AF7 Pension Transfers 2023/24
Part 4 Ensuring the advice is appropriate.

This part will look at how advisers can ensure that transfer advice is appropriate. It will not consider detailed compliance issues which will be dealt with in the final part. If the advice is appropriate it is more likely that the file will be judged as compliant but a process that is just structured as a tick box exercise may not be sufficiently customer focussed for the advice to be appropriate.

How this relates to the exam

The case study questions in AF7 will not ask you to make a recommendation. It will test your ability to identify the key factors that should be considered in making a recommendation. It could also give you the recommendation and ask you to state the factors in the case study that supported the recommendation.

The milestones for this part are to be able to:

- Understand the two elements of giving transfer advice
- Have an overview of what a good advice process might look like.
- Understand the importance of pre-retirement planning.
- Understand the importance of identifying the client's objectives.
- Identify the additional information needed to make a recommendation.
- Identify the factors that indicate whether a transfer should or should not be recommended.

The two elements

Transferring from a DB scheme involves two separate but linked decisions:

- Whether to give up safeguarded benefits
- Where to transfer to, should a transfer occur

The FCA in GC20/1 states that *these two pieces of advice **should not be treated separately** as they relate to connected transactions.* If the recommendation is to remain then the second point is academic but if a transfer is recommended advisors must ascertain the client's ATR in respect of both the transfer and the subsequent investment.

Some clients (self-investors) may not wish to receive advice on the second part and this will be considered in the section on compliance.

An outline of the advice process

This is a possible framework that can be used to consider the key factors at each stage.

- Pre-retirement planning to establish the level of income required in retirement.
- Explore the client's reasons for wishing to transfer.
- Establish relevant facts about the individual and the ceding scheme.
- Identify the key factors that will influence the recommendation
- Show whether transferring or remaining would best meet the client's objectives
- If a transfer is recommended establish what is the appropriate withdrawal rate to provide a sustainable income.
- Recommend how the drawdown fund should be invested.
- Carry out regular reviews to ensure the plan remains on track.

Pension transfer before retirement age

It is possible to transfer a pension before retirement either on changing jobs or taking a TV from a former employer. This presents additional issues.

- It is difficult to establish the level of income the client would need at retirement
- The pension the client would receive at retirement by transferring will be unknown.
- The transferred fund must achieve a set level of growth to match the revalued pension they would have received at retirement
- An active member could leave the scheme whilst still working for the employer but this is almost certainly inappropriate. Apart from being exposed to the above risks they would lose the future accrual they would have received if they had remained in the scheme. The employer is also unlikely to contribute to any new arrangement.

There is a case that anyone below minimum pension age wishing to transfer should "wait and see". A transfer is irrevocable but by staying, at least for the moment, the pension is being revalued and the issue can be revisited later. For that reason, some firms decline to advise anyone on pension transfers if they are under 55 unless they are in poor health

Pre-retirement planning

Retirement is a key event in anyone's life. Income in retirement tends to be lower than in work and many individuals will be concerned that this may be insufficient. A detailed discussion on the client's post retirement income and expenditure is essential even if the client isn't considering transferring their pension.

Expenditure should be split into three broad categories:

- **Essential expenditure**. These would be items such as council tax, utility bills, food and clothing that must be paid.
- **Non-essential /Lifestyle expenditure**. These would be "everyday luxuries" such as going out for a meal or going to a show. You can do without them but life would not be as pleasant.
- **Discretionary spending**. An example might be a long holiday or a cruise. It would be great if you could do them but it isn't going to have too much of an impact if you can't.

The pattern of expenditure is likely to change on retirement. The costs of travelling to work will disappear but utility bills may increase more time is spent at home. Typically, in the early years expenditure will increase as there is more time to do the things that couldn't be done whilst working. Capital needs should also be considered such as the cost of replacing a company car.

Having established an expenditure pattern, the other side of the coin is to establish the sources of income. Household income after retirement may take some time to settle because:

- There may be a gap of 4 to 7 years between taking a company pension and receiving state pension
- One member of the household may continue to work
- An individual may continue to work on a part time/self-employed basis

This exercise should cover both immediate and ongoing needs and it would be beneficial to use some type of cash flow model as it gives a concrete visualisation of potential income and expenditure. This will be looked at in more detail in the next part.

Client's reasons for transferring

Getting a clear financial objective is the foundation of good quality advice. Transferring pension rights is not an objective, it may be a way of achieving an objective.

Potential objectives could include one or more of the following:

- Better death benefits
- To pay off debts
- To provide house deposit for child.
- To pay for university fees.
- Wish to retire earlier than the scheme pension age.
- Wish to pass on wealth to family
- Want a more flexible income
- Wish to have personal investment control and management.

- Concerns over stability of employer and scheme funding.

An exam question may give you the client's objectives and ask you to show how transferring would (or would not) meet these objectives.

Whilst all these objectives might be met by transferring a DB pension we need to:

- See if those objectives can be met by alternative methods.
- Consider whether achieving these objectives outweighs the loss of DB benefits.

Alternative options

Transferring a pension might be one way to meet the client's objectives but there could be alternatives. When the primary objective is the raise capital the first point is to check that this could be done by taking the maximum PCLS from the scheme. If that is insufficient the following options could be considered.

- Selling other assets.
- Taking out a loan.
- Equity release.

If the aim is to secure better death benefits, purchasing life cover should be considered.

Tom is 40 and has just changed jobs. He has a preserved pension which gives full revaluation at statutory rates but if he dies before the pension is taken, the scheme would only pay a lump sum of £20,000 and no spouse's pension. A CETV of £400,000 has been quoted but the adviser should consider whether taking out life assurance is a better way of replacing the protection that has been lost by changing jobs.

There should be a conversation around these alternatives which should be recorded in the fact find and suitability letter.

Fact Finding

Whilst the usual "know your customer", rules apply there are specific points that need to be established when advising on transfers:

- Details of the ceding scheme
- Details about the client.

Information about the ceding scheme will be mainly **hard facts**. Getting information about the client is about getting **soft facts**. The FCA in GC20/1 recommends the use of open and soft question to get an insight into the customer's views

Details of the ceding scheme

The main features of the ceding scheme need to be analysed both to see if the scheme can meet the client's objectives and whether the potential loss of these benefits would have an adverse effect on the client.

The key points that should be identified are:

- **The amount of the preserved pension (broken down into GMP, Excess Benefits and Post 97 benefits).**
- **The scheme's funding and the financial strength of the employer**. Whilst the Pension Protection Fund offers a safety net if someone's potential benefits are more than the cap transferring to a PP/SIPP would remove this risk. However just because the scheme is in deficit could not, on its own be a justification for transferring. As a minimum the adviser would need to establish:
    - Extent of the underfunding and strength of the employer covenant
    - Details of the recovery plan and timescales for a return to full funding
    - Members length of service and closeness to scheme pension age
    - Difference in the member's current pension entitlement and PPF compensation
    - Escalation, revaluation and spouse's benefits under the scheme and under the PPF
- **PCLS and commutation factor.**
- **Scheme retirement age and early retirement penalties**. This is a hard fact that needs to be linked to the age the member would like to take benefits.
- **Lump sum death benefits pre-retirement** Whilst a deferred pension is a right for those who leave with over two years of service there is no requirement to maintain any lump sum death benefit. How much this is should be ascertained and compared with the potential return of fund by transferring the TV to a Personal Pension.
- **Survivor benefits pre and post retirement.** A spouse may not be eligible to any pension should the deferred member die before drawing the pension. Once the pension is drawn a surviving spouse will almost always be entitled to a pension but the amount needs to be checked.
- **Definition of a spouse/dependant**. Some schemes will only pay a spouse's pension to a legal spouse which would be disadvantageous to a couple that aren't married.
- **Is a partial transfer available**? A scheme may allow members to just transfer part of their benefits which would enable them to cover essential spending from the pension but transfer the excess.
- **Deferred pension**. Does the scheme offer a higher pension for taking it at a later date?
- **Revaluation rates.** To check whether these are more than the legal minimum.
- **Escalation rates.** To check whether these are more than the legal minimum.

Details of the client

- **Retirement income required** This can best be addressed at the point of retirement. It should be split into essential and discretionary spending. If the scheme pension provides the required income is there any point in transferring?
- **Attitude to risk**. Since transferring to a PP involves risk, we must establish the client's attitude. There must be a separate ATR for both the transfer itself and the subsequent investment of the transferred funds.
- **Capacity for loss** this is likely to focus on consequences of the loss of income and is related to the next factor.

In a recent J05 paper the definitions of ATR and CFL were given as

ATR is a person's willingness to take risk
In return for the opportunity of generating a higher return
Capacity for loss is a person's ability to absorb loss
Without it affecting their financial security

- **Other assets/income.** Someone who isn't totally reliant on the transferred pension is likely to have a greater capacity for loss than someone whose sole income is the pension. Consideration needs to be given to the retirement income of the spouse and whether he or she has their own pension.
- **Importance of lump sum death benefits**. Note the phrase "importance of" which is a useful phrase to use in an answer. A single person with no dependents might not be too concerned if the preserved scheme pays a low cash benefit on death. Alternatively, a married person might want to maximise this and the benefit from a PP might look attractive. This could also be very important for someone with chronic ill health.
- **Importance of tax free cash**. Transferring may give potentially more tax-free cash Moving into FAD could also mean that more cash could be taken albeit that it would be taxed. Linked to this would be the issue of whether the member has a mortgage or other debts.
- **Importance of passing capital to family on death**. A DB pension ends on the death of the member or their spouse. Transferring and using FAD means there is a possibility of passing this on.
- **Importance of tax free cash**
- **Present and future marital status**. A single person may feel retaining pension provides very poor value if death were to occur pre or post retirement. In addition, the TV would have been calculated on the basis that a spouse's pension would be payable so it could be argued that the TV gives good value to a single person.
- **State of health.** Rather morbidly linked to death benefits and how long the pension might be paid.
- **Intended retirement age**. Whilst taking benefits early from a DB scheme is usually a formality there will probably be a reduction in the initial pension.
- **Transitional protection** Whether the client has any or is eligible for this.
- **Impact of MPAA**. If a withdrawal is made from a FAD the individual will be subject to the MPAA which could be significant if they intend to continue working and make further pension contributions.

- **Willingness to take ongoing investment decisions/previous investment experience**. If the client has been predominantly a cash saver, would they be prepared to take on the work of managing a pension portfolio in drawdown?

Coming to a recommendation

As stated in the first part, the choice facing the DB member at the point of retirement is:

- Having a known guaranteed lifetime income that includes a spouse's pension and some inflation protection but with no access to capital other than the initial PCLS and may be poor value in the event of member's early death.

OR

- Taking a capital sum with complete freedom on how to spend it and the option of passing some of this to children/grandchildren but at the risk that the money will run out whilst the member is still alive.

Having considered in the previous parts how benefits are provided by the DB scheme and a transfer to a SIPP it's possible to draw up a list of factors that could support staying or transferring.

EXAM TIP!

The case study questions usually include these two commands:

- State the **additional information** you would need to make a recommendation
- State **the factors** you would need to take into account in making a recommendation

When asked for additional information **you must state any relevant information that is not in the case study.** You will not get any marks for repeating what is in the case study.

When asked for factors **you must write down all the facts given in the case study that are relevant in coming to your recommendation.**

Factors supporting remaining with scheme

- DB scheme is sole or is a major part of the client's post-work income.
- The pension covers the client's essential and non-essential outgoings.
- The scheme offers good indexation.
- The client is in good health.
- The client's spouse has limited pension provision.
- Capital needs can be met by the PCLS

- Few other investments or assets
- Not concerned with passing capital on after death.
- Little previous investment experience.

Factors supporting a transfer

- DB scheme is a minor part of their post-work income.
- Client's essential and non-essential outgoings can be met by other sources of income.
- They don't require a lifetime income
- Substantial other assets and investments.
- The client is in poor health and/or has no spouse or dependants
- Spouse has good pension rights.
- The client has capital needs in excess of the PCLS
- They wish to pass capital on the children.
- Comfortable with investing significant amounts.

It's important to stress that this is not a checklist and just because a certain number are met, that is insufficient to support a recommendation one way or the other.

Let's look at some of these in more detail:

The scheme under consideration is a major/minor part of the individual's retirement income

Bill has a preserved pension of £2,000 pa but the pension from his current employer's pension is £20,000. The loss of the £2,000 secured income is likely to be minimal.

Helen has a DB pension of £22,000 a year. This is her sole pension so transferring this would have a significant impact on her future income.

Client doesn't require a lifetime income.

This would be the case if individuals wished to:

- Keep the CETV uncrystallised for the foreseeable future with the aim of either passing it on to spouse or children on death or planning to take benefits later in retirement.
- Take all of the fund over a short period.

Hue has substantial wealth and enough income from other investments to meet his needs. He wants to transfer his DB pension to be able pass it to his children and grandchildren without paying IHT.

Anita has an indexed linked pension that is enough to meet her income needs. She has a small preserved pension from a former employer. She has been quoted a transfer value of £60,000 and plans to use this to help with her grandchildren's university costs and take some expensive holidays over the next 6 years.

In both examples a recommendation to transfer is likely to be appropriate because:

- The client had other sources of income that met their outgoings.
- There is a clear objective that can be met by transferring the pension.

Client's health and life expectancy

Transferring to a SIPP usually gives a higher lump sum death benefit. This can be particularly attractive to a single person in ill health.

David is single and has had a history of heart problems ahead of retirement. He feels it is unlikely that he will live past 70 and likes the prospect of passing on a capital sum.

Andrea has enjoyed excellent health and believes she could live well into her late 80's. She feels having a guaranteed lifetime income is very attractive.

Of course, no one can predict the future and Andrea could die shortly after taking her pension. Her family might regret she didn't transfer as they would have received a large lump sum.

If death occurs within two years of transfer and the client was aware of their limited life expectancy, HMRC may claim that the transferred amount is part of the deceased's estate. This was recently adjudicated by the Supreme Court in the Staveley case and whilst it held that in that particular case HMRC could not include it in the estate, it does not mean that such a transfer will always be exempt from IHT.

Risk

As with any advice process the client's attitude to risk and capacity for loss must be established.

The FCA has said that with when transferring safeguarded benefits ATR is a binary decision. This client is either prepared or not prepared to accept the risk.

Establishing capacity for loss is significant as by moving to flexible benefits the client could suffer a drop in income. To establish this following should be discussed and recorded

- Time to retirement
- Likely life expectancy
- Any dependants
- Partner's income
- Income needs
- Split between essential and discretionary spending
- Anticipated changes in expenditure
- Other sources of capital and income
- Outstanding liabilities.

Some final issues

These might be considered as deep background issues.

- Transfer Values may have fallen. If a decision on transferring is deferred transfer values may be higher in future years.
- A transfer is irrevocable. Transferring out of a DB scheme cannot be reversed.
- Legislation may change. There can be no guarantee that the ability to transfer will be available in future years. This might be a change in legislation or tighter regulation.

That concludes this part so you should now:

- Understand the two elements of giving transfer advice
- Have an overview of what a good advice process might look like.
- Understand the importance of pre-retirement planning.
- Understand the importance of identifying the client's objectives.
- Identify the additional information needed to make a recommendation.
- Identify the factors that indicate whether a transfer should or should not be recommended.