Replacement Business

Replacement business, (transfers or switching, whatever you may call it), has been on the FSA radar for some time i.e. the pension switching review in 2008. However, in April 2012 they published the Guidance Document 'Assessing Suitability: Replacement business and centralised investment propositions' http://www.fsa.gov.uk/static/pubs/guidance/gc12-06.pdf. They are also focussing on this topic in the Positive Compliance seminars they are conducting throughout this year. These communications make it very clear what the FSA is expecting on a client file for replacement business meaning if firms persist in poor practices then they will have no excuse if the regulator takes action.

When you read through the guidance paper you will most probably think that this is the same message that the FSA has said before, which is true, but it is also very specific that firms which conduct replacement business should consider:-

- Their sales process
- The controls in place to reduce the risk of unsuitable recommendations to switch taking place
- The management information collated on replacement business
- The challenge provided by whoever conducts the file reviews on whether the switch was suitable for the client or not.

The issue that the FSA commonly identifies when conducting file reviews is that firms fail to consider the impact and the suitability of any additional charges that may be incurred by the client. It would seem that the FSA still identifies cases where the costs and features of the existing product are not considered and how this compares to the proposed contract. For example would an internal fund switch be more appropriate for the client? Why was this discounted? Other times this information is disclosed to the client but not in a way that they are likely to understand the implications of switching.

Another example of poor practice includes recommending a switch based upon fund performance but having no supporting evidence to show that the performance prospects of the new contract are likely to be better.

The main factors determining the investment return include charges, performance and tax treatment. The FSA expects firms to consider all of these points before switching, even when investment performance is not the client's primary objective. An example of tax treatment is whether there is a chargeable gain on surrendering a bond and the impact of this on the client. Should there be partial surrenders across all segments or full surrenders of some segments of the bond?

Other key expectations of the regulator include:-

- Where a more expensive solution is being recommended there needs to be good reason – the client needs to see the value in paying the higher charges.

- Firms must establish and record the client's specific objectives rather than generics i.e. if the client wants income, why, how much and how long for?
- **'Advisers should never approach a fact finding exercise with a pre-conceived agenda to switch the client's existing investments into a new solution as this may not be the most suitable option for the client'**. For example, even though a firm would like clients to be placed onto their client proposition or investment model, it still needs to be suitable for the client and blanket transfers across to a platform cannot be done without considering the existing investments.
- **The suitability reports must reflect the client's specific needs and not generic objectives across all suitability reports.** This means that firms may need to look at their template reports to see if they need improving. Furthermore training to the advisers and/or paraplanners may be required on this point.
- The FSA will challenge firms who state that 'wider investment choice' is the justification to switch to a plan with higher costs if the existing product already has a wide enough investment choice to meet the desired asset allocation.

Good practice

The paper sets out some good practice ideas for firms to consider:-

- The use of Reduction in Yield costs and TER figures in the cost comparisons in suitability reports.
- Consideration of the impact of trading costs and the volume of trades that may be expected within discretionary management portfolios must be given and confirmed to the client. This means that firms may need to ask more in depth questions to the discretionary fund manager used regarding their costs. These costs should be confirmed in the suitability report.
- The use of replacement business forms to record information between the ceding and new schemes and reasons for transferring. Some forms require a client signature as well as the adviser. Some firms add these forms to the back of suitability reports as appendices.
- Classifying all replacement business as high risk from a file checking perspective – the FSA confirmed that they consider all replacement business as high risk at the Positive Compliance seminars.
- Pre-approval for all replacement business prior to the client signing the application form – this may be dependent upon the size of the firm, how much replacement business is conducted, internal resources and the type of replacement business written.
- Using management information to monitor the levels of replacement business that all advisers do i.e. is there a benchmark where if this is exceeded it will be investigated? Is there a trend arising?
- Place a maximum amount of additional cost allowed on transfer before pre-approval is required i.e. if additional cost is 0.5%+ then must be approved by the Supervisor – again this depends on resource. This could be used as management information if an adviser is constantly looking for pre-approval.
- The file reviewers need to understand the firm's client proposition and any boundaries that have been set by the firm. The file reviewer must be able to challenge the suitability of the advice given and identify if any internal breaches are conducted. How many times has the

file checker identified any concerns on replacement business? Do they understand the firm's sales process?

Conclusion

The document is well worth a read. Many firms have implemented a lot of changes following the pension switching review. However this guidance confirms that the practices introduced for pension switches should be in place for all replacement business.

As firms want clients to move onto new client propositions, they still need to be mindful of the FSA requirements before moving client monies onto a new contract. It has to be suitable for the client and not the firm.

Advisers need to be particularly mindful of recording the client's specific objectives, confirming this in the suitability report and confirming how the recommendation meets those specific objectives. Stating that the client just wanted income or growth is not good enough anymore.

Firms may consider placing more focus on replacement business as part of their KPI's and management information going forward.

There is no doubt that the FSA will be looking at this issue more and more going forward.

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