

From: the Financial Services Authority

9th December 2008

Dear Proprietor / Compliance Officer

PENSION SWITCHING ADVICE

We are writing to firms that have provided 'pension-switching advice' to:

- report key findings from our thematic project on the suitability of advice given since April 2006 (A-Day);
- explain the action you should take; and
- set out the follow-up work we will do to ensure firms have taken appropriate action.

To help you to ensure your firm complies with our rules, the Annex to this letter summarises the standards we used to assess the suitability of the advice on switching given by firms.

The [report](#) on the broader findings from our project is available on our website.

The findings from our thematic work

Our findings are based on visits to 30 firms (a broad cross-section of the market, accounting for around 10% of pension-switching sales since A-day) and the review of 500 of their files.

The results were variable across our sample. Some firms were consistently giving suitable advice, but we were concerned to find some firms giving unsuitable advice in a high proportion of cases:

- a quarter of firms each had 33% or more of their sampled files assessed as unsuitable;
- half of firms had between 1% and 32% of their sampled files assessed as unsuitable;
- a quarter of firms had no sampled files assessed as unsuitable; and
- across our whole sample, we assessed advice to be unsuitable in 16% of the switching cases reviewed.

The main reasons why we considered the advice to be unsuitable were:

- the switch involved extra product costs without good reason (79% of unsuitable cases);
- the fund(s) recommended were not suitable for the customer's attitude to risk and personal circumstances (40% of unsuitable cases);
- the adviser failed to explain the need for, or put in place, ongoing reviews when these are necessary (26% of unsuitable cases); and
- the switch involved loss of benefits from the ceding scheme without good reason (14% of unsuitable cases).

Note that many files were unsuitable for *more than one of these reasons*.

Action you should take now

We are asking you to assess, in the light of the contents of this letter, the advice your firm provides to customers to switch their pensions, in order to ensure that your firm has treated customers fairly in the past and continues to do so, and that it is giving suitable advice in line with our rules and guidance. We expect that you will need to:

- consider the approach your firm has taken in its past pension sales¹, and if necessary, look at a *sample* of individual files on past sales, as well as at your sales processes and systems and controls in this area;
- take appropriate remedial action if failings are identified, including providing redress to customers where necessary;
- consider whether your firm should change its approach (including sales processes and systems and controls) to advice and sales going forward; and
- consider whether your management information can tell you whether or not your firm is delivering fair customer outcomes in this area.

To assist you, we will publish (early in the New Year) a file review template which you may wish to use in assessing the suitability of your switching advice.

Further action we intend to take

We will conduct follow-up work in the third quarter of 2009, including visits and desk-based file reviews, to check firms have acted on the contents of this letter. If we identify failings concerning the suitability of advice relating to pensions switching and find that firms have not undertaken appropriate action in response to this letter, they may be subject to regulatory action including, where appropriate, referral for further investigation with a view to possible enforcement action.

¹ We do not expect you to include advice to transfer from an occupational scheme to a SIPP, given prior to April 2007, where the investment held by the SIPP was unregulated (for example, direct holdings in commercial property). This is because such advice was not regulated by us then.

Please note, however, that this time line is merely indicative, and does not in any way limit our right to take regulatory action against firms sooner, where we consider this appropriate in light of any failings we have identified.

Yours sincerely

Financial Services Authority

This letter does not give Handbook guidance but updates you on the findings from our thematic review on the quality of advice for pension switches and our requirements in this area. The letter and its annex do not define the suitability standards for pension switching advice. Firms should have regard to this communication as FSA supporting material which is intended to assist firms in complying with the FSA's rules and Principles. There may be several ways of complying with a regulatory requirement, and following guidance or other material we publish, such as this, is only one approach. For further information, please refer to the section on FSA guidance and supporting materials in our Enforcement Guide, paragraphs 2.22 – 2.27 (<http://fsahandbook.info/FSA/html/handbook/EG/link/PDF>). A firm's senior management remain responsible for establishing and implementing effective controls over the conduct of pension switching advice.

ANNEX

1. This Annex summarises the standards against which we assessed whether firms were giving suitable advice for pension switches. Based on our Principles and rules (see the end of this annex), we identified four key customer outcomes that would indicate customers had received unsuitable advice, and we reviewed files to test for these.

Unsuitable outcome: the customer is switched to a pension incurring extra product costs without good reason

2. If advisers recommend a switch to a more expensive scheme, there should be valid grounds to justify the extra cost. In providing suitable advice the adviser must assess the needs of their customer and whether existing or alternative products can meet those needs. An adviser should also consider how its recommendation is in the best interests of the customer.
3. For example, we considered an unsuitable outcome was likely to have occurred where the reason for the switch into a pension incurring extra product costs was:
 - investment flexibility, but this was neither used nor likely to be used in the near future;
 - fund performance, but there was no indication the new scheme was likely to be better;
 - the flexibility of a drawdown option, but there was no indication this option was needed; or
 - consolidation, but the extra cost was not explained and justified.
4. We also considered an unsuitable outcome was likely to have occurred where the customer was switched to a more expensive pension than a stakeholder pension, but a stakeholder pension would have met their needs.
5. Our assessment of whether customers were being switched to pensions incurring extra product costs without good reason focussed on the following areas.

Need to transfer

6. Advisers must consider the needs of their customer to make sure that the recommendation is suitable. The reasons for the switch should be clearly identified and based on the genuine needs of the individual customer. A customer will not always have a clear view of their needs before seeing an adviser, and it can be part of the adviser's role to discuss and clarify needs for customers. This should be a balanced, educative process and should not involve the adviser leading a customer toward a pre-determined course of action.

Advice to transfer out of the ceding scheme

7. Once a need has been identified, advisers should conduct an adequate investigation of the options available through existing policies before recommending a switch into a new scheme. Advisers should review each ceding scheme to understand how it relates to the customer's needs and be able to inform the customer of differences between the ceding scheme and the new scheme. The suitability report must contain sufficient information to justify why the customer should transfer out. This might include the following considerations:
 - Options within the existing scheme(s): if the customer or adviser feels the ceding scheme is in some way inadequate, we would expect some objective evidence to demonstrate this inadequacy; and
 - With-profits: where leaving a with-profits fund is a reason for the transaction, we expect the adviser to provide an adequate analysis of the fund, looking at more than whether a market value reduction applies and the current bonus and recent bonus history. Good practice might include examining the underlying asset allocation, the free-asset ratio, whether the fund is open or closed to new business and the Principles and Practices of Financial Management (PPFM) document (describing how the firm runs its with-profits business).

Advice to transfer into the receiving scheme

8. In evaluating whether switching is suitable for a customer, the adviser must recommend a suitable alternative. The adviser should consider the available options open to the customer and whether they meet the customer's needs. Other important considerations include the following:
 - Where independent tools are used to select the provider, this process should take into account customer needs and tools should not be manipulated to reach a desired outcome.
 - Key features illustrations should be accurate and disclose the actual charges of the recommended pension, particularly where different funds have different charges. For example, if the final fund choice includes external funds (which tend to have higher charges than internal funds) the illustration should provide an accurate reflection of their charges.
 - Customers should be provided with sufficient information (that is fair, clear and not misleading) about how much the additional features or flexibility cost to help them understand the implications of the switch. Good practice would be to provide information about costs in a way that allows the customer to compare the new and ceding schemes easily. Simply listing the charges of the ceding scheme in the suitability report but not also covering the new scheme costs (or relying on the Key Features Documents) does not necessarily provide the customer with

information they can use as it may be difficult to calculate and compare the overall costs².

- Advisers should be mindful of the impact of additional costs (for example, when using external funds). Access to external funds that offer scope for additional returns can be a valuable benefit for customers. However, in a low inflation/low return environment, comparatively small differences in charges can have a significant impact on overall returns. For example, it will be harder for Fund Manager X to outperform Fund Manager Y (who has 1% pa lower charges) when overall returns are around, say, 8% pa, than when overall returns are around, say, 12% pa. Furthermore, where the variation in returns is smaller (for example with fixed interest investments) then differences between charges become more important.

Consolidation

9. Different customers will assign a different value to the simplified administration achieved by consolidating schemes into a single plan. Some customers might even be willing to pay somewhat more to achieve this. However, there is always likely to be a point at which additional costs would not provide value for money to the customer. So it is important that advisers clearly and fairly explain any additional costs involved in consolidating pensions into a different pension. This will allow the consumer to reflect on the real value to them of consolidation, and the adviser to then take this informed view into account when advising on whether the consolidating switches are in fact suitable or not. The adviser should also consider other cheaper options (like consolidating into one of the existing schemes or a stakeholder plan).

Discounting stakeholder pensions

10. Where an adviser does not recommend a stakeholder pension, there must be a valid reason. In addition, the suitability report must state why the recommended scheme is at least as suitable as a stakeholder pension³. For example, if the adviser recommends using a more expensive product to gain access to a wider range of funds but the customer has no need for a wide range of funds and invests entirely into, for example, a managed fund also available through a stakeholder pension, then this is unlikely to be a valid justification to incur the additional expense. Advisers should consider the true cost of the new scheme in order to provide an adequate explanation of how the new scheme relates to stakeholder charges.

² We acknowledge that cost comparisons may sometimes be problematic. For example, with SIPP's there is also no requirement for a projection to be produced. However, we do not consider that these practical problems negate the requirement for advisers to fulfil their obligations.

³ COBS 19.2.2R: this requirement is commonly known as RU64 (in reference to the PIA Regulatory Update 64 in which it was introduced).

Unsuitable outcome: the customer is switched to a new pension and loses benefits from their ceding pension (for example, guaranteed annuity rates) without these being justified

11. Some existing schemes offer features or benefits that would be of value to the customer but may not be available with the new scheme. It may still be suitable to transfer the plan when taking account of other factors, but the customer needs to understand the implications of proceeding and why the adviser believes it is still justified.
12. Advisers should always check whether each ceding scheme has guaranteed benefits (such as a guaranteed annuity rate or guaranteed benefits in with-profits policies). Where this is the case, advisers should take these benefits into account in preparing their recommendations. Advisers should also explain the existing scheme benefits to the customer and put them into context by explaining whether they are likely to be higher than market rates, for example. Where the adviser believes it is still suitable to recommend the switch, the reasons must be explained and justification provided.

Unsuitable outcome: the customer is switched to a pension that does not match the customer's attitude to risk and personal circumstances

13. As part of the suitability process and in writing the suitability report, advisers must consider the customer's attitude to risk and personal circumstances, and how the recommendation reflects them. Advice will not be suitable if the customer is exposed to a greater amount of risk than is appropriate for them. Similarly, if the investments are too cautious for the customer's risk profile, the investment advice will also be unsuitable and the customer's investments may not perform as well as they expect.
14. In addition to the customer's attitude to risk, there are other factors the adviser must consider when selecting products and funds. These include the customer's objectives, financial situation, financial knowledge and experience, their age (and hence the term of the investment) and any other relevant personal circumstances, such as existing investments. When selecting funds, advisers should be clear about the nature and level of risk of the funds and other investment planning issues such as the benefits of diversity.

Unsuitable outcome: the customer is switched to a pension where there is the need for ongoing advice but this has not been explained, not been offered or where offered, has not been provided

15. Where an 'asset allocation' approach has been recommended⁴, the scheme needs to be reviewed periodically, and rebalanced where necessary, to ensure it continues to be suitable. Otherwise, a portfolio made up of individual funds to meet a certain asset allocation will become unbalanced over time, and this may mean the solution no

⁴ We use the expression 'asset allocation approach' to cover the situation where the adviser recommends a spread of individual funds (each usually investing in a single asset class or sector) to meet an asset allocation profile that is suitable for the customer's ATR and personal circumstances.

longer meets the customer's attitude to risk and personal circumstances. The same risk applies when funds with different risk profiles are used⁵. So, advisers should:

- make clear to customers the need for ongoing reviews of the investments to rebalance the portfolio and make sure it continues to meet their risk profile; and
- confirm this in the suitability report⁶.

16. The adviser also needs to make clear whether or not he (or his firm) proposes to provide such ongoing reviews. If he does propose this, he must treat customers fairly by ensuring these reviews are indeed then provided⁷.

KEY PRINCIPLES AND RULES

The most relevant Principles for Businesses (PRIN 2.1.1R) that apply are:

Principle 2 Skill, care and diligence: A firm must conduct its business with due skill, care and diligence.

Principle 3 Management and control: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

Principle 6 Customers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.

Principle 7 Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

Principle 9 Customers' relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

The most relevant rules (based on COBS references) are:

COBS 2.1.1R A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).

COBS 4.2.1R A firm must ensure that a communication or a financial promotion is fair, clear and not misleading.

⁵ If riskier equity funds outperform other funds in the long term, the risk rating of the portfolio will increase.

⁶ COBS 9.4.7R(3): The suitability report must explain any possible disadvantages of the transaction for the client.

⁷ TCF outcome 5: 'Consumers are provided with products that perform as firms have led them to expect and the associated service is both of an acceptable standard and as they have been led to expect.'

COBS 9.2.1R A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.

COBS 9.2.2R A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing, meets his investment objectives.

COBS 9.4.1R A firm must provide a suitability report to a retail client if the firm makes a personal recommendation to the client.

COBS 9.4.7R The suitability report must, at least:

- specify the client's demands and needs;
- explain why the firm has concluded that the recommended transaction is suitable for the client having regard to the information provided by the client; and
- explain any possible disadvantages of the transaction for the client.

COBS 19.2.2R When a firm prepares a suitability report, it must in the case of a personal pension scheme, explain why it considers the personal pension scheme to be at least as suitable as a stakeholder pension scheme.

And for pension transfers in our Handbook glossary definition (rather than switches more generally):

COBS 19.1.1R: If an individual who is not a pension transfer specialist gives a personal recommendation about a pension transfer or pension opt-out on a firm's behalf, the firm must ensure that the recommendation is checked by a pension transfer specialist.

COBS 19.1.2R: A firm must:

- (1) compare the benefits likely (on reasonable assumptions) to be paid under a defined benefits pension scheme with the benefits afforded by a personal pension scheme or stakeholder pension scheme, before it advises a retail client to transfer out of a defined benefits pension scheme;
- (2) ensure that that comparison includes enough information for the client to be able to make an informed decision;
- (3) give the client a copy of the comparison, drawing the client's attention to the factors that do and do not support the firm's advice, no later than when the key features document is provided; and
- (4) take reasonable steps to ensure that the client understands the firm's comparison and its advice.