RORY PERCIVAL
Training and Consultancy Ltd
SUPPORTING PROFESSIONALISM

AJBell Investcentre

Does your client and investment proposition need a PROD?

In January 2018, MiFID II introduced the 'Product Intervention and Product Governance Sourcebook' or PROD. This may sound like a handbook that applies to product providers and indeed it includes many rules for these firms; but it also includes sections that are relevant to advisory firms – or 'distributors' as the handbook inappropriately calls you.

The aim of the handbook is to ensure firms have good product governance. In advisory terms, this refers to the approach to providing advice to clients, including the design and implementation of the firm's centralised investment proposition (CIP), centralised retirement proposition (CRP), platform selection and initial and ongoing advisory services.

There are rules around understanding products and liaising with providers, but I want to focus on the advisory firm's proposition for clients. This is enshrined in PROD 3.3.15 R (1) which states that: "Distributors must have in place adequate product governance arrangements to ensure that … the financial instruments and investment services they intend to distribute are compatible with the needs, characteristics and objectives of the identified target market".

What does this mean in practice?

You must understand your client bank and target market, and design investment solutions – and advisory services – that work for these clients. This will inevitably involve platform selection as well. This means conducting a firm-level assessment of the client bank and the segments of clients that you have, rather than giving suitable advice to individual clients (which clearly you must still do).

I am in a small firm, do I need to do this?

The handbook states that firms must comply with the PROD rules in a way that is proportionate and appropriate. Hence you still need to go through this process but it is likely to be less onerous than would be the case with a large firm.

Don't we do this already?

You should have been doing this – it has been guidance for around ten years – but I would question how well firms are doing this. For example:

Asset-based advisory services. Many firms provide different levels of ongoing service dependent on the level of the client's investible assets. This is more of a firm-centric rather than a client-centric approach, as the level of assets is a poor indicator of the type of services that are appropriate.

Platform selection. Firms often select a single platform on the basis of a range of factors relating to the nature of the investment solution and ongoing services they want to deliver. This may be fine but it seems that sometimes this is more for the convenience of firms than the benefit of clients. I hear some advisers saying that platform costs are all fairly similar, which is simply not true. You should be looking for good value for money on behalf of your clients by seeking the most cost-effective platform(s) for the functionality, service levels etc you need.

What do you recommend?

Firstly, segment your client bank. I recommend doing this at two levels – at an appropriate high level and also sub-segments. I think life stages works better than asset levels as a high level segmentation (see table).

Category	Summary	Possible investment solution	Platform selection	Advisory service
Young accumulators	Clients up to the age of 45/50 (typically) whose main focus is to build their wealth and save for retirement	Simple and low maintenance; eg multi-asset fund, MPS	Low-cost with functionality needed	Light touch with additional advice at major life events (eg marriage, job change)
Serious about retirement	Clients from 45/50 to five years before retirement who now need to be more serious about retirement planning	Probably still simple and low maintenance	As above	Moderate. Focus on cash-flow planning and advice about making up shortfalls
Glidepath into retirement	Clients between five years from starting to retire up until full retirement	Appropriate for decumulation; e.g. income-focus if going to natural income or different asset classes for 'pots' approach to decumulation	Cost-effective but has additional functionality for decumulation needed	Intensive. Cash-flow planning and advice about increasingly drawing income/capital and tax wrappers
Retirement income	Clients in full retirement	Dependant on income needs; may include annuity, drawdown as above etc	As above	Intensive if in drawdown to ensure sustainable income. Possibly IHT planning and care cost planning

Next, think about sub-segments. For example, you may have clients who run small businesses where remuneration structure and tax planning feature significantly. Or senior executives who have significant share-holdings in their employer and hence a bespoke discretionary management service might work well to manage out the imbalance over time.

I have given some examples but you need to see what works for your clients. If you undertake this segmentation process effectively, then the nature of the investment solutions, criteria for platform selection and the advisory services will probably be immediately apparent. This will help create an advice and service framework that is better geared for your client bank. Clearly you will then need to ensure individual clients receive suitable advice.

How should I document this?

The FCA does not prescribe any approach to record-keeping but it does say you must keep a record of your process. I suggest you create your own matrix of clients as above although this will be much more detailed in practice once you have added in the sub-segments. I would then take the investment solution and platform selection columns information and create separate research and due diligence (R&DD) documents for each of these. The matrix comments could provide a context section at the beginning of your R&DD documents and it is these client segment needs that form the drivers for your investment solution and platforms selection R&DD. Similarly, for the advisory services column, I suggest you create a separate document with the rationale for the design of your service proposition for the client segments, using the matrix comments as a starting point.

Rory Percival, Founder, Rory Percival Training and Consultancy Ltd.

AJ Bell Management Limited (company number 03948391), AJ Bell Securities Limited (company number 02723420) and
AJ Bell Asset Management Limited (company number 09742568) are authorised and regulated by the Financial Conduct Authority.
All companies are registered in England and Wales at 4 Exchange Quay, Salford Quays, Manchester M5 3EE. See website for full details.

AJBIC/RP-DBS/20190222

Defined benefit transfers

Defined benefit (DB) transfers remain topical and the Financial Conduct Authority (FCA) recently published its latest policy statement introducing new rules and guidance. Rory Percival provides an update on some of the key aspects of this year's policy developments.

Policy Statement PS18/6 (March)

PS18/6 introduced the appropriate pension transfer analysis (APTA) which includes the transfer value comparator (TVC) and additional guidance on assessing suitability.

APTA/TVC

The APTA can best be described as a 'suitability pack' which encompasses all the analyses you undertake to assess the suitability of the transfer. The key point is that it is personalised to the client and hence is not an old-style TVA with the TVC added.

The mandatory part of the APTA is the TVC. This is a heavily prescribed bar chart comparison between the cash equivalent transfer value (CETV) and the fund required to buy a comparable annuity. The 'loss' shown on TVCs is proving to be 30 – 50% or more. This is likely to put some clients off. Also, it is likely to influence FOS decisions (I am less concerned about the FCA) and it will be looking at the file to see if the advantages outweigh these significant 'losses'. Consequently, you need to be really clear on file about the client's objectives – with adequate colour and detail – and also about the client's strength of feelings.

Assessing suitability guidance

The client's intentions for accessing pension benefits

Suitability is all about meeting the client's objectives and hence understanding about the client's intentions for accessing pension benefits is fundamental. Files which record the client's objective of 'flexibility' without any colour and detail are simply inadequate. They do not clearly demonstrate that the transfer is in the client's best interests and hence do not meet FCA requirements.

The client's realistic retirement income needs

This is a key area and touches on the importance of what I refer to as 'core secure income'. Core secure income includes state pension, DB benefits, annuities, guaranteed third way products and, possibly, good quality rental income.

When establishing the client's realistic retirement income needs, I suggest establishing their fixed outgoings and discretionary spending plans. Although this may involve some discussion and assistance to the client with calculating this, it is essential to obtain this information for two key reasons: in order to meet the requirements of COBS 19 to consider how the income needs can be met and also to assess whether the recommendation meets the client's capacity for loss.

You then need to consider how this income is going to be met. Having adequate core secure income at least to cover the client's fixed outgoings – but preferably their discretionary spending as well – puts the client in a very secure financial position. They know that, whatever happens, they have enough money to live on.

My interpretation is that the FCA considers core secure income to be an important factor in suitability. If the DB scheme is needed to provide part of this core secure income, then this is significant factor to take into account when assessing the suitability of the transfer.

Considering alternative courses of action to meet the client's objectives

The FCA expects advisers to consider other ways of meeting the client's objectives and maintaining the DB scheme. In essence, the DB transfer should be the last resort to meet the client's objectives. The file should demonstrate that alternative options have been considered – and considered genuinely – not just going through the motions and ticking the box.

Policy Statement PS18/20 (October)

This second PS introduced some additional rules and guidance such as the requirement for a suitability report but I want to focus on two main areas – triage and attitude to transfer risk.

Triage services

Many firms use a triage process where some clients, for whom the full advice process is not necessary or worthwhile, are filtered out. The FCA is concerned that sometimes this might be inappropriately straying into giving advice. The FCA is bringing in guidance to help clarify how triage services might work – by being an educational process – without straying into advice.

An FCA supervisor expressed this very well by saying 'triage is not the firm filtering the client out, but rather giving the client generic information so that he/she can filter themselves out'. The guidance suggests that the generic information can explain 'the features of pension schemes with flexible benefits and pension schemes with safeguarded benefits that make them more or less suitable for general groups of people'. This means the information can be more helpful than simply explaining how the respective pension arrangements work.

Attitude to transfer risk

This is a new expression and is entirely separate from the client's attitude to (investment) risk (ATR). You should therefore treat it separately from your risk profiling process. The attitude to transfer risk is about the client's attitude towards the features of the DB scheme benefits and certainty of income versus the flexible benefits approach. The list of issues raised in this section of the Handbook (COBS 19.1.6G(4)(b)) should be turned into a series of questions to ask the client at the fact-finding stage. I suggest also summarising these in the suitability report (perhaps under the heading 'Security versus flexibility').

Overall, the policy changes are wide-ranging but sensible, but they do involve changes to your advice process.

Rory Percival, Founder, Rory Percival Training and Consultancy Ltd.

What's your centralised retirement proposition?

In January 2019 the Financial Conduct Authority published its Sector Views document. This sets out its views about each sector of the financial services market, the nature of the markets and the risks it perceives in each. In this it stated its concern that "some adviser firms have not yet updated their investment strategies for decumulation clients. In addition, they may not have adequately considered decumulation risks."

This concern appears to be borne out by research in recent months which also suggests that many firms are using the same investment strategy for decumulation clients as they do for accumulation clients. This is despite the different dynamics of clients' needs in retirement and different risks, in particular sequence of return risk and pound-cost ravaging. Simply adopting the same investment strategy in retirement can be dangerous for clients and the FCA is on to this.

Sequence of return risk and pound-cost ravaging are often conflated but I consider them to be slightly different, albeit overlapping. Sequence of return risk is when market downturns in the early years of retirement have a disproportionate impact on sustainability of income over the client's lifetime. Pound-cost ravaging is pound-cost averaging in reverse. It's the double whammy of taking withdrawals at the same time as a fall in the markets.

Is the FCA saying you need different portfolios in retirement? Maybe, but it doesn't actually say portfolios, it says investment strategies. I interpret this more widely about how you advise clients about their investments in retirement, particularly around how you manage withdrawals and hence manage sequence of return risk and pound-cost ravaging. In broad terms, there have historically been three strategies you can adopt:

Sustainable withdrawal rate

This is where a level of withdrawal is taken that is considered to be sustainable over the client's lifetime. I think it would be better for all concerned if we refer to this as 'sustainable withdrawal rate' rather than 'safe withdrawal rate'. The idea is that, even in poor market conditions and materialising sequence of return risk, the withdrawals will still be sustainable. There is extensive research available on what sustainable withdrawal rates are in light of different asset allocations, and figures of around 3.5% – 4.0% are common. There are cash-flow and other modelling tools available that will also help here. The portfolio could be the same as your accumulation centralised investment proposition at the appropriate risk level because you are managing the additional risks by means of your withdrawal strategy.

Natural income

This is simply where the client takes the natural income from the underlying investments. In this situation, it may well be appropriate to have a different portfolio from your centralised investment proposition; ie one that is geared to providing income. The downside is that there is no real flexibility in the income level and it can vary over time but it could work well for some clients where these are not an issue and they want to leave capital to others. It is also an easy concept to grasp by clients.

Pots

This is where you have a series of different investment pots to meet withdrawal needs at different times; typically cash for early years. The downside is the drag the lower risk assets have on the returns but the upside is that it can be a reassuring approach for clients and encourage them not to make silly decisions like coming out of the market when it is down. It can help with that all-important peace of mind even if it doesn't provide the highest monetary value. In this scenario, your centralised investment proposition could be the investment used in the 5+ years pot.

Security plus flexibility

I would like to suggest a fourth strategy which I am calling 'security plus flexibility'. There is a lot of talk in the sector about the shape of the client's income in retirement. Typically, this involves higher levels of income in the early years when they are still comparatively fit and able to get out and about and spend money on hobbies, holidays and other activities, and lower levels of income in later life when they are no longer able to do this.

The starting point with security plus flexibility involves securing the level of income the client needs in later life. For some the state pension may be sufficient for this.

For others, the state pension and their defined benefit scheme may be enough. For others, the state pension and a small annuity may be needed.

Once the later life income need has been secured then the client has complete flexibility with their other assets – cash, ISAs and pensions – knowing that, even if they spend all of these, they will have enough money to live on later down the line. This has the advantage over a sustainable withdrawal rate (SWR) approach in that you have genuine flexibility with the other assets. With SWR you are always having to be mindful when spending to ensure the withdrawals are sustainable. This approach provides peace of mind for the client but also the flexibility that the pension freedoms introduced.

Financial planning is fundamentally about helping clients achieve and maintain their financial security and to be able to do what they want with their life. I am concerned that the advice market may be increasingly focusing on investments and the best way to make the most of investments.
There is a small but fundamental difference between the approaches. I think the security plus flexibility approach sits at the heart of what I think financial planning should be about even if, in a purest investment perspective, it doesn't provide the highest numbers for the client.

What is suitability?

The FCA has rules requiring firm to take reasonable steps to ensure suitable advice is provided to clients. But what is suitable advice? In this article, I seek to flag a range of key aspects of suitability.

No most suitable requirement

There is rarely, if ever, any single investment solution that is clearly better than all other options. Usually, there are several different investment options which can be suitable for a particular client. One adviser might have a preference for passive investment solutions, another active, another having client assets managed by a DIM. Some may prefer running a model portfolio of individual asset class funds, another recommends multi-asset funds. In most cases, the client does not have any particular personal circumstances or investment preferences that mean that any one of these options is better than another; they are all ways of investing funds for growth (or income) and can be suitable for someone with these objectives.

There are two important caveats to this:

- More money is better than less money. I appreciate this is not a controversial point but it relates to costs and tax-efficiency. In almost all circumstances, clients have an implicit ob-jective of wanting to make money when investing. Costs and tax have the effect of re-ducing the level of return the client achieves and so works against their objective. Hence it is suitable to recommend the more tax-efficient and the lower-cost investment (all other things being equal). Where there are additional costs, or lesser tax-efficiency, then there needs to be a good reason for this for the recommendation to be suitable (and this reason needs to be relevant to the individual client).
- No demonstrably better alternative. The FCA will only rate a case unsuitable if there is a demonstrably better alternative; for example, if the client's objectives could have been met at lower cost.

Restricted advice

Following on from the points above, clearly restricted advice can be suitable even though the investment recommended may not be the best on the market. Indeed, it can be quite a poor or expensive investment and still be suitable, but if the firm is restricted in such a way that it does not have an investment option that is suitable for the client, then the firm should not advise on the next best option.

Pension freedoms

The pension freedoms didn't create any entirely new challenges for suitability, but shone a bright light on some existing areas, particularly the nature of the client's objectives, balancing conflicting objectives and the nature of pensions and investments.

Client objectives

It is good practice for advisers to help clients by providing them with balanced information and steering them towards rational decisions. However, the FCA recognises that clients can sometimes be irrational with their objectives and if the adviser's recommendation helps them realise that objective, then (with two caveats, which I'll explain shortly), this meets the FCA's requirements.

For example, a client might want to cash in a pension to go and travel around the world. The adviser must gather sufficient information about the client, including his/her objectives, in order to provide suitable advice. This will probably include a client objective of also having enough money to live on in retirement. It may well be suitable for the advice to be to cash in a pension and travel the world, so long as the client also has enough to live on in retirement from other sources (i.e. has met his/her other objective).

The first caveat is that there shouldn't be a demonstrably better alternative; so, in the example above, if the client has adequate cash reserves for the world trip, this would be better than cashing in the pension. The second caveat is that the client's objectives may be irrational but they should be based on correct information. For example, the client may be very keen to transfer his/her DB pension, given worries about the solvency of the former employer, and the client has said 'I don't want to lose all my pension'. As an adviser, you know this is not how it works – the pension is separate from the employer and there is also the availability of the Pension Protection Fund. In this situation, you need to explain the position so that the client can re-evaluate their objectives.

Balancing conflicting objectives

Often clients cannot have it all. The main pension freedoms example is taking cash from the pension now and having a higher level of income in retirement – one has a detrimental effect on the other. There are compromises to be made but the advice to cash in the pension can be suitable, so long as the adviser:

a) discusses the options in a balanced way with the client

b) corrects any factual errors influencing the client's view

c) meets the client's objectives

d) there is no demonstrably better way to meet the client's objective

e) explains the disadvantages

The nature of pensions and investments

Pension freedoms mean that pensions should no longer be considered as primarily for retirement income; they are now tax-efficient investments. It is perfectly valid to recommend pensions in situations where clients need cash rather than retirement income in the future.