was not explained or offered or put in place

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