howden

# Pension transfers – Defined Benefit transfers and the insurance market

Steve Ray, Director, Professional Indemnity, Howden UK

Much has been written about the risk factors affecting Defined Benefit Pension Transfers and the stance that Professional Indemnity Insurers have taken when evaluating the risks associated with these. We have written previously about the steps which firms need to ensure they are able to demonstrate they have taken in order to get a good hearing from the Insurers. As time goes by however and the FCA provide more guidance from the various rounds of fact finding that they have undertaken it becomes clearer where the problem areas will arise and indeed what should prove to be lower risk activity.

The start point however remains that the FCA stance has always been that as their start point that giving up an annual income with some sort of index linking for life should probably be the exception rather than the rule.

As Insurance brokers specialising in the field of the provision of Professional Indemnity Insurance for the Financial Advisory community, we are under constant pressure from both existing clients and potential new clients because of activities surrounding Defined Benefit Pension transfers. We continue to campaign to keep risks in perspective but we do need Financial Advisers to recognise and respond to the inherent risks in DB transfers.

We have witnessed the hardening of Insurer's attitudes since Pension Freedom as time has gone by and as the numbers have increased. Why is this?

- The recent stock market 'correction' form a high of 7,792 on 12 January 2018 to 6,900 in March 2018 (but back up again at the time of writing) puts into sharp contrast the timing of taking a cash lump sum over a guaranteed income for life, with a sum of money invested, which is required to last the rest of your life - it is the positive returns in the early years which allow the fund to grow and to last. This also helps to highlight the concerns over sequence risk, as expounded by many analysts in this field.
- There are now some 200,000* people who have taken a Pension transfer, many of which will have been completed for sensible reasons and the individual will have been in an informed position with sufficient information to accept the transfer value. What is of concern is the number of possible transfers against the numbers actually completing. Reading between the lines we imagine that the FCA is alarmed at the numbers, i.e. of those seeking guidance, a good proportion of those would not be suitable for transfer. Those who have no clear

plan for their post transfer balances and are comfortable with their income from their DB scheme should stay where they are and not transfer
- One needs to remember that Insurers have been here before; with the Pensions review post the transfer of individuals from teachers and other group schemes into personal pensions. The review cost advisers, the Insurance providers and the insurers of the advisers some £11.8bn on behalf of 1.7m individuals* – the failing of this process are well remembered.

Today, of course, this market is far more carefully regulated and advisers have to undertake specialist professional examinations as well as on-going training before they can work in this very complex and specialist area of advice. Under the FCA's CP18/7 paper they are looking to add mandatory investment qualifications to those advising in this field.

Transfer values from certain Defined Benefit Pension schemes have been (particularly in 2017) at all-time highs (although for many schemes the transfer values have now reduced) as owners and trustees attempted to de-risk their schemes by removing long term liabilities.

As with everyone else, we feel that the FCA were not expecting the Government's original announcement on this subject and as a result have been playing catch up ever since. However, the FCA's stance has consistently been this is for the few and not the many. This is partly where Insurers concerns lie. The FCA have been involved in a number of rounds of fact finding, with some practices voluntarily giving up their permissions and some having them removed without choice. It is Insurers' worry that the latest round of questionnaires may lead to skilled person reviews and possibly enforcement.

As the market becomes more mature and we see more clearly how the FCA views this activity, Insurers also start to clarify and express their expectations of what is and, more importantly, what is not within their appetite. Clearly a well thought through process, which includes full holistic financial planning, including attitude to risk, capacity for loss, pre-sale checking, and the like will probably be viewed as a minimum standard. The importance of this approach is that if the transfer is deemed suitable, the client's wider assets and liabilities will build a picture about why. Similarly, little work in this area and the reason for the transfer simply as 'death benefits' is likely to raise concerns.

The next matters that we need to give thought to, as highlighted in CP18/7 are:

- Providing full advice even when you are advising a client not to transfer, this makes sense for cases where it is not obvious from the start, but for those where one would quickly realise this is not suitable clients may balk at the idea of paying for something that is unlikely to result in anything other than a foregone conclusion;

- Contingent fees, we would expect to see more definitive guidance from the FCA in their next publication; and
- That they are not comfortable with the whole outsourced arrangement and still see a number of grey areas in terms of client ownership – between the originating Financial Adviser and the specialist.

* FCA's estimations of the numbers which transferred – January 2018

* Ian Cowie, The Sunday Times

# Protecting their Nest Egg

## Steve Ray, Director, Professional Indemnity, Howden UK

At a recent event, a special advisor to the Financial Conduct Authority (FCA) stated that: “More than half of the defined benefit transfers which the Regulator looked at where the recommendation was to move the retirement pot were unsuitable or unclear.”

Why do insurers have such a problem with defined benefit (DB) pension transfers? As insurance brokers we discuss this with clients and non-clients on a regular basis. The headline reason is simple: insurers are concerned that FCA focus (including past issues like the pensions review back in the 1990s) and the values involved in a claim arising from unsuitable advice will cost a lot to rectify. However, like any simple issue there are a number of underlying points which makes this considerably more complex.

**Best practice advice**
The problem stems from two individual issues.

The first is that when George Osborne, as Chancellor of the Exchequer, announced pension freedoms and more particularly the ability for individuals (where invited by employers or trustees) to take their funds from their defined benefit schemes; this was as much a surprise to the regulators as to the rest of the population. The FCA has maintained their position that swapping certainty, i.e. a guaranteed income (matched by some sort of index linking) for life against a tax-free lump sum and an investible amount to tide the individual over for the rest of their life, is a risky proposition. Their position, it would appear, is faced with the opportunity to transfer or not, that ‘probably not’ is the right answer.
The FCA are also concerned, rightly, about ‘scammers’, (The Pensions Regulator has used enforcement powers on suspected scams some 281 times since 2012*). They are also worried that a subsequent investment could end up in unsuitable property funds, for example in Cape Verde or storage pods.

The second point concerns the position the Financial Ombudsman Service might take when faced with a complaint. This should be a very serious part of the advisers thought process when providing advice in this area. Clearly, the FOS will look at the experience of the individual, whether they might be considered vulnerable in any way, and marrying up the attitude to risk and the investment proposition advanced. There may be some unpleasant outcomes for advisers, and ergo Insurers, who don’t follow best practice guidelines or are cavalier in this regard.
The FCA have been conducting reviews, particularly for firms which have been undertaking large numbers of DB transfers and it is well known that a number of firms have had their permissions removed or suspended. The FCA’s practice note of 24 January 2017 sets out their expectations clearly.

So, how can we translate the above into some practical guidance for advisers operating in this area? Before we do this, we must re-emphasise that insurers do have concerns, so if you are going to provide advice in relation to DB transfers, you

will need to be prepared to (probably) pay more for your insurance in terms of both premium and excess.
On the plus side, fees for this work should be good, so you can afford to invest in developing a robust approach to risk management.

**Practical advice for advisors includes:**

- Ensure your advisers are appropriately qualified.
- Ensure your insurers know you are operating in this area and how you are going about it.
- Ensure you have a fully documented process.
- Ensure the advice is holistic and in-line with the FCA Practice Note as referenced above.
    - Look carefully at other assets,
    - Understand the client's requirements for funds in retirement.
    - Do look at death benefits and inheritance tax planning (but these in isolation may not be sufficient in a subsequent review);
- Ensure you gather all relevant information and that you document this – it will be helpful to summarise this information for insurers at your next renewal.
- Document fully the mathematical calculations, demonstrating the differences between taking early retirement and the cash-free sum and pension by remaining in the scheme from the opportunity to transfer – the calculations can be very persuasive.
- Document the number of transfers you discuss but reject early.
- Keep up-to-date with any information from the FCA and be prepared to tweak processes.

**In addition, insurers will want to know whether:**

- you have ever given pension transfer advice to a third-party independent financial advisor
- you have ever outsourced pension advice and/or;
- you have undertaken pension transfers on an execution only or insistent client basis.

**Other areas for consideration:**

- Where the individual has an impaired life expectancy client's attitude to risk. Clearly if the client moves into an investment portfolio and they are ultra cautious, any sort of short-term loss is going to be difficult to defend.
- Point out the risks of short term capital expenditure, eroding the value of their investable sum.
- Helping children or grandchildren onto the property ladder should only be considered for those with considerable assets.
- Buying a Lamborghini or a yacht may not be the most sensible investment proposition.
- A client's concern over the ongoing viability or indeed any press articles over the ongoing viability of a scheme could be important risk mitigation factors.

howden

*Maggie Craig, special adviser to the FCA made this comment at ‘FT Advisers Unpackaging Pensions’ event on 4th October 2017. It appears that this comment was based on a sample of 88 cases.
*Money marketing, 5th October 2017, as a result of a Freedom of Information Act request.

**We strive to produce informative content to help businesses and individuals stay on top of the latest news and issues that may impact them. We would like to continue sending you relevant articles and event invitations but the implementation of the General Data Protection Regulation in May 2018 means that we will need your consent to do so. To provide that consent, please click here. Let’s keep in touch – on your terms**

# Approaching with Caution: The pros and cons of defined benefit pension scheme transfers

## Liam Mayne, Partner at Barnett Waddingham with commentary from Howden

Liam Mayne explains why transfers from defined benefit pension schemes are more popular than ever and what that means for individuals, employers and independent financial advisers

Hands up who would like a guaranteed income for the rest of their life paid for (mostly) by your employer? Who would like this to increase (broadly) in line with inflation every year? And who would like their spouse or partner to carry on receiving (a proportion of) the income after you pass away? I'm guessing quite a few of you.

That is the promise that 11 million members of the UK's 5,800 private sector final salary, or defined benefit (DB), pension schemes have, to a greater or lesser extent. It includes 5.1 million deferred members, who left their scheme but have not yet started receiving the pension they have built up, who are the focus of this article.

The law has always provided these deferred members with a right to transfer out their DB pension to another pension scheme – swapping a guaranteed income for life for a cash sum. But, generally, taking a transfer just meant investing this cash sum in a defined contribution (DC) pension scheme, with all the risk that entailed, and then buying an expensive annuity at the end of it. This gave a lower guaranteed income than had they simply stayed in the DB scheme in the first place. So, transfers out of DB pension schemes were very few and far between.

The 'Freedom and Choice' changes that came into effect in 2015 changed that logic. It has had profound implications for deferred members of DB schemes, for the employers sponsoring these DB schemes and for independent financial advisers (IFAs) who provide (the now legally required) advice on DB to DC pension transfers.

Let's start with members. Freedom and Choice means that money in a DC scheme can be taken flexibly as soon as the member reaches age 55 – either all at once as a cash lump sum, drawn down in regular instalments or anything in-between. This type of flexibility is not available in DB schemes. This provides members with a much stronger incentive to transfer out their DB pension than existed before.

The Pensions Regulator (tPR) and the Financial Conduct Authority (FCA) are naturally cautious about the merits of transferring DB pension benefits. Their view is that individuals, and their IFAs, should start from the premise that such a transfer is not in their best interest.

But for employers, there is a different side to the story.

It is well-publicised that the costs associated with DB schemes have risen dramatically in recent years. According to data published by the Pension Protection Fund (PPF – the industry lifeboat scheme), the average pension scheme in 2006 had 'PPF liabilities' of £100 million. That increased to over £250 million in 2016. Over just 16 months since the end of 2015, my firm estimates that the aggregate DB pension liabilities to be disclosed in the accounts of companies in the FTSE 350 has

increased by 28 per cent, or just over £180 billion. And hardly a week seems to go by without an example of another company struggling under the weight of their DB pension scheme costs.

Why? Primarily, this is a consequence of a decade of low interest rates. This has pushed up the price of the safe, income-bearing bonds that many pension schemes plan to buy in future, to match the pensions they have promised to pay. But members of DB pension schemes, like the wider UK population, are also expected to live a lot longer than when these schemes were set up – which makes paying a pension for life more expensive too. Latest estimates show that a 65-year-old man today is expected to live for another 22 years, and for a woman it is 24 years.

Naturally, employers are looking for ways to control these costs. Having largely closed their scheme to new employees, and then stopped the build-up of new benefits for current employees, they are turning their attention to the 5.1 million deferred members.

For an employer, whenever a deferred member takes a transfer value from their DB scheme, the cost of providing the benefits to that individual are crystallised and settled immediately – there is no future uncertainty. In addition, the law allows transfer values to be set at a level below the prudent reserve they are required to hold if the member stayed in the scheme. So, by members taking a transfer value, they can be reducing both the amount of funding and ongoing risk to the employer.

From the member's perspective, for the same reason that the pension scheme liabilities have increased so sharply in recent years, transfer values being offered are also at record high levels. Whilst they do vary from scheme to scheme, transfer values of anywhere between 20 to 40 times the annual income that the member would otherwise receive are not uncommon.

It is worth taking stock of the potential numbers at play here. DB pension schemes are currently sitting on assets totaling £1,300 billion. Crudely assigning 45 per cent to the 5.1 million deferred members (out of 11 million in total) suggests DB schemes may be holding £585 billion in respect of them. Assuming the bulk of them will reach retirement age over the next 20 years, and that anywhere from 10 per cent to 30 per cent might transfer out, suggests a potential flow of transfers of £3 billion to £9 billion a year across perhaps 25,000 to 75,000 individuals annually.

Given the perfect storm of the new flexibilities in DC schemes, record high transfer values and employers looking to mitigate their costs, many pension schemes are now routinely offering transfer values to deferred members. For employers, this has become a well-recognised risk management option and the flow of transfers out of DB schemes looks set only to increase.

However, the group perhaps most impacted by all of this is the IFAs. In conjunction with the 2015 changes, the government, recognising the potentially detrimental decisions members might make, made it a legal requirement that DB members take financial advice before being allowed to take a transfer value of £30,000 or more. Consequently, the demand for pension transfer advice – a relatively specialised area – has exploded.

Increasingly, employers are prepared to cover the cost of the advice, or in some cases are legally required to. As a result, IFAs are partnering with employers and

their pension schemes to provide a smooth and efficient process for deferred members wanting to consider their options. Just as the savings for employers are considerable, so is the potential market – and associated liability – for IFAs. Based on the numbers above, the advice market could be anywhere from 50,000 to 150,000 individuals a year, or more.

As past pension mis-selling episodes have proven, the potential for exposure to bad practice in this area should not be underestimated. Insurers providing Professional Indemnity cover for IFAs will no doubt be taking a closer look at the level of pension transfer advice being given. It is also notable that this year the FCA is consulting on increasing the level of redress an individual is entitled to where they receive poor pension transfer advice.

For members, employers, their pension schemes and IFAs, it is a land of opportunity, but one that should definitely be approached with the appropriate degree of caution.

**Howden comment**

Clearly with this value of funds in play there are significant risks. Insurers are very concerned that transfers which are not well managed could give rise to claims in the future.

The FCA provided a practice guidance note on 24 January 2017 which detailed their expectations of how these transfers should be handled. The Pensions Regulator advised in May, following a Freedom of Information request, that 67,700 people transferred out of defined benefit schemes in the year to 31st March 2017. The FCA has been investigating firms' approach to defined benefit transfers with a number of firms having had their permissions removed.

We would countenance significant caution from advisers undertaking work in this area. First, ensure your Insurer is aware that this work is something that you do and be very clear about what you don't do. Document very clearly why this is suitable for the client (and in detail) so that if the client spends their funds unwisely and run out of money that they cannot pursue you for not pointing out the risks of swapping a guaranteed annual income for a significant amount of upfront cash.

We spend a lot of time discussing this issue with various parties (clients, Insurers and solicitors) and we see best practice in this area as an evolving process and we will look to keep our clients involved as this develops.