Chartered Insurance Institute
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Financial planning practice

R06

2022-23
STUDY TEXT

Financial planning practice

R06: 2022–23 Study text

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Updates and amendments to this study text
This edition is based on the 2022–23 tax year and examination syllabus which will be examined from 1 September 2022 until 31 August 2023. Any changes to the exam or syllabus, and any updates to the content of this study text, will be posted online so that you have access to the latest information. You will be notified via email when an update has been published. To view updates: **1.** Visit *www.cii.co.uk/qualifications* **2.** Select the appropriate qualification **3.** Select your unit from the list provided Under 'Unit updates', examination changes and the testing position are shown under 'Qualifications update'; study text updates are shown under 'Learning solutions update'. Please ensure your email address is current to receive notifications.

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Using this study text

Welcome to the **R06: Financial planning practice** study text which is designed to support the R06 syllabus, a copy of which is included in the next section.

Please note that in order to create a logical and effective study path, the contents of this study text do not necessarily mirror the order of the syllabus, which forms the basis of the assessment. To assist you in your learning we have followed the syllabus with a table that indicates where each syllabus learning outcome is covered in the study text. These are also listed on the first page of each chapter.

Each chapter also has stated learning objectives to help you further assess your progress in understanding the topics covered.

Contained within the study text are a number of features which we hope will enhance your study:

Activities: reinforce learning through practical exercises.

Be aware: draws attention to important points or areas that may need further clarification or consideration.

Case studies: short scenarios that will test your understanding of what you have read in a real life context.

Consider this: stimulating thought around points made in the text for which there is no absolute right or wrong answer.

Examples: provide practical illustrations of points made in the text.

In-text questions: to test your recall of topics.

Key points: act as a memory jogger at the end of each chapter.

Key terms: introduce the key concepts and specialist terms covered in each chapter.

Refer to:

Refer to: extracts from other CII study texts, which provide valuable information on or background to the topic. The sections referred to are available for you to view and download on RevisionMate.

Reinforce: encourages you to revisit a point previously learned in the course to embed understanding.

Sources/quotations: cast further light on the subject from industry sources.

On the Web: introduce you to other information sources that help to supplement the text.

At the end of every chapter there is also a set of self-test questions that you should use to check your knowledge and understanding of what you have just studied. Compare your answers with those given at the back of the book.

By referring back to the learning outcomes after you have completed your study of each chapter and attempting the end of chapter self-test questions, you will be able to assess your progress and identify any areas that you may need to revisit.

Not all features appear in every study text.

Note
Website references correct at the time of publication.

Examination syllabus

Chartered Insurance Institute

Financial planning practice

Purpose

This unit enables candidates to demonstrate their expertise in the application of the financial planning process through combining and applying learning content from **all the other units in the CII RQF level 4 Diploma in Regulated Financial Planning**:

- Financial services, regulation and ethics;
- Investment principles and risk;
- Personal taxation;
- Pensions and retirement planning;
- Financial protection.

Summary of learning outcomes	
1.	**Obtain appropriate client information and understand clients' needs, wants, values and risk profile essential to the financial planning process**
2.	**Synthesise the range of client information, subjective factors and indicators to provide the basis for financial planning assumptions and decisions**
3.	**Analyse a client's situation and the advantages and disadvantages of appropriate options**
4.	**Formulate suitable financial plans for action and explain and justify recommendations**
5.	**Implement, review and maintain financial plans to achieve the clients' objectives and adapt to changes in circumstances**

Important notes

- Method of assessment: Two case studies with short answer questions. Three hours are allowed for this paper.
- This syllabus will be examined from 1 September 2022 to 31 August 2023.
- Candidates will be examined on the basis of English law and practice in the tax year 2022/2023 unless otherwise stated.
- Candidates should refer to the CII website for the latest information on changes to law and practice and when they will be examined:
  1. Visit *www.cii.co.uk/qualifications*
  2. Select the appropriate qualification
  3. Select your unit from the list provided
  4. Select qualification update on the right hand side of the page

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R06

1. **Obtain appropriate client information and understand clients' needs, wants, values and risk profile essential to the financial planning process**

1.1 Establish and explain the client/adviser relationship and the importance of positive customer outcomes.

1.2 Establish clients' aims and objectives, their needs and wants, values and priorities.

1.3 Explain the different types of financial risk, and how the different types of risk apply to clients.

1.4 Establish the client's risk profile and explain what this means in terms the client will understand.

2. **Synthesise the range of client information, subjective factors and indicators to provide the basis for financial planning assumptions and decisions**

2.1 Recognise any potential inconsistencies in client information, subjective factors or indicators.

2.2 Identify where additional information is required and ask appropriate questions.

3. **Analyse a client's situation and the advantages and disadvantages of appropriate options**

3.1 Analyse a client's situation using relevant financial information.

3.2 Identify gaps in a client's current financial provision and identify how the client's financial provision could be improved.

3.3 Examine the options available and their respective advantages and disadvantages.

4. **Formulate suitable financial plans for action and explain and justify recommendations**

4.1 Formulate a suitable financial plan and make recommendations.

4.2 Explain and justify your recommendations.

4.3 Explain any risks or limitations in the plan.

5. **Implement, review and maintain financial plans to achieve the clients' objectives and adapt to changes in circumstances**

5.1 Explain how the plan is to be implemented.

5.2 Conduct reviews at appropriate times using appropriate benchmarks and adapt to changes in circumstances.

Reading list

The following list provides details of further reading which may assist you with your studies.

Note: The examination will test the syllabus alone.

The reading list is provided for guidance only and is not in itself the subject of the examination.

The resources listed here will help you keep up-to-date with developments and provide a wider coverage of syllabus topics.

CII study texts

Financial planning practice. London: CII. Study text R06.

Financial services, regulation and ethics. London: CII. Study text R01.

Investment principles and risk. London: CII. Study text R02.

Personal taxation. London: CII. Study text R03.

Pensions and retirement planning. London: CII. Study text R04.

Financial protection. London: CII. Study text R05.

eBooks

The following eBooks are available via *www.cii.co.uk/elibrary*(CII/PFS members only):

Business ethics in the 21st Century. Norman E. Bowie. Dordrecht: Springer, 2013.

Foundations of financial risk: and overview of financial risk and risk-based regulation. Richard Apostolik, Christopher Donohue. New Jersey: Wiley, 2015.

Implementing the wealth management index: tools to build your practice and measure client success. Ross Levin. New Jersey: Bloomberg Press, 2012.

International finance regulation: the quest for financial stability. Georges Ugeux. Wiley, 2014.

Investor behaviour: the psychology of financial planning and investing. H. Kent Baker. Hoboken, New Jersey: Wiley, 2014.

Mastering financial calculations: a step-by-step guide to the mathematics of financial market instruments. 3rd ed. Bob Steiner. Harlow: FT Prentice Hall, 2012. *

Recreating sustainable retirement: resilience, solvency and tail risk. P. Brett Hammond, et al. Oxford: Oxford University Press, 2014.

Winning client trust. Chris Davies. London: Ecademy Press, 2011.

Journals and magazines
Financial adviser. London: FT Business. Weekly. Available online at *www.ftadviser.com*.

Financial times. London: Financial Times. Daily. Available online at *www.ft.com*.

Personal finance professional (previously Financial solutions). London: CII. Six issues a year.

Money marketing. London: Centaur Communications. Weekly. Available online at *www.moneymarketing.co.uk*.

Further articles and technical bulletins are available at *www.cii.co.uk/learning/learning-content-hub* (CII/PFS members only).

Reference materials
International dictionary of banking and finance. John Clark. Hoboken, New Jersey: Routledge, 2013.*

Harriman's financial dictionary: over 2,600 essential financial terms. Edited by Simon Briscoe and Jane Fuller. Petersfield: Harriman House, 2007.*

Examination guides

Guides are produced for each sitting of written answer examinations. These include the exam questions, examiners' comments on candidates' performance and key points for inclusion in answers.

You are strongly advised to study exam guides from the last two sittings. Please visit *www.cii.co.uk/learning/qualifications* to access online or contact CII Customer Service for further information on +44 (0)20 8989 8464.

Alternatively, if you have a current study text enrolment, the latest exam guides are available via *ciigroup.org/login*.

Exam technique/study skills

There are many modestly priced guides available in bookshops. You should choose one which suits your requirements.

* Also available as an eBook through eLibrary via *www.cii.co.uk/elibrary* (CII/PFS members only).

R06 syllabus quick-reference guide

Syllabus learning outcome		Study text chapter and section
1.	**Obtain appropriate client information and understand clients' needs, wants, values and risk profile essential to the financial planning process**	
1.1	Establish and explain the client/adviser relationship and the importance of positive customer outcomes.	*1A*, *1B*, *1C*, *1D*, *1E*
1.2	Establish clients' aims and objectives, their needs and wants, values and priorities.	*1C*, *1D*, *1E*
1.3	Explain the different types of financial risk, and how the different types of risk apply to clients.	*2A*, *2B*
1.4	Establish the client's risk profile and explain what this means in terms the client will understand.	*2C*, *2D*
2.	**Synthesise the range of client information, subjective factors and indicators to provide the basis for financial planning assumptions and decisions**	
2.1	Recognise any potential inconsistencies in client information, subjective factors or indicators.	*3A*, *3B*, *3C*, *3D*, *3E*, *3F*
2.2	Identify where additional information is required and ask appropriate questions.	*3A*, *3B*, *3C*, *3D*, *3E*, *3F*
3.	**Analyse a client's situation and the advantages and disadvantages of appropriate options**	
3.1	Analyse a client's situation using relevant financial information.	*3G*, *4A*, *4B*, *4C*, *4D*, *4E*, *4F*, *4G*, *4H*, *4I*, *4J*
3.2	Identify gaps in a client's current financial provision and identify how the client's financial provision could be improved.	*3G*, *4A*, *4B*, *4C*, *4D*, *4E*, *4F*, *4G*, *4H*, *4I*, *4J*
3.3	Examine the options available and their respective advantages and disadvantages.	*3G*, *4A*, *4B*, *4C*, *4D*, *4E*, *4F*, *4G*, *4H*, *4I*, *4J*
4.	**Formulate suitable financial plans for action and explain and justify recommendations**	
4.1	Formulate a suitable financial plan and make recommendations.	*5A*, *5B*, *5C*, *5D*, *5E*, *5F*
4.2	Explain and justify your recommendations.	*6A*, *6B*, *6C*, *6D*, *6E*, *6F*, *6G*, *6H*, *6I*
4.3	Explain any risks or limitations in the plan.	*6A*, *6B*, *6C*, *6D*, *6E*, *6F*, *6G*, *6H*
5.	**Implement, review and maintain financial plans to achieve the clients' objectives and adapt to changes in circumstances**	
5.1	Explain how the plan is to be implemented.	*7A*, *7B*
5.2	Conduct reviews at appropriate times using appropriate benchmarks and adapt to changes in circumstances.	*7C*, *7D*

Introduction

The purpose of this study text is to help advisers develop and demonstrate their financial planning capabilities. It tests the practical application of technical knowledge and planning skills already gained, typically through previous study, thereby supporting the provision of competent and appropriate advice. This study text, therefore, takes an in-depth look at the financial planning process.

We begin with an overview of the International Organization for Standardization standard ISO 22222, which describes financial planning as a six-step process. We examine the financial planner's regulatory responsibilities at the start of the financial planning process, focusing, in particular, on the client agreement, status disclosure, the different types of financial advice that can be provided, record-keeping and the importance of the fair treatment of customers. We also take an initial look at establishing the client's aims and objectives, the investment process and the benefits of using a financial planner.

Risk and volatility, in the context of both financial and investment planning, are considered next. We review the different types of risk that apply to clients and how those risks can be managed, before discussing the process of risk profiling and the use of risk profiling tools in the financial planning process.

The fact-finding process is the next area we focus on. The process of gathering information about the client for synthesis (the creation of a clear summary) is a skilled one which necessitates the use of a variety of questioning techniques to elicit the facts required. Successfully carried out, it will lead to a full understanding of the client's situation and financial planning objectives. Fact-finding does not necessarily involve just the client and their financial planner (or paraplanner). Financial planners need to know their own limitations and when to call on the knowledge and expertise of specialists, such as accountants, lawyers and fund managers. In order to carry out the synthesising process, and the analysis which follows, it is helpful to have an understanding of the concepts of compound interest and discounting, so we include worked examples of these for you.

Once client information has been gathered and synthesised, the next stage in the financial planning process is analysis. We therefore examine this stage of the process, looking at how to identify the strengths and weaknesses in the client's current situation and how to quantify gaps and shortfalls between the client's needs and wants and their existing provision using tools. This enables the financial planner to proceed to draw up plans for the resolution of these issues in the recommendations stage, bearing in mind the client's priorities.

Next we examine how to formulate the financial plan for both short- and long-term objectives. At this recommendation stage, the financial plan is developed and presented to the client. Clients may be concerned about flexibility, costs and tax. The financial planner will need to bear in mind the lessons from behavioural finance, which help us to understand the psychology of a client's decision-making. They will also need the self-confidence required to present the drawbacks to their proposals, as well as the benefits.

In the closing chapter of the study text, we discuss the final stages of the process – the implementation of the plan, conducting regular reviews and maintaining the plan. Implementation may involve the use of platforms, which are covered in some detail. We also reflect on the different ways in which advisers can charge for their services, including the potential advantages and disadvantages of each method. We also consider the need for reviews and the circumstances in which it might be appropriate to conduct them.

In summary, the focus of this study text is the financial planning process as a whole. While some technical information is included, there is an assumption of prior learning, in particular from R01–05. You may therefore like to have these study texts to hand as you work your way through R06.

Contents

1

Establish client objectives, needs and priorities

Contents	Syllabus learning outcomes
A The financial planning process	*1.1*
B The planner's responsibilities, the client agreement and types and limitations of advice	*1.1*
C Establishing the client's aims and objectives	*1.1*, *1.2*
D Overview of the investment advice process	*1.1*, *1.2*
E The benefits of using a financial planner	*1.1*, *1.2*
Key points	

Learning objectives

After studying this chapter, you should be able to:

- describe the financial planner's responsibilities and terms of engagement, including the types and limitations of advice;
- apply the appropriate techniques for asking about the client's aims and objectives, their needs and priorities;
- outline the process of giving investment advice; and
- state the benefits of using a financial planner.

Key terms

This chapter features explanations of the following ideas:

Adviser charging	Basic advice	BS 8577	Client's aims and objectives
Closed-ended questions	Execution-only	Fair treatment of customers	Independent advice
ISO 22222 six steps	Limited advice	Needs analysis	Open-ended questions
Positive customer outcomes	Recognised specialist activities	Restricted advice	SMART objectives

A The financial planning process

The International Organization for Standardization (widely known as the ISO), in its standard ISO 22222, describes financial planning as a six-step process:

1. Establish and define the client and personal financial planner relationship.
2. Gather client data and determine goals and expectations.
3. Analyse and evaluate the client's financial status.
4. Develop and present the financial plan.
5. Implement the financial planning recommendations.
6. Monitor the financial plan and the financial planning relationship.

Defining the process of financial planning is just part of ISO 22222, which also specifies professional and ethical behaviour, as well as the competences and experience personal financial planners require.

The following sections, from *ISO step 1 – establish and define the client and personal financial planner relationship* on page 1/2 to *ISO step 6 – monitor the financial plan and the financial planning relationship* on page 1/4, look at each of these ***ISO 22222 six steps*** in further detail.

A1 ISO step 1 – establish and define the client and personal financial planner relationship

At the start of each engagement with a client, the financial planner should provide information about the services being offered. The information provided should cover:

- the scope of the service being offered;
- the financial planner's qualifications and experience; and
- details of the financial planner's conformity to ISO 22222.

This information should be in writing, although the financial planner should take the opportunity to explain it in a face-to-face meeting with the client.

Many financial planners offer an initial meeting to new clients on a no cost, no obligation basis.

A1A Information about the client

The financial planner should ask the client about their:

- personal details;
- employment status;
- relationship status;
- financial position;
- State, employer and private benefits;
- insurances and entitlements (for example, pensions);
- immediate needs; and
- short- and long-term goals.

A variety of methods for gathering information is used, including interviews, questionnaires, face-to-face meetings, telephone conversations and correspondence.

A1B Terms of engagement

The financial planner should provide the client with a written document of the terms of engagement for the services to be provided, setting out:

- the regulatory status of the firm and the type of advice it offers;
- the scope of services the financial planner provides;
- how the financial planner will communicate with the client;
- client classification;
- record-keeping;
- anti-money laundering procedures;
- the advice process;
- any known conflicts of interest, e.g. between the firm or the planner and the client;
- the adviser's fees for initial and ongoing advice;
- the service that will be provided and the time period in which it will be provided, e.g. when valuations will be provided;
- the duration of the agreement, e.g. a year;
- the frequency of contact and/or reviews, e.g. not fewer than annual meetings; and
- confidentiality provisions.

The main purpose of the terms of engagement document is to ensure that the client has a clear idea of the scope and cost of the work the financial planner will carry out.

The client should not have any misapprehensions about the level of service that will be provided. There should be clarity on such issues as the amount of reporting on investments, the frequency of reviewing the client's circumstances and plans, and whether the financial planning firm will alert the client to any changes to their planning that might be needed in the future.

Consider this…

Look at your firm's terms of engagement document and consider how it fulfils these requirements.

A2 ISO step 2 – gather client data and determine goals and expectations

The financial planner needs to gather further information about the client in addition to the data requested in step 1. This should include:

- cash flow statements;
- assets and liabilities;
- risk management arrangements;
- contracts;
- statements;
- forms and legal documents;
- the client's needs, goals and objectives with timeframes;
- economic assumptions;
- information about the client's risk tolerance; and
- the client's attitude to environmental, social and governance impacts, as well as ethical and religious considerations.

Refer to

See *Record-keeping* on page 1/13 for more on record-keeping.

The financial planner must always maintain confidentiality regarding the information provided by clients. They should also retain client records for a minimum period. In the UK, this period is prescribed by the FCA.

A3 ISO step 3 – analyse and evaluate the client's financial status

The financial planner should use the information gathered in steps 1 and 2 – taking into account the client's current status, expected future changes, and their goals and preferences – to produce an evaluation.

This evaluation should outline the client's current strengths and vulnerabilities and compare them against the client's goals, plans, restrictions and tolerance to financial risk, as well as their capacity for loss. Important issues include the client's current and future income needs, and their tax position.

A4 ISO step 4 – develop and present the financial plan

Using the information from steps 1–3, the financial planner should develop the plan by reviewing, discussing and resolving any issues with the client. These issues may be regarding understanding of the client's circumstances and goals and their interpretation of these, as well as the client's tolerance for financial risk and their taxation position. The plan should clearly outline the methods that will be used to help achieve the client's goals.

The financial planner should present a plan for the client with suitable and practical financial recommendations.

A5 ISO step 5 – implement the financial planning recommendations

Based on the plan produced in step 4, the financial planner will help the client implement the recommendations in line with the terms of engagement.

The financial planner should produce documentation recording the extent to which the client has accepted the recommendations.

A6 ISO step 6 – monitor the financial plan and the financial planning relationship

The financial planner should continue to implement the financial plan and use the planning process to update it as necessary.

A7 British Standards for financial planning firms

The British Standards Institution (BSI) standard for financial planning firms aims to help boost consumer confidence and trust in financial planning firms. The standard, called ***BS 8577** – Framework for the provision of financial advice and planning services* sets out the requirements for the consistent delivery of a fair, transparent and professional interaction with clients.

The standard is designed for those with responsibility for the overall management and delivery of financial advice and planning services, whether these are of a personal, corporate or business financial planning nature. It also provides a benchmark for best business and professional practice, which helps to ensure that consumer interests are protected.The BSI standard complements ISO 22222 and is based on nine overarching principles:

1. **Transparency**. Firms should conduct all their activities in a transparent manner.
2. **Disclosure**. Accurate and relevant information should be provided to all parties in a clear and concise manner.
3. **Integrity**. Firms should be honest, responsive, accountable and committed to acting responsibly, reliably and fairly with all parties.
4. **Due care and diligence**. Firms should conduct their activities with due care and diligence.
5. **Accessibility**. Firms should take all reasonable steps to ensure that the accessibility needs of all personnel and customers are addressed.

6. **Confidentiality**. Firms should take all reasonable steps to safeguard client confidentiality unless subject to regulatory and/or legal obligations.
7. **Professionalism**. Firms should demonstrate adherence to all relevant rules and regulations, and commit to codes of conduct and professional standards.
8. **Conflicts of interest**. These should be disclosed and managed fairly.
9. **Competence**. All personnel should have the skills, knowledge and expertise relevant to their role. In particular, all personal financial planners should conform to ISO 22222.

In addition, the firm should require all personnel to comply with the ten ethical principles outlined in ISO 22222.

B The planner's responsibilities, the client agreement and types and limitations of advice

From a regulatory perspective, the FCA is responsible for ensuring that relevant markets function well. It also oversees the conduct of business regulation of all financial services firms (how they deal with their customers), as well as the prudential regulation of those firms who are not large enough to be regulated by the Prudential Regulation Authority (PRA).

The regulatory requirements for financial planners are to treat their clients fairly and to be clear, fair and not misleading in all communications with them. There are also other principles requiring financial planners to act with integrity, skill, care and diligence, as well as to manage conflicts of interest fairly. Overall, these are essentially statements of common sense about how a professional financial planner should deal with clients in order to gain and retain their trust.

The FCA's Conduct of Business Sourcebook (COBS), part of the FCA Handbook, sets out the regulatory position regarding the ***fair treatment of customers***. It also covers the need to assess the suitability of any recommendations in light of a client's financial situation, investment objectives, knowledge and experience.

Be aware

FCA's new Consumer Principle
The FCA has identified that firms in retail financial markets are not consistently and sufficiently prioritising good customer outcomes, which causes consumers harm and erodes their trust.

Under the FCA's new **Consumer Principle**, which is expected to come into effect by 31 July 2022, firms will need to act to deliver good outcomes for retail clients. This Consumer Principle replaces Principle 6 ('A firm must pay due regard to the interests of its customers and treat them fairly') and Principle 7 ('A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is fair and not misleading') for retail clients.

The new Principle is underpinned by three cross-cutting rules whereby firms must:

- act in good faith towards retail customers;
- avoid foreseeable harm to retail customers;
- and enable and support retail customers to pursue their financial objectives.

As a result of the new Principle, the FCA expects to see good outcomes in four areas:

- products and services;
- price and value;
- consumer understanding; and
- consumer support.

For further information, you can visit: *www.fca.org.uk/publication/consultation/cp21-36.pdf*.

B1 Status of the financial planner

Financial planners must make their regulatory status very clear to clients before providing services. This means they must tell clients whether they are independent or are offering advice on a restricted basis (and if so, the nature of the restriction).

A financial planner has to ensure that the client is aware of certain specific information about the firm and what its relationship with the client will be. This information can be presented in any format, but is typically given in the firm's client agreement.

Rather than rush through the presentation of these documents, it is a good idea to use them as the basis for explaining the relationship the client will have with the financial planner and the firm.

B1A Independent advice

The FCA Handbook states that ***independent advice*** is 'a personal recommendation to a client where the personal recommendation provided meets the requirements of the rule on independent advice' (COBS 6.2B.11R).

In summary, the standards for independent advice are that it must assess a sufficient range of relevant products available on the market.

This product range must be sufficiently diverse with regard to the type and issuer or product provider to ensure that the client's investment objectives can be suitably met. The range must also not be limited to relevant products issued or provided by the adviser firm (or entities that have close links or close working relationships with the adviser firm) so as to not impair the independent basis of the advice given.

The effect of the regulations is that the assessment undertaken by a firm stating they are providing independent advice for a retail client (i.e. a client who is neither a professional client nor an eligible counterparty) in the UK must include a range of financial instruments, structured deposits and other retail investment products, which in each case must meet the requirements for diversity and scope.

Financial planners who have chosen to be independent are required to have a working knowledge of the whole of the relevant market, at least to the level at which they can assess the suitability of a particular product type for a client.

B1B Focused independent advice

A firm presenting itself as providing independent advice may provide broad and general advice, or specialist and specific advice (focused independent advice). An adviser offering focused independent advice can present themselves as being independent, but they must make it clear to their client that the independence relates to a specific advice area only.

B1C Restricted advice

The FCA Handbook defines ***restricted advice*** as 'a personal recommendation to a client which is not independent advice; or basic advice'.

One difference between independent and restricted advice is in its disclosure. The restriction could be product-related – for example, a firm may only advise on pensions (although a firm can now call itself 'independent' while only offering advice on pensions (*Focused independent advice* on page 1/6), for example, if it advises on all pension product types, and meets the independence requirements in terms of sufficiency and diversity outlined above) – or provider-related, for example, where the firm only recommends the products of certain providers. Where restricted advice is provided, a written statement must be given to the client detailing the nature of the restriction. A firm, however, is still expected to meet the same standards as required for independent advice with regard to suitability, inducement, adviser charging and professionalism.

B1D Basic advice

Basic advice is a form of restricted advice where the adviser uses pre-scripted questions to identify the client's financial priorities and to decide whether a product from the range of low-cost, regulated saving and investment stakeholder products is suitable. If offering basic advice, the adviser should explain that it is a short, simple form of financial advice.

Advisers offering basic advice are not subject to adviser charging and so are able to earn commission on individual sales. They are also not subject to the same qualification requirements as independent or restricted advisers.

For the purposes of this study text, it is assumed that the financial planner is not offering basic advice.

B1E Recognised specialist activities

The FCA has acknowledged that certain areas of advice are highly specialised and, therefore, it recognises them as such in its training and competence regime. For example, advising on pension transfers and long-term care are ***recognised specialist activities***. Non-provision of these services does not mean that a firm cannot hold itself as being independent. However, the FCA does expect an adviser to recognise where pension transfer advice or a long-term care contract would be appropriate. Having identified a need, the adviser providing independent advice should be in a position to refer the client to a specialist colleague or another firm or organisation that can provide advice on these areas.

B1F Firms providing both independent and restricted advice

While an investment firm can provide both restricted and independent investment advice, its advisers can only give one or the other, not both. Care must be taken when communicating the nature of the advice being provided to clients. For example, the trading name of the firm should not include 'independent' where both types of advice are offered to clients. The regulator has suggested that clients can be offered a choice of independent and restricted advice, or a firm can adopt different trading names for the different types of advice.

The most important aspect is that it must be made clear to a client the type of advice they are receiving.

> **Reinforce**
> The FCA's thematic review, TR14/5, on the delivery of independent advice reflects on how it is being practised in the field. The review includes examples of both good and bad practice and can be found at:
> *www.fca.org.uk/static/documents/thematic-reviews/tr14-05.pdf*.

B2 Advice tools and investment strategies

The FCA has acknowledged the need for firms to use technology to help select appropriate products and investments, and to manage those investments over time. Whatever method is used for research and investment management, the advice given must be suitable and in the client's best interests, whether it is independent or restricted advice.

Where firms use a third party or technology to conduct product research, it is the firm's responsibility to ensure that both use criteria which are sufficient to meet the requirements of the regulator.

B2A Panels

Firms can use research to filter the relevant product market into a panel from which products or funds are selected when giving advice. Where a firm offers independent advice, however, it needs to be able to offer off-panel advice when it is in the client's best interests. The regulator expects independent advisers to know what is and is not included on the panel, so that they can identify and address the needs of a client where an off-panel solution would be more suitable.

It is also possible for a firm to exclude a certain type or class of retail investment product from its panel if, after carrying out the relevant due diligence, there is a valid reason for doing so that is consistent with the client best interest rule.

For example, a firm could exclude unregulated collective investment schemes (UCISs) where it believes that the high level of risk associated with these products is not appropriate for its clients.

B2B Platforms

Where independent advice is provided, similar rules apply on the use of platforms. The regulator's view is that platforms do not currently offer products from the whole of the retail market. It is therefore unlikely that a single platform would meet the standards required for independence for every single client transaction.

Refer to
See *Platforms* on page 7/4 for more on platforms.

The regulator expects a firm and its advisers to understand the limitations of its chosen platform and to provide an off-platform solution, or an alternative platform, where this is in the best interests of their client.

Activity
Review the regulator's latest package of measures to help consumers who invest through investment platforms at: *www.fca.org.uk/news/press-releases/fca-acts-improve-competition-investment-platforms-market*.

B2C Model portfolios

In this context, 'model portfolio' refers to a pre-constructed collection of designated investments that meets a specific risk profile, and not to retail investment products that have similar characteristics (such as a fund of funds).

Where a firm is constructing its own model portfolios for use when providing independent advice, it should ensure that its research process also meets the standards for independent advice. Where the construction and management of model portfolios is outsourced to a third party, the adviser is responsible for ensuring that the criteria used in its research process are sufficient to allow the third party to meet the independent advice rules.

The suitability of the model portfolio should be based on the client's entire portfolio rather than just the individual product and should also take into account the client's preferences and requirements. The model portfolio as a whole should be considered when determining whether it is consistent with the client's attitude to risk, rather than the individual components held within it. In addition, the model portfolio must be in the client's best interests, which will include an assessment of its charges. If the portfolio is not suitable for a client or is not consistent with their needs and requirements, then either it should not be recommended or it should be tailored so that it is suitable.

Advisers offering independent advice should be aware of the make-up of their firm's model portfolios and the situations where they would and would not be a suitable recommendation. The regulator expects that firms offering independent advice do not use model portfolios as their default solution, regardless of whether they can be tailored for individual clients. Instead, they should be able to recommend other investment solutions and advise on other retail investment products where these are appropriate to the needs of their clients.

B2D Discretionary investment management services

Where an adviser recommends a discretionary investment management (DIM) service to a client, they must do so only if it is the best solution for the client, taking into consideration their personal circumstances, investment needs and requirements.

Advice on this basis is not considered by the regulator to be a personal recommendation to which the standard rules on independent advice would apply. However, to meet its obligations under the Principles for Businesses (PRIN), an independent adviser should objectively consider a wide range of investment solutions available in the relevant market before recommending a DIM service, which should not be offered as a default solution.

While the recommendation of a discretionary investment manager is not a personal recommendation, a firm is still expected to undertake sufficient due diligence before recommending one to ensure that it can make a judgment about the suitability of the services provided for that client.

Where an adviser makes a recommendation explicitly or implicitly to use specific investment funds offered by a discretionary investment manager, such as a specific risk-rated portfolio, then this would be classed as a personal recommendation. Therefore, the rules for personal recommendations, including those regarding independence, would apply in full.

Consider this…
What type of approach is adopted by your own firm? Does it meet the requirements for independent or restricted advice?

B3 Limits of authorisation and competence

Financial planners should make clear the limits of their personal authorisation and competence, as well as those of their firm:

- The firm's client agreement should make it clear which areas the firm is authorised to advise on. Clients should be made aware of this at an early stage and certainly before the transaction of any investment business.
- The agreement should include whether they are giving advice on an independent or restricted basis.
- It is a requirement to have a signed client agreement with certain types of client, e.g. if the intention is to manage their portfolio on a discretionary basis.

Refer to
See *Recognised specialist activities* on page 1/7 for more on recognised specialist activities.

Financial planners must be able to recognise when they are not authorised or competent to advise. This could be in areas such as pension transfers and long-term care. When a planner encounters such areas, they should refer the client to an expert either inside or outside the firm.

B4 The regulatory position

The FCA requires financial planners to have enough personal and financial information about a client to be able to give suitable financial advice. In particular, the financial planner should have enough information to know that the client:

- can afford the recommended investment or other financial product;
- understands the risks involved in the investments; and
- understands how the recommendations meet their aims and needs.

Establishing the client's attitude to, tolerance of and capacity for investment risk is one of the most important elements of successful financial planning. It is essential that the client understands the meaning of financial risk and how it affects the selection of appropriate products, investments and planning techniques.

It is also important that the assumptions that underlie the planning process are reasonable and that the financial planner explains them to clients.

B4A The 'assessing suitability' rule

The basic 'assessing suitability' rule is that the firm giving the advice to a retail client must have enough personal and financial information about them to ensure that any recommendation made is suitable for the client.

To conform with the 'suitability' rule, the planner must justify affordability, risks and fulfilment of objectives and needs.

B4B Vulnerable customers

Delivering positive outcomes is especially important for vulnerable customers. Vulnerable customers are people who require an additional duty of care, typically on account of their age, state of health or current circumstances (for example, if they are recently bereaved).

The issue of customers in vulnerable positions is an increasing focus of the FCA. It considers that such individuals may be at risk of poor customer outcomes and therefore, requires firms and advisers to ensure they receive an appropriate level of care, which may be different than what is required for other customers.

Understanding what constitutes an individual who may be in a vulnerable position is not straightforward; vulnerability can come in many guises, and examples may include:

- an individual having to make purchases or financial decisions during stressful points in time, such as bereavement or choosing care arrangements for someone close to them; or
- an individual having personal characteristics such as:
  - physical disability;
  - poor mental health;
  - compulsive or impulsive behaviour; or
  - impaired cognitive skills due to illness or ageing.

Vulnerability can affect individuals across all financial products and services, and may be a long-term characteristic or one that is transient in its nature.

The FCA has issued guidance for firms on treating vulnerable customers fairly (*FG21/1: Guidance for firms on the fair treatment of vulnerable customers*), which clarifies what the FCA considers is required under the FCA principles. The guidance is grouped into four key areas that firms should address.

Table 1.1: Key areas of FCA guidance on treating vulnerable customers fairly	
1. Understanding the needs of vulnerable customers	• Understand the nature and scale of characteristics of vulnerability that exist in their target market and customer base, and how this might affect the consumer experience and outcomes.
2. Skills and capabilities of staff	• Firms should make sure that all staff, in particular those who operate at the frontline, have the appropriate skills and capability to treat customers in a vulnerable position fairly and to understand the signs of vulnerability.
3. Practical action	• Firms should consider the positive and negative impacts of a product or service on customers who may be in a vulnerable position and design products and services to avoid potential harmful impacts. • Customer service processes and systems should be flexible enough to empower and support frontline staff to use their discretion to respond flexibly to the needs of such customers. • Firms should consider what communication channels and what tailored communications they may be able to provide to ensure communications are clear and easy to understand for customers who may be in a vulnerable position.
4. Monitoring and evaluation	• The FCA expects firms to embed awareness of vulnerability into every aspect of their work, including monitoring and evaluating the impacts of any action they take through testing and feedback.

On the Web

Further resources on vulnerability can be found at the following websites:

- FCA's *FG21/1: Guidance for firms on the fair treatment of vulnerable customers*: *www.fca.org.uk/publications/finalised-guidance/guidance-firms-fair-treatment-vulnerable-customers*.
- The Financial Vulnerability Taskforce: *www.fvtaskforce.com/resource-library*.

B5 The information that should be collected

The information collected by the financial planner should provide a clear picture of the client's personal and financial circumstances. It should also lead to a clear identification of the client's:

- needs and objectives;
- assets and liabilities;
- income and expenditure (to assess affordability);
- priorities; and
- attitude to risk.

This information should be enough for the financial planner to be able to make suitable recommendations. The record of information on each client must be readily available and accessible at all times. It can be either electronic or paper based.

If the client is asked to give consent to the information record, there should be a prominent warning to read it in full first. While consent is not in itself a regulatory requirement, it is a requirement of data protection rules that a client gives their consent to having their data retained.

B6 Execution-only and limited advice

A client may be unwilling to disclose information in some circumstances. The financial planner needs to decide how to deal with this situation.

B6A Execution-only

One option is to treat the client as an ***execution-only*** client. In that case, it is essential to give no advice whatsoever. The financial planner's role is simply to provide information and carry out the client's wishes.

The client should confirm, in writing and preferably in their own words, that they have neither sought nor received advice. If the financial planner feels that it is possible to continue to give advice despite the non-disclosure, the client should confirm in writing that they have not disclosed the information requested and that they are aware this may influence the advice given by the financial planner.

B6B Execution-only platforms

In recent years, there has been a growth in online execution-only services, which have become increasingly complex. The regulator has warned platform service providers that although the detailed descriptions of risk appropriateness of individual funds and risk profiling tools are fine, the manner in which they are presented and structured should not imply advice has been given.

Refer to

See *Platforms* on page 7/4 for more on platforms.

B6C Limited advice

Some clients may only want ***limited advice*** in a specific area, rather than on the whole of their financial circumstances.

The client should be fully aware of the limited nature of the advice given and the financial planner should record this in the suitability report.

B7 Professional clients

Very few clients can be treated as professional clients rather than as retail clients.

However, a person who is a professional investor might be prepared to be treated as a professional client because they would prefer not to receive all the risk warnings or go through the full process of assessing suitability.

The advantage of having a professional client is that the costs and time involved in providing investment risk warnings and documenting them can be omitted. However, the drawback, mainly for the client, is that if they buy an investment that they do not fully understand, they will have lost much of the protection given to retail clients because of their professional status.

A firm is expected to carry out qualitative and (where appropriate) quantitative assessments of the client to establish that they are capable of making their own investment decisions and understand the risks concerning the nature of the transactions or services envisaged.

To treat the client as an elective professional client, the firm also has to ensure that the following steps are taken:

1. A written statement is required from the client stating that they wish to be treated as a professional client either generally or in respect of a particular service, transaction or product.

2. The firm must provide a clear written warning detailing the investor compensation rights that the client may lose.
3. A written statement, separate from the contract, is required from the client confirming that they understand the consequences of losing consumer protection.

The remainder of this study text assumes that the client is a retail client.

B7A Collective investment schemes and non-mainstream pooled investments

Regulated collective investment schemes (CISs) are UK-based schemes that have been authorised by the FCA or non-UK-based CISs that have been recognised by the FCA. These CISs must meet certain criteria set down by the FCA and can be promoted to the general public without any restriction.

UCISs and certain close substitutes, collectively known as non-mainstream pooled investments (NMPIs), are not subject to the same restrictions as regulated CISs, for example, in terms of how they are run and their powers of investment. Due to the lack of restrictions on borrowing and types of assets invested in, as well as no requirement for a prudent spread of risk, these investments are generally considered to be high risk. Additionally, clients may not be covered by the Financial Ombudsman Service (FOS) or the Financial Services Compensation Scheme (FSCS).

Although these investments are not regulated themselves, advising on and arranging NMPIs are regulated activities and subject to FCA regulation. Given their high-risk nature, the FCA prohibits the promotion of NMPIs to the general public. NMPIs can only be promoted to certain types of investor, including:

- certified high-net-worth individuals;
- certified sophisticated investors;
- self-certified sophisticated investors; and
- individuals who fall within one of the categories detailed in COBS 4.12: *Restrictions on the promotion of non-mainstream pooled investments*.

Schemes covered by the marketing ban include:

- units in qualified investor schemes (QISs);
- traded life policy investments;
- units in UCISs; and
- securities issued by special purpose vehicles (SPVs) pooling investments in assets other than listed or unlisted shares or bonds.

A number of products are outside the scope of the marketing ban, and these include:

- exchange-traded products;
- overseas investment companies that meet the criteria for investment trust status if based in the UK;
- real estate investment trusts (REITs);
- venture capital trusts (VCTs); and
- enterprise investment schemes (EISs) and seed enterprise investment schemes (SEISs), unless structured as UCISs.

B8 Insistent clients

Some clients want to make particular investments that are not suitable for them. If the financial planner believes that an investment is unsuitable, they should express this in writing and carry out the transaction only if the client insists. Alternatively, they could decide not to act for the client.

On the Web

The FCA has published information on the pension reforms and insistent clients in order to remind advisers of the FCA's position on insistent clients. See: *www.fca.org.uk/firms/pension-reforms-insistent-clients*.

Detailed guidance can be found at: *www.handbook.fca.org.uk/handbook/COBS/9/5A.html*.

B9 Record-keeping

The standard periods of record-keeping under the COBS rules differ according to the type of firm and the nature of the records. However, they can be summarised as follows:

- **Indefinitely** – for pension transfers, pension opt-outs or free-standing additional voluntary contributions (FSAVCs).
- **Five years** – for life policies and pension contracts, although financial promotions for such products should be retained for **six years**.
- **Three years** – for any other case.

These are the minimum specified retention periods. In practice, financial planners may feel that it would be prudent to keep records longer. This is in case questions arise about the suitability of financial advice, which may happen many years after the event.

Financial planners should be aware of the provisions of the **UK General Data Protection Regulation (UK GDPR)** and the **Data Protection Act 2018** relating to the holding of information, its security and passing it on to third parties. These rules cover paper records as well as those that are held electronically.

B10 Fair treatment of customers

Key performance indicators help in measuring this. For example:

Firms must strive to deliver ***positive customer outcomes*** at all times. Clients must, therefore, be treated fairly, not only initially but on an ongoing basis. Key performance indicators help in measuring this. For example:

- Are clients given a wide range of advice?
- Is the advice suitable and of good quality?
- Does the financial planner use a wide range of products and providers?
- Do clients retain the products recommended by the financial planner, or are there many cancellations, lapses or replacements?
- Is there a high level of complaints from clients?

Be aware

The importance of ethical behaviour in delivering positive customer outcomes
The principles set by the FCA reflect the professional and ethical standards that should guide those who work in insurance as they go about their day-to-day activities. However, it's vitally important for an industry that relies on trust for customers to have confidence that they are dealing with people who are putting their interests first; not because they have to, but because they believe it's the right thing to do.

Organisations with a record of great customer service, that treat every customer fairly and with respect, build themselves a good reputation; those that do not are unlikely to be recommended to other people.

The CII Code of Ethics provides members of the insurance and personal finance profession with a framework in which to apply their role-specific technical knowledge in delivering positive customer outcomes. Under the fifth 'Core duty' within the Code, members are required to: 'treat people fairly regardless of: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion and belief, sex and sexual orientation'.

B11 Adviser charging

Commission payments from retail investment products are banned. Advisers charge fees for their advice based on the services they provide.

Adviser charging must be disclosed to the client up front using some form of price list or menu of costs. Ongoing charges can only be levied where an ongoing service is provided and the client has agreed to this service. Fees should be commensurate with the level of service provided, and any agreement must make clear the services that the adviser will provide. Fees should be disclosed in monetary terms even if the fees equate to a percentage of the investment value – for example, 2% of £100,000 would be £2,000.

Under the current rules, advisers can still receive payment of trail commission on legacy assets that are not held on platforms. However, any 'disturbance' of these assets (for example, top ups, switches or rebalancing) will result in the trail being switched off.

C Establishing the client's aims and objectives

The process of building the relationship between the financial planner and the client can take time, as it is crucial that the client's trust is gained and that they feel confident in sharing some of the most important and often intimate aspects of their life. A client must feel able to talk openly about their preferences, dislikes, aspirations, hopes and fears.

The relationship needs to be very interactive. The process is not usually a straightforward matter where the client provides information and the planner produces a solution. In some cases, it may be as simple as that, but in most financial planning relationships, the process prompts the client to redefine their aims and objectives in the light of what is financially feasible.

The financial planner is both a guide and a sounding board. They may encourage and warn, but are also there to listen and provide information and solutions to the problems they help the client define.

The process is also iterative, with the planner and client going over matters several times as the client gradually defines what they want to achieve concerning their finances and possibly their life generally. In many cases, they are considering for the first time their attitudes to such matters as risk, their future standard of living, their health, their relationship with work and retirement, and the possibility of using insurance to protect themselves and their families.

Financial planning is a service that may use financial products, but these are really just a means to an end. Familiarity with a range of products is crucial to the process, but knowledge and an understanding of the client are even more important, including an understanding of the client's aims and objectives, which is crucial in the fact-finding process. Some clients have a good understanding of their general aims, but many do not. Often, the aims and objectives are defined during, and as a result of, the financial planning process. The financial planning experience may be the first time that a client has thought seriously about their long-term future, or tested their aspirations and assumptions against financial realities.

Clients may change or develop their aims over the years, as they become more informed about financial issues and accustomed to making decisions about matters such as saving, insurance and tax planning. They will also be affected by life changes such as starting a family, losing a parent, changing jobs, starting a business, encountering financial difficulties or getting divorced.

Marriage or living with a partner can change perspectives and introduce new, and possibly conflicting, views and aspirations. The financial planner needs to be aware that a couple may not share the same approach to life and money, even if that is not obvious in the meetings, especially if one client appears dominant.

Understanding the ***client's aims and objectives*** involves:

- recognising the client's needs and objectives;
- distinguishing between immediate and future objectives;
- quantifying and qualifying the objectives; and
- prioritisation.

C1 Recognising the client's needs and objectives

Finding out what clients want to achieve with their finances can be one of the longest and most difficult aspects of the fact-finding process. Some financial planners have taken their approach to establishing the client's financial aims and objectives much further through the concept of life planning, which has been developed by George Kinder, of the Kinder Institute, and others. The aim is to help financial planners discover their clients' most profound goals through a structured questioning process and then construct a financial plan based on their aspirations.

Clients often have a clear idea of at least some of their objective financial needs – a larger retirement fund, a mortgage to buy a house, a bigger income – but they may not always recognise all of their needs or they may misunderstand aspects of them. For example, it is common to overlook the need for health protection or to underestimate the amount needed to fund a comfortable retirement. Even if clients understand their general aims, they usually need help in refining these aspirations into specific, quantified objectives, such as a target retirement fund.

Helping clients to identify their general aims and specific objectives continues throughout the fact-finding process and afterwards. Nevertheless, it can be regarded as a separate stage in financial planning.

As far as possible, the client's objectives should follow the ***SMART objectives*** acronym – specific, measurable, action-related, realistic and time-related. If they do not, it is hard to make realistic and useful plans.

The following example illustrates how the SMART acronym works in practice.

Example 1.1

The SMART acronym

- **S**pecific – we want to retire at the age of 60.
- **M**easurable – we would like a retirement income that is equivalent to £24,000 net a year in today's terms.
- **A**ction-related – in this context, it should be capable of being acted on, e.g. by increasing the level of regular savings or by making a lump sum pension contribution.
- **R**ealistic – we can afford to save this amount each month.
- **T**ime-related – the retirement fund should be at least £400,000 in eight years' time.

This clarification of personal and tailored objectives is an important element of the fair treatment of customers. If the objectives lack clarity, the resulting solutions will too. Often, people have more objectives than their current finances will allow. The client should then be asked to prioritise their needs in terms of importance, and this must be documented in the fact-find.

C1A Family background

Family and personal relationships/dependencies are at the heart of much financial planning, so it is essential to understand the client's family situation and background. Generally, this should just be a clear description of the relevant key individuals. In most cases, a simple list is adequate but, in some situations, it may be clearer to use a family tree.

C1B Questioning techniques

There are two main methods of finding out the client's needs and objectives.

Questioning is likely to be the most effective method, and helps to develop a relationship of openness and trust between client and financial planner.

There are two kinds of question:

- ***Open-ended questions*** encourage the respondent to talk freely about a topic or expand on a point made earlier. These questions are deliberately designed so that they cannot be answered by 'yes', 'no' or any other one- or two-word answer. In fact-finding, these questions are used to highlight the details that are most important to the client, to uncover their needs and to explore their objectives and feelings. These questions typically elicit what are known as 'soft facts'.
- ***Closed-ended questions***, on the other hand, demand short, specific answers. They allow the adviser to limit the client's answer to 'yes/no', a specific fact or an amount of money. Closed-ended questions tell the adviser exactly what single piece of information they need to know. These questions typically elicit 'hard facts'.

Refer to

See *Hard and soft facts* on page 3/24 for more on hard and soft facts.

Listing possible aims and objectives is another approach. The client can make choices from a list and possibly rank them in order of importance.

This can be useful as a prompt and can help open the client's mind to the range of possibilities. A sample list is as follows:

- **Increase** my net spendable income.
- **Improve** my quality of life.
- **Save** on tax (including income tax, National Insurance contributions (NICs), capital gains tax (CGT) and inheritance tax (IHT)).
- **Increase** the return on my investments.
- **Save** money by using it effectively.
- **Increase** my expected income in retirement.
- **Gain** peace of mind by feeling financially comfortable.
- **Reduce** paperwork.
- **Improve** my insight into the present and future values of my pension schemes.
- **Increase** my financial security.
- **Reduce** time spent worrying about my financial affairs.
- **Achieve** financial independence.
- **Improve** my business performance.
- **Safeguard** my family and dependants.
- **Improve** the organisation of my financial affairs.
- **Increase** my financial awareness.
- **Reduce** personal, business and investment risks.
- **Increase** the net amounts I give to charity.

C1C Issues relevant to identifying clients' aims and objectives

Clients' statements about their aims and objectives should not always be taken at face value. When identifying clients' aims and objectives, financial planners should be aware of the following issues:

- Some aims may be unrealistic; the client may assume excessive rates of investment growth.
- Some aims may be mutually incompatible; a client might be expecting an investment strategy that provides high returns with very low risk.
- There may be a conflict between the aims of one spouse/partner and the other; one partner may want to retire early and live in Spain, while the other may want them to stay at work longer and retire in the UK.

It is also important to identify the amount of financial risk the client is willing to take to achieve their aims and objectives. In broad terms, the degree of risk affects the potential for reward: a high risk may mean a potentially higher reward but with a greater risk of losing money, while a low risk will generally mean a lower reward but, equally, a lower margin for loss.

> **Refer to**
> Financial risk is discussed in greater detail in *Explaining financial risk and volatility* on page 2/2 and *The concept of investment risk and understanding a client's risk profile* on page 2/3.

The challenge for investors is to obtain the best investment returns possible without accepting a level of risk they cannot afford to take. For example, while the capital in a UK deposit account is deemed to be more or less risk free, it will achieve no capital growth and its purchasing power will lose value because of inflation. In contrast, asset-backed investments, such as collective investment schemes, will typically outperform inflation over the longer term. However, there are no guarantees that this will take place and, throughout the investment term, the investor's capital is exposed to the fluctuations of the stock market, meaning that the investor may not always be able to get back their initial investment.

C2 Distinguishing between immediate and future objectives

Most clients can distinguish between their immediate and longer-term objectives but may find it difficult to achieve both:

- An example of an **immediate objective** may be to reduce current expenditure, which could involve paying off credit card debt, switching to a mortgage with a lower rate or paying utility bills by direct debit.
- An example of a **future objective** may be to provide sufficient capital and income to be financially independent at age 60. Methods may include diverting money from current expenditure into a pension plan and/or other investments for retirement.

Clients tend to prioritise short-term needs or wants, such as meeting immediate expenditure needs or obtaining a mortgage to buy a home. In many cases, the short-term objectives involve the sacrifice of longer-term aims that they have neither considered nor articulated clearly.

In contrast, financial planners tend to prioritise long-term or contingent needs, such as pensions and protection. Most of these objectives require the client to sacrifice more immediate and tangible benefits.

The dialogue between the financial planner and client therefore typically involves a reconciliation of what the client wants with what the financial planner considers that the client needs and is achievable.

C2A Timescale and savings objectives

Clients may also have savings objectives that can be divided into short-term and longer-term.

Short-term objectives may include:

- paying off expensive debt, such as a credit or store card;
- saving for immediate needs, such as a major item of household expenditure, the next holiday, school fees or a tax bill;
- saving for a medium-term objective in the next five years – say, a wedding, a major holiday or children's university costs; and
- building up a short-term cash reserve of 'rainy day money'.

Longer-term objectives for five years or more could include:

- saving for a major item of expenditure, such as university fees or a deposit for a house; and
- saving for retirement.

C3 Quantifying and qualifying the objectives

It is important to find out the client's qualitative and quantitative aims and objectives:

- **Qualitative statements** generally involve comparisons and preferences. An example of a qualitative statement is: 'I want to retire on an adequate income'.
- **Quantitative statements** can be reduced to something measurable, i.e. figures.
  An example of a quantitative statement is: 'I want to retire on an income that is not less than 75% of my pre-retirement earnings'.

Where possible, objectives should be both quantified and qualified.

Example 1.2

eg

Objective statement

The statement 'I would like my children to be educated privately' is a general wish. In contrast, the following is a clear, quantified and qualified objective:

> I would like my children to be educated privately. I would like them to attend a preparatory school from age seven to age eleven at a present-day cost of £4,800 a term, and then a private secondary school until age 18 at a present-day cost of £5,400 a term.

A client is more likely to use a qualitative statement. The financial planner should assist in expanding that statement into a quantitative statement by careful prompting and questioning.

C4 Prioritisation

The fact-finding process generally leads to the client and financial planner identifying a range of aims and objectives. The chances are that some will be more important or urgent than others, and often it is not possible to tackle them all at the same time. In these circumstances, it will become necessary to focus on prioritisation.

Most people share the same broad hierarchy of needs. The most basic aim is to have enough income to cover the essential expenses of accommodation, food, heating and so on. Achieving this might involve cutting costs and, in particular, cutting borrowing costs. Beyond these basic aims, financial protection against the potential financial impact of death or illness could be a priority for clients who depend on their earnings from their work, especially if they have family responsibilities. Such protection might not be a priority for someone with substantial assets.

Saving for the future – and especially for retirement – might be a high priority for many people during their working lives. Others may see the need to raise funds with which to buy a home as far more important than saving for retirement which may be a long time in the future. For retired clients, maximising income and minimising the potential IHT on their estate could be their top priorities.

Priorities change over time as people’s circumstances and attitudes develop, so prioritising is a process that needs to be done repeatedly throughout the client’s lifetime. Even in the planning process, it may be necessary to set the priorities and then reset them. Clients often change their views and priorities as they learn more about financial issues, understand their own circumstances better and think more about their financial planning generally.

It is quite common for a client to start off thinking that their top priority is one thing and end up with a different key aim. For example, a client may think that IHT planning should be the main aim but then end up deciding that they cannot afford to do estate planning unless they resolve some other issue, such as their retirement planning, so that they have enough income to live on and make gifts after they stop working.

C4A Techniques for establishing and prioritising objectives

Financial planners use a number of methods to help clients identify their main concerns and ambitions, as well as assisting them in deciding on their priorities. This can often be achieved in a very simple and practical way; for example, by using a ***needs analysis*** grid.

An example is shown in the following figure.

Figure 1.1: Needs analysis grid

Want to do now	Want to do later
Must do now	Must do later

Refer to
A list of possible aims and objectives is given in *Questioning techniques* on page 1/15.

One approach is to provide clients with a list of possible aims and objectives. The planner should ask the client to add their own goals – for example, go on a world cruise, set up a charitable trust or retire to the coast. The list can then be transferred to sticky notes or cards. The client should then be encouraged to choose which one of the quadrants (see Figure 1.1) they would place the notes in and to discuss the issues that arise as a result.

D Overview of the investment advice process

Investment planning is a very important component of the overall financial planning process. It is helpful at this point to outline the planning process as it specifically applies to investment issues and to show the progress of the main stages:

1. Establishing the client's goals and expectations.
2. Understanding the client's status.
3. Drawing up a statement of the client's investment aims.
4. Recommending appropriate asset allocation.
5. Making fund (or stock) selection recommendations.
6. Implementing and monitoring the plan.

D1 Stage 1 – establishing the client's goals and expectations

The investment strategy needs to fit into the client's overall financial and life goals. The financial planner needs to establish the client's timescale and whether the need is for income or capital growth, or both.

A vital part of understanding the client's needs and goals is finding out how much investment risk the client is prepared to take.

Two of the factors that determine this are the client's:

- **Capacity for loss**. The FCA describes this as 'the customer's ability to absorb falls in the value of their investment'. This is determined by objective factors, including their level of income and wealth, expenditure requirements, investment timescale and need for liquidity. If any loss of capital would have a materially detrimental effect on a client's standard of living, the FCA expects this to be taken into account in assessing the risk that they are able to take.
- **Risk tolerance**. The degree of volatility in investment returns that a client is prepared to withstand. This is therefore more about subjective and psychological issues.

These two factors, however, are not static. They change over time and are influenced by changes in the client's circumstances, including:

- **Age** – generally, the closer a client is to retirement, the less investment risk they are prepared or able to take. A younger client generally has the ability to earn more to replace investment losses, but a retired client may not have this luxury.
- **Health** – for example, someone in poor health is less likely to be in a position to take investment risk as they might not be able to recoup losses at a later date.
- **Income and wealth** – the greater and more secure a person's disposable income is, the more likely they are to have built up an emergency fund and other assets. This means they are better able to take on investment risk from both a financial and psychological perspective.
- **Experience** – a client's understanding of what is meant by investment risk generally increases as they experience changing economic and market conditions, but this understanding can be clouded by particularly positive or negative experiences, and this can affect the amount of investment risk they are willing to take. In such circumstances, a financial planner may need to spend some time helping the client overcome such a bias through education.
- **Personality** – a client who is risk averse in their general outlook on life is likely to be the same regarding any investments made, whereas a client who is more inclined to embrace risk in their general life will, in all likelihood, reflect this general approach when investing. However, just because a client is self-employed or engages in dangerous hobbies does not mean the financial planner should assume they are high-risk investors, and the usual process for establishing risk tolerance should still be followed.

Financial planners need to find out what risk means to a particular investor – in other words, what would be most worrying about the outcome from an investment in relation to a specific goal?

Refer to
Risk profiling is covered in detail in *Risk profiling* on page 2/6.

They also need to know the level of losses that a client is prepared and able to tolerate from their investments in return for the prospect of investment returns. This process is generally known as 'risk profiling'.

The results of risk profiling tools or questionnaires should form the basis of a further discussion with the client taking into account their investment needs, objectives and capacity for loss. They should not be used on a stand-alone basis.

Closely related to the issue of risk is the client's need to hold some liquid cash or 'rainy day money' to meet emergencies and short-term needs. Clients should be encouraged to have a few months' expenditure as cash reserves. The exact amount needed will depend on their circumstances and their attitude to using alternative sources of short-term funding, such as overdrafts and credit cards.

D2 Stage 2 – understanding the client's status

The investment strategy involves understanding many of the more objective factors about clients, such as their tax position, the size of their portfolio and the extent to which they have built up investments in pensions and individual savings accounts (ISAs).

D3 Stage 3 – drawing up a statement of the client's investment aims

This should be a statement in which the client agrees to set out:

- the purpose of the investments;
- their income or growth objectives; and
- a statement about risk.

Example 1.3

Phil and Elena
Phil and Elena want their investments to provide them with capital growth so that they can retire in comfort in about 20 years' time. Phil and Elena have no need for their investments to provide them with income at present. They have agreed that growth is their main priority and would like to see a broad average annual return of about 6% a year.

Phil and Elena have accumulated £300,000 in UK equity collective funds that they do not intend to sell. They also have £55,000 in equity and cash ISAs, and £255,000 in a self-invested personal pension (SIPP) in cash. They are saving at the rate of about £30,000 a year.

They are prepared to take relatively large risks with their investments at present in view of their level of wealth and timescale. They would be prepared to hold all their assets in equities, although they think that such a lack of diversification would be unwise.

D4 Stage 4 – recommending appropriate asset allocation

This stage sets out the recommendations for the proportions of each asset class that the client should invest in. This is dependent on the client's investment risk profile. The main asset classes are likely to be:

- cash;
- fixed interest;
- property; and
- equities.

The statement may further refine the asset allocation by geographical spread and currency, or by market sectors. The financial planner may also consider including additional asset classes, such as commodities and hedge funds, if these are appropriate for the client's risk profile.

The asset allocation recommendation can be carried out by the financial planner or outsourced to a greater or lesser extent. Some outsourced systems and processes provide asset allocation models for each risk profile. The return for each level of risk lies on the 'efficient frontier'. This means that there is no other asset allocation that will give a higher prospective return for each level of risk.

Example 1.4

Phil and Elena (continued)
The asset allocation suggested for Phil and Elena is:

- 60% global equities;
- 20% fixed interest;
- 10% hedge funds; and
- 10% cash.

The asset allocation recommendation is usually backed up with information about past and expected future returns, as well as degrees of volatility.

D5 Stage 5 – making fund (or stock) selection recommendations

There are many different types of fund within the asset classes. As with asset allocation, financial planners can choose to provide in-house fund selection and management services, or outsource the function to a discretionary investment manager.

Example 1.5

Phil and Elena (continued)
Phil and Elena agree to invest mostly in a range of exchange-traded funds (ETFs) and in a minority of actively managed funds.

D6 Stage 6 – implementing and monitoring the plan

Once the recommendations have been accepted, the financial planner or investment manager will buy the appropriate funds or other investments, and continue to monitor and rebalance the investments, keeping them under review and revising the strategy as required.

E The benefits of using a financial planner

Clients may seek the services of a financial planner to deal with a specific issue or for a comprehensive financial plan. Generally, most clients are not aware of the range of functions of a financial planner and the benefits they can derive from their services.

As part of the process of establishing a sustainable professional relationship, it may be worth explaining the main advantages of using a financial planner. These include:

- identifying problems and goals;
- identifying financial strategies;
- setting priorities;
- researching the market for the best products;
- getting the planning done;
- making and/or preserving wealth, and providing peace of mind; and
- avoiding common financial mistakes.

Identifying problems and goals
Sorting out money problems can be a challenge for people from all walks of life.

Example 1.6

Frank and Ida

Frank and Ida are both university lecturers in their late 40s. They have built up credit card debt on which they pay very high rates of interest. The few financial goals they have are ill-considered and some of them are very unrealistic (such as the date at which they believe they could afford to retire).

They pay more tax than they need to because they do not use their ISA allowances. They can be irrational about money: for instance, Frank inherited some shares from his father which, out of respect, he has held unchanged. A financial planner could help Frank and Ida identify their money problems by giving them the advice they need to address these issues in a rational manner.

Identifying financial strategies

Many people find it hard to think clearly about financial issues. They could make good decisions if they were offered a range of possibilities, but they do not know their options. A financial planner can present a route map of different options, allowing their clients to make choices.

Setting priorities

Many clients need to talk through their aims and objectives in order to decide which are the most important. Often, they do not know their own mind until they have discussed it with an independent, knowledgeable third party who can listen, ask good questions and give a dispassionate view.

Example 1.7

Charlotte and Jane

Charlotte and Jane are a young couple who both work and have plenty of disposable income. To date, they have been putting aside some of this income, on an ad-hoc basis, to build up a deposit for their first home and spending the rest of it on weekends away with their friends. They are frustrated that they do not seem to have made as much progress with their savings as they would like, given the amount they earn. A financial planner can help them by setting up a more formal savings arrangement, so that they set aside a specific amount each month to achieve the deposit they require by an agreed date.

Researching the market for the best products

It is important to research the market to get to know the best products and providers. Due to the sheer volume of information available, this is difficult for an individual client to do, whereas a financial planning firm will have the resources and the know-how to do this.

Refer to

See *Product evaluation, research and selection* on page 6/35 for more on product evaluation and selection.

Getting the planning done

People who are time-poor and cash-rich very often do not have the time or motivation to do the hard work needed to put together a financial plan, even if they have the knowledge and skill.

Making and/or preserving wealth and providing peace of mind

Financial planners should help their clients to achieve reasonable rates of return on their investments without incurring undue levels of risk. They should also make sure that the main hazards are covered by appropriate insurance.

Avoiding common financial mistakes

One of the most useful ways that financial planners can assist their clients is by helping them to avoid common mistakes. Behavioural finance experts say that most of these mistakes are predictable and hard-wired into human beings. Just by pointing them out, financial planners can often stop clients from behaving irrationally in relation to their finances.

In particular:

- Most people procrastinate about planning and taking action to implement the plans.
- Many people spend too much of their income and do not budget.
- There is an associated tendency for people who spend too much to over-borrow, especially on credit cards and other expensive consumer debt.
- It is very common to delay planning for retirement or to save for other reasons. Most people overvalue the importance of immediate income and undervalue or ignore their future income needs.
- Many clients find it very tempting to choose investments that are too good to be true.
- Most decisions have a very big emotional component, and the financial planner can help clients to make them on more rational grounds.
- Clients often take on too much or too little risk.

Key points

The main ideas covered by this chapter can be summarised as follows:

The financial planning process

- The International Organization for Standardization's standard, ISO 22222, describes financial planning as a six-stage process:
  1. Establish and define the client and personal financial planner relationship.
  2. Gather client data and determine goals and expectations.
  3. Analyse and evaluate the client's financial status.
  4. Develop and present the financial plan.
  5. Implement the financial planning recommendations.
  6. Monitor the financial plan and the financial planning relationship.
- The financial planner should provide the client with a written document of the terms of engagement for the services to be provided. This should ensure that the client has a very clear idea of the scope of the work the financial planner will carry out and what the work will cost.
- The British Standards Institution's BS 8577 standard for firms provides a benchmark for best business and professional practice, and so underpins the standards for delivery of financial planning set out in ISO 22222.

The planner's responsibilities, the client agreement and types and limitations of advice

- The financial planner must tell the client whether they are an independent or restricted adviser, or if they give basic advice only.
- The planner is required to provide the client with certain additional specific information, such as the level of fees and areas of authorisation.
- The planner must have enough personal and financial information to ensure that any recommendation made is suitable for the client.
- Where a client is unwilling to disclose information, it may be necessary to treat them as an execution-only client.
- Depending on the type of advice given, there are differing minimum holding periods for keeping client records prescribed by the FCA.
- The FCA's new Consumer Principle requires firms to act to deliver good outcomes for retail clients.
- The financial planner should have enough information to know that the client:
  – can afford the recommendation;
  – understands the risks involved; and
  – understands how the recommendation meets their needs.

Establishing the clients' aims and objectives

- The planner will help the client identify their general aims and specific objectives. Objectives should be:
  – specific;
  – measurable;
  – action-related;
  – realistic; and
  – time-related.
- The planner should use a mix of open and closed questions in order to gather hard and soft facts, as well as to establish and clarify aims and objectives.
- It is important to distinguish between immediate and future objectives.
- Where possible, the planner should get the client to both quantify and qualify their objectives.

Key points

- In all likelihood, it will not be possible to address all of the client's objectives in full or at once, and so it will be necessary to help the client to prioritise.

Overview of the investment advice process

- A vital part of understanding the client's needs and goals is finding out how much investment risk the client is prepared to take.
- The FCA describes capacity for loss as 'the customer's ability to absorb falls in the value of their investment'.
- Risk tolerance is the degree of volatility in investment returns that a client is prepared to withstand.

The benefits of using a financial planner

- The main advantages of using a financial planner are:
  - identifying problems and goals;
  - identifying financial strategies;
  - setting priorities;
  - researching the market for the best products;
  - getting the planning done;
  - making and/or preserving wealth, and providing peace of mind; and
  - avoiding common financial mistakes.

2

Explaining financial risk and establishing a client's risk profile

Contents	Syllabus learning outcomes
A Explaining financial risk and volatility	*1.3*
B The concept of investment risk and understanding a client's risk profile	*1.3*
C Using risk profiling tools	*1.4*
D Establishing and explaining the client's risk profile	*1.4*
Key points	

Learning objectives

After studying this chapter, you should be able to:

- explain financial risk and volatility;
- identify the different types of risk that apply to clients;
- describe the use of, and the assumptions used in, risk profiling tools;
- explain how risk profiling tools link to the client's risk profile and the recommended plan; and
- establish the client's risk profile and explain what this means in terms that the client will understand.

Key terms

This chapter features explanations of the following ideas:

Changes in interest rates	Credit risk	Diversification	Inflation risk
Liquidity risk	Mortality and morbidity risk	Non-systematic risk	Political and regulatory risk
Pound cost averaging	Psychometric risk profiling	Risk aversion	Risk profiling
Stochastic modelling	Systematic risk	Tolerance of risk	Volatility

A Explaining financial risk and volatility

Much of the financial planning process involves explaining risk to clients and observing their reactions in order to understand the level of risk they are prepared to take. The word ‘risk’ has several different meanings and applies to many aspects of life. Few clients will have given much thought to investment risk or the key metrics of the past performance of the different asset classes. Similarly, many will not have considered their own risk of mortality or morbidity.

The main area of risk to consider is investment risk, but there are several other types of financial risk that can be identified during the financial planning process that present significant issues. These include mortality and morbidity risk, unemployment, relationship breakdown, litigation, and loss of home or possessions.

The following sections will look at these financial risks in further detail.

A1 Mortality and morbidity risk – financial loss in the event of death and incapacity through illness or accident

An important part of the financial planning process is considering the implications of premature death or incapacity through illness or accident for a client, members of their family and other dependants, i.e. the ***mortality and morbidity risk***.

A premature death in a family – of the breadwinner, other income earners or the homemaker – will usually lead to a loss of earnings and/or higher expenditure. The financial planner should estimate these losses and costs, and arrange insurance cover over the appropriate period.

Incapacity, whether brought about by illness or an accident, can lead to a loss of earnings and extra expenses. Loss of earnings is critical for people of working age. The resulting increased expenditure will also be significant for anyone who will need extra help in looking after themselves or their family, whether they are working or retired and whether they are caring for children or other dependants.

Most life risks are associated with premature death, but there is also the danger that a person could outlive their finances in old age – a risk known as longevity risk. In deciding whether to buy a lifetime annuity, the financial planner has to help clients decide between the relative attractions of flexibly accessing their pension fund and the longevity insurance provided by a standard annuity. However, since the introduction of pension flexibility, there is an emerging middle ground of flexible lifetime annuities that offer a degree of flexibility, with the extent of the flexibility determined by the annuity provider.

Reinforce

Now that members of defined contribution pension schemes can, if they want to, cash in their entire fund from age 55 (currently), the danger of outliving one’s pension pot has become a reality for many.

A2 Unemployment

Most people of working age should be prepared for a period of unemployment at some time in their careers. State benefits might provide a cushion for some people. However, in most cases, clients will find that the level of benefit is insufficient to meet their normal outgoings, especially during the delay that typically occurs before the Department for Work and Pensions (DWP) pays benefits.

There are two main approaches to unemployment provision:

- building up an investment cushion or savings; and
- taking out unemployment insurance, where available.

Both of these provide temporary help, but more drastic changes to lifestyle, and particularly to housing, may be needed if there is a prolonged period of unemployment.

A3 Relationship breakdown

A high proportion of relationships and marriages end in divorce or separation. For couples who are unmarried, some kind of agreement is advisable; for married couples or civil partners with very substantial assets, pre-nuptial/pre-civil partnership agreements may provide a degree of protection now that UK courts are paying increasing attention to them.

A4 Litigation

Society is becoming increasingly litigious. Losing a court case or being financially unable to fight one could be very harmful to a client's finances. Legal expenses insurance, either as part of a home insurance policy or as a stand-alone policy, can therefore be very valuable.

A5 Loss of home or possessions

The loss of a home that is uninsured or underinsured could be a major financial disaster. It is essential that a client's major possessions are fully insured. Lenders generally insist on cover for a property on which they have a charge, but it is not safe to assume that all homes are insured. Many are not subject to a mortgage – and where a mortgage does exist, lenders usually only require buildings cover, meaning that the contents may not be covered.

B The concept of investment risk and understanding a client's risk profile

One of the FCA's fundamental principles is that a firm must give suitable advice to a retail client and it must have enough information about the client to ensure this requirement is met. In particular, every client needs to understand the risks that are involved in an investment that is being recommended to them and how it will meet their objectives and needs. Understanding the client's risk profile and capacity for loss is an important part of the process.

Activity
The FCA has a section on their website that brings together key material about assessing suitability. Visit: *www.fca.org.uk/firms/assessing-suitability*.

B1 Types of investment risk

Risk can be categorised in different ways. The main types of risk are:

- ***Systematic risk*** (or market risk) – the risk that there might be a reduction in expected returns as a result of a fall in stock markets generally.
- ***Non-systematic risk*** (or investment-specific risk) – the risk that there might be a reduction in expected returns as a result of some event or circumstance specific to a particular company.

Inflation risk is a major consideration in the design of any investment plan. Inflation erodes the value of the capital and interest payments of deposit-based investments, leading to negative real returns in many cases. The best long-term protection against inflation is thought to be provided by long-term investment in real assets, such as shares, property, infrastructure and commodities.

Changes in interest rates affect the relative attractiveness of different investments. Rising rates present a risk to those unable to switch out of fixed rate products and can lead to lower dividend payouts. Falling rates make variable rate accounts less attractive.

Political and regulatory risk: Political risk is the term used to describe the risk that a new or changed government will have different fiscal and monetary objectives, including a decision to make changes to the taxation system (**taxation risk**). Similarly, regulatory risk is the risk that a change in laws and regulations will materially impact the returns of an individual investment or a particular market.

Credit risk is particularly important for investors in bonds or those placing deposits with financial institutions. There are a number of types of credit risk, including:

- **Default risk** – the risk that the value of a fixed-interest investment will fall when a credit rating agency, for example, decides that the probability of default has increased.
- **Downgrade risk** – the risk that a credit agency downgrades a bond and the price falls.
- **Counterparty risk** – the risk that any counterparty to a contract will not pay what it is has promised to pay.
- **Bail-in risk** – the risk that an institution’s shareholders, bondholders or depositors are called on to provide assistance.

Where an investment is made overseas by a UK-based investor, there is **currency risk**. This is the risk that sterling may appreciate against the overseas currency. For example, if sterling is strong against the US dollar, any capital growth can be eliminated from investment in US markets and the value of dollar dividends in sterling terms is reduced.

A final key risk is ***liquidity risk***. This is the risk faced by investors when they are forced to sell a security at a price below its fair value. Asset classes such as private equity and property can be particularly illiquid.

Diversification

The most important strategy for reducing risk is ***diversification***, i.e. investing in a variety of asset classes. Diversification can take place across the main asset classes, across world markets and within individual markets, such as different sectors within the UK market.

Diversification:

- reduces the risk of relying on any one particular investment and avoids over-exposure to a single asset class;
- spreads the opportunity for potential returns and protects against inflation across the asset classes;
- minimises the risk and ***volatility*** of the overall portfolio by investing in uncorrelated assets;
- increases the possibility of stable returns through all economic cycles; and
- when combined with regular rebalancing, can ensure that a portfolio stays in line with the investor’s attitude to risk over time.

Pound cost averaging

Rather than investing a single lump sum, making regular contributions into a savings or pension contract can reduce risk and enhance returns. Risk is reduced as the chances of investing at the very top of the market or just before a significant fall are lessened.

For example, if you invested a lump sum of £10,000 just prior to a stock market crash, you would, on paper at least, make an immediate and significant loss. However, if you decided to invest £1,000 a month over ten months and the market crashes after your first payment, your initial paper loss is smaller, and the remaining contributions may buy more units or shares than you might otherwise have been able to because the price is lower. This is known as ***pound cost averaging*** and can offset the effects of volatility, providing the long-term direction of investment value is upward.

Investing on a regular basis can also help with an individual’s liquidity position, in so far as smaller, more frequent contributions do not require them to give up access to a lump sum that might otherwise be earmarked for another use.

B2 Investment risk aversion

Unsurprisingly, most people do not like the risk of making a loss. Clients need to understand that their ***risk aversion*** is reasonable, but that financial planning inevitably involves managing risk rather than avoiding it altogether.

- Rational investors will choose an investment that never falls in value (all other things being equal) because this gives them the option of selling the investment at any time without penalty.
- However, investors are generally forced to choose between investments. For example, a client may have to decide between equities that are relatively volatile but have the potential for relatively high long-term returns and cash deposits that are stable but generally produce low long-term (and currently short-term) returns.
- Some of the risks of investing in equities can be reduced by diversifying into a range of different shares, sectors and markets in order to avoid non-systematic risk and correlated returns (all shares moving up or down together). Diversification into different asset classes can also reduce risk because returns are generally uncorrelated. However, there are periods (e.g. in 2008/09) when diversification as a strategy is largely ineffective because all sectors, markets and most asset classes are moving together in the same direction.
- The difference in the rate of return between an investment involving risk and a risk-free investment is the 'risk premium'. This is the amount that investors require above the rate that they can obtain in a safe investment in order to persuade them to invest in a riskier one.
- If investors are investing for the long term, the risk of day-to-day volatility is relatively unimportant, because what really matters is the long-term return. They can benefit from buying investments with fewer guarantees but a long-term higher total rate of return, as long as they benefit from the extra return provided by the risk premium.

The warning that past performance is not a reliable indicator of future results needs emphasising. The events of 2008/09 have shown that the unexpected can happen and that the behaviour of markets over long periods does not help to predict major catastrophes and their consequences. The scale and breadth of the 2008 global financial crisis looks surprising from the point of view of textbook modern portfolio theory, most painfully in the failure of diversification to offer expected levels of protection. Therefore, financial planners and their clients need to avoid making deterministic predictions about the behaviour of investments.

More recently, the FTSE 100 fell by 14.3% during 2020, suffering its worst year since the 2008 global financial crisis. It has, however, almost recovered to its pre-pandemic level with many analysts predicting further gains as 2022 progresses.

This does not necessarily mean that financial planners and their clients should abandon the insights about risk that modern portfolio theory has provided. However, it should lead everyone to be sceptical about drawing conclusions about the short-term predictability of investment markets.

Financial planning is about helping investors meet their medium- and long-term investment goals.

Therefore, planners should focus on helping investors to:

- Think rationally about what they are trying to achieve with their investments.
- Understand what matters to them and hence what risk is and their attitude to it.
- Construct sensible strategic and long-term asset allocations to achieve goals consistent with their views about risk.
- Have realistic expectations about outcomes.
- Monitor the progress of their investments against their goals.

In this context, relatively short-term phenomena like the 2008 global financial crisis and the COVID-19 pandemic should not deflect an investor.

Stochastic models used for financial planning may take these events into account in producing long-term forecasts but should not be used for tactical asset allocation. These stochastic models are not designed to predict specific events. A good stochastic model should take events like a financial crisis into account in producing its long-term forecasts, but it cannot predict that a recession is about to occur.

B3 Risk profiling

People's tolerance for investment risk varies, and investment risk means different things to different investors. Variations arise because of the diversity of clients' individual circumstances, experiences and psychological make-up.

Financial planners need to establish what risk means to a particular investor – in other words, what would be the most worrying outcome from an investment in relation to a specific goal. They also need to know the level of losses that a client is prepared and able to tolerate from their investments in return for the prospect of investment returns. This process is generally described as ***risk profiling***.

Rational investors aim to minimise risk and maximise their investment returns but, in reality, risk and return are generally positively correlated. Clients who are only prepared to hold low-risk investments cannot usually expect high long-term returns and might therefore fall short of their objectives (e.g. in providing a target level of income in retirement). Clients who are prepared to buy investments with greater risk may have the prospect of higher long-term returns than those expected from an asset class like cash, but they might be disappointed if the investments fall in value at the time they are needed.

The risk assessment process should aim to understand two main aspects of the client's position:

- their aims and the resources available to meet those aims; and
- their objective and subjective ability to tolerate losses.

Based on the risk profiling process, the planner should be able to recommend an appropriate spread of asset classes, depending on their likely risk factors and the need to diversify the investments. After that, they should consider issues such as fund selection and choice of tax wrapper.

B4 Risk profiles – objective and subjective factors

A client's risk profile is made up of both objective and subjective factors.

Objective factors include a client's timescale, income and asset position. For example:

- A short timescale means that investments will have little time to recover from fluctuations.
- Someone with a relatively high income and/or net assets can generally afford to take higher risks than someone with fewer financial resources.

The degree to which someone can afford to take on risk is sometimes called their **risk capacity** – that is typically the monetary amount that a person can afford to lose without it endangering their financial objectives.

Subjective factors include a client's attitudes and aims. For example:

- Some people are temperamentally more risk averse than others. In many cases, attitudes may be psychologically deep-seated, but they may also be the result of a lack of understanding of investment and financial issues.
- The psychological trait of risk tolerance or risk preference is reasonably stable but may be affected by life events. It describes the extent to which a person is prepared to trade off risk against possible return.

These objective and subjective factors may overlap. Someone who is relatively prosperous and who may not be retiring for a long time tends to be psychologically much more relaxed about risk than someone who has limited means and/or is close to retirement.

Example 2.1

Risk assessment

In retirement planning, risk assessment involves establishing the target level of retirement income and capital, and comparing this with the funds available and the realistic level of saving between now and retirement that the client is able and willing to undertake.

For example, Garth, aged 45, wants to retire in 20 years' time (objective factor) with a retirement income of £12,000 a year and a capital sum of £30,000 (his aims). His current pension plan, which is invested in a fairly cautious fund that matches his attitude to risk (subjective factor), is on target to provide him with an income of £9,000 a year and a capital sum of £25,000. He has disposable income of £200 a month (resources – objective factor) but no other savings or pension provision (resources – objective factors).

Garth has three choices, each with its own risk. He can:

- increase his contributions into the existing fund;
- move to a higher-risk fund in the hope of achieving the higher return he needs; or
- revise his retirement income and capital targets to £9,000 and £25,000 respectively.

Ultimately, his choice will depend on the relative importance of his aims and risk profile, and which risk he is most comfortable with taking.

B4A Investment risk and capacity for loss

Volatility in isolation cannot provide the full picture of a client's attitude to investment risk. A client may be willing to accept the volatility of the stock market, but the impact this might have on their lifestyle if they are not able to achieve their financial objectives must also be considered.

As previously stated, the FCA defines 'capacity for loss' as 'the customer's ability to absorb falls in the value of their investment'. The factors that determine this are mainly objective, although some subjective factors may be included. It is difficult to gauge capacity for loss through the use of a questionnaire, as there are many different factors that will have an influence on each individual client, such as the size of the investment in relation to their overall portfolio and the timescale for achieving the investment objective.

Example 2.2

Nikolai and David

Nikolai, aged 55, is a member of a defined benefit (DB) pension scheme that, if he stays with his current employer, will provide 30/80ths of his final salary as a pension when he retires at age 65, along with a lump sum. When he does retire at 65, he intends to indulge his passion for sailing and, to maintain his desired lifestyle, he will need an income of at least 75% of his salary in today's terms. He intends to use his lump sum to buy a boat, and this is likely to use up most of his capital assets. His retirement age is important, as he will need to be reasonably fit.

David is also aged 55 and a member of a small self-administered pension scheme that is projected to provide around 35% of his current salary at age 65, plus a lump sum. He enjoys his job and, although he has always aimed to retire at age 65, he is not sure that he will actually be ready to stop work in ten years' time. He is targeting around 65% of his salary as retirement income, as this would provide a comfortable lifestyle, but he could probably survive on around 50% if necessary.

At first glance, it would appear that Nikolai would have a greater capacity for loss than David, as he has a guaranteed source of income. However, he has a much bigger gap in terms of his income requirement, 37.5%, and his timescale is relatively fixed. If he does not meet his target income by his selected retirement date, this will likely have a huge impact on his ability to achieve the lifestyle he wants. Given the circumstances, Nikolai would have a low capacity for loss.

David, on the other hand, is prepared to work for longer and has a more modest income requirement. If he were unable to achieve his target income at age 65, it is likely that he would continue working for a number of years and this would not unduly impact his lifestyle. Therefore, he would have a greater capacity for loss.

Along with establishing client goals, it may be useful to establish a baseline, or the minimum amount that would be acceptable. In the example, Nikolai has little room for manoeuvre; even a small drop of 5% in his retirement income is likely to impact adversely on his ability to achieve his objectives. David, on the other hand, could absorb a reduction of around 15% in his retirement income before it reached an unacceptable level.

Refer to

See *Lifetime cash flow projections* on page 4/26 for more on cash flow modelling.

Cash flow modelling can be used to establish the client's capacity for loss boundaries by working through various stress-testing ('what if') scenarios demonstrating the effect that different factors could have on their investment objectives.

An alternative approach involves focusing on forecast outcomes over periods that are similar to the investor's goal. This gives a longer-term perspective to risk that is appropriate to a client's time horizon for investment and avoids some of the limitations outlined earlier. A stochastic model can be used to produce these forecasts, and the results can be presented in a way that makes the risk/return trade-offs real to the investor.

It is also possible to use stochastic forecasts to express risk as a potential shortfall in an outcome. This can be a very powerful way of communicating risk. For example, a financial planner could explain that, based on a forecast of the client's retirement income in 15 years' time, the most likely shortfall is £40,000 a year; however, there is a 25% chance that the shortfall could be £6,000 a year less if the client follows an 'adventurous' investment profile.

Consider this…

What are the different types of risk that may have an impact on investment advice?

B4B Factors that can affect a person's tolerance of risk

A person's risk profile is not necessarily static. The process of establishing aims and objectives, and discussing the behaviour of asset classes and investments generally, can in itself change a person's willingness to take on more or less risk.

Refer to

See *Behavioural finance* on page 5/2 for more on behavioural finance.

Through this discussion, the person may also gain further understanding of the predictable mistakes that most investors tend to make and the biases that people have. Behavioural finance has provided many insights into investors' irrational behaviour, and sharing some of these with clients can help them to make better decisions.

Many people are initially poorly informed about investment issues and change their views as they learn more. In their discussion with their financial planners, they should learn about the past performance of different asset classes, which should help them to understand broadly how different types of investment might behave in the future.

For example:

- The discussion of the long-term returns on asset-backed investments (such as equities) might lead a client to consider more equity-based investments for a strategy with a 20-year time horizon. The same discussion might lead them to think that only cash deposits or similar holdings would be appropriate for an investment with a one- or two-year period to maturity. Stochastic modelling, in particular, can provide a robust underpinning to the advice process, helping clients and their advisers understand the trade-off between risk and return.
- Many clients are overly reliant on certain types of investment, e.g. shares in the company that employs them or investments that they have inherited. The 'familiarity effect' and 'endowment effect' are well established in behavioural finance studies, and part of the process of advice may require moving clients on from such attitudes. This irrational approach can paradoxically lead to clients taking higher overall risks with their portfolios if they are not prepared to diversify and buy non-correlating investments.

- People disproportionately dislike losses more than they like profits, according to prospect theory. A profit of £1,000 is psychologically less appealing than a loss of £1,000 is upsetting, even though they balance one another.
- Attitudes can change with circumstances. A client who is worried about being made redundant is likely to be more cautious than a client with greater job security.
- ***Tolerance of risk*** is to some extent correlated with education and age. Better educated and younger people are generally less risk averse, according to FinaMetrica, an adviser risk profiling business owned by Morningstar.
- Risk tolerance can increase as people become used to dealing with risk. Someone who has lived with the fluctuations of the equity market is likely to be more capable of dealing with the stress than someone who is new to equity investing.
- The event sequencing of early outcomes from investing can have a considerable influence on people's attitudes to risky investing. Someone whose first experience of investing has led to a gain will be much more optimistic (early win effect) than an investor whose first experience was a loss (snakebite effect).

Refer to
See *Psychometric risk profiling* on page 2/11 for more on risk profiling.

In many respects, the discussions about investment and risk are at least as important as the risk profiling process itself. Clients may well change their minds as a result of the discussions. However, it is essential that financial planners are scrupulously fair and do not seek to persuade clients into investment strategies that may lead to losses they cannot tolerate.

B5 Investment risk and volatility

Typically, advisers assess clients' risk profiles and assign asset allocations or product solutions to the different risk categories – one for the cautious investor, another for the balanced investor and so on. However, this raises a number of questions:

- How are these asset allocations or product solutions determined?
- How are they mapped to the risk profiles?
- What does risk really mean in the context of the client's circumstances and objectives?

There are many possible definitions of risk. For example, it could be risk of capital loss, e.g. 'I've worked hard for my money and I would hate to see it just go up in smoke'. Alternatively, it could refer to a threshold, e.g. 'I really need a retirement income of at least £20,000 a year or I won't be able to make ends meet'. It could also be the amount of variation or volatility in the outcome at retirement, as well as the effect of inflation.

Despite this, the default definition is frequently short-term volatility. But does annual volatility of returns have any real meaning or relevance to the investor, especially where the aim is long-term capital growth? These may seem like academic questions, but they really matter to investors and their expectations.

B5A Volatility as a measure of risk

Refer to
Stochastic modelling is discussed further in *Stochastic modelling* on page 2/13.

Stochastic modelling can provide simple and direct solutions that are also robust and influential. Rather than simply defining risk as the volatility of annual returns, it can define risk in a way that is meaningful to investors. It can also give them a well-rounded view of their prospects based on the things that really matter – likely outcomes.

Nevertheless, volatility of investment returns is the most frequently used measure of risk. Some investment risk ratings are based on the standard deviations of returns over 36-month periods, while others focus on forecast outcomes over longer time horizons.

Standard deviation is a convenient way to measure risk. The different risk levels associated with different investments can be reduced to a simple series of comparable numbers, and it is also possible to use a ratio – the Sharpe ratio – that relates returns from investments to their volatility. The Sharpe ratio allows investors to see to what extent managers achieve investment returns by taking excessive risk and to what extent they have been skilful.

It is also relatively easy to convey the practical meaning of standard deviation to clients in order to describe the risk that they are taking on. In broad terms, a standard deviation for an investment of 4% means that, based on past performance, the investment should not fluctuate up or down by more than:

- 4% for about 68% of months;
- 8% for about 95% of months; or
- 12% for about 99.7% of months.

Very occasionally – less than one month in 200 – it might fluctuate by more.

The use of volatility as a proxy for risk has certain limitations. In particular:

- Measures of volatility are drawn from past performance figures. These may not resemble the future and can even change rapidly and radically. In 2008, the fluctuations in many markets were much greater than expected and led to some suggestions that the normal distribution curve on which standard deviation is based may not be an appropriate way to describe investment markets.
- Volatility measures do not necessarily measure trends. The volatility of a declining investment could be the same as the volatility of a rising investment.
- Short-term volatility may be very different from long-term security of returns. Arguably, long-term (20 years) cash returns from gilts have been very variable, depending on such issues as interest rate trends and inflation. In some periods they have been good, e.g. the 1990s to 2008, but in some periods, such as 1945–90 and from 2009 onwards, they have generally been poor.

It is important to explain to clients these limitations, especially that data about past performance can be misleading if used as a guide to future performance.

Another way to communicate risk to clients is to provide them with information about the maximum loss or fall in value that a type of investment has shown over a given period from peak to trough. This is often referred to as drawdown. It is helpful because most clients find this simple to understand. Like volatility data, drawdown data are based on past performance, which may vary considerably over time. There are, however, some aspects of the future that are simply unknowable.

B6 The complexity of risk profiling

A much-used approach in establishing a client's attitude to risk is to describe different types of investment attitudes to find out which is closest to the client's view. It is important that the profiles are in written form to ensure objective analysis and proper recording.

There are a number of different approaches, one of which is given in the following example.

Example 2.3

Simple approach to establishing a client's attitude to risk
Which of the following descriptions best describes your attitude to risk?

- no risk;
- low risk;
- low/medium risk;
- medium risk;
- medium/high risk; or
- high risk.

This methodology – or some variation of it – has been widely used in the past. However, there are a number of problems with this simplistic approach, as the terms are not precise.

'Medium risk' and 'five on a scale of one to ten', by themselves and out of context, are largely meaningless descriptions of a client's risk profile. Many clients accept a low or medium risk description because it sounds reasonable, but without any clear idea of what risks they are incurring. It is necessary to spell out the implications in terms of what might happen to the investments, allowing the client to see what kinds of risks and returns they are prepared to take on.

Similarly, clients can interpret 'low risk' or 'medium risk' differently, even after the situation has been explained. Furthermore, 'very likely to increase in value over a five-year period' could imply a 70% chance of growth to one investor, but a 95% chance to another investor.

B6A Critical yield

The rate of return needed to meet the objective based on a given level of investment is often described as the 'critical yield'.

One way to help clients consider their approach to investment risk is to present them with a choice based on the critical yield or investment return required to achieve a set objective. Critical yield is the level of return required from investments to achieve specific objectives.

For example, a client may not build up enough retirement funds to enjoy the standard of living that they want. Achieving the target level of funds will be dependent on two factors:

1. the level of investment; and
2. the rate of investment return.

In many situations, a client is faced with a choice.

If the level of investment is a current fund of £*y* plus ongoing regular savings of £*x* a year, the client will need to have a critical yield (or rate of growth) on those investments of *z*% in order to meet their objective. In many cases, the critical yield needed to achieve the target fund implies that the investment strategy will be relatively risky.

They have to decide whether to accept:

- a higher degree of risk than is usually acceptable, with the possibility of a shortfall that might be even greater than from a less risky strategy if the investments drastically underperform;
- a lower standard of living associated with a lower target fund, but with a much lower chance of underachieving this target; or
- the need to invest more now or in the future.

The concept of critical yield may be helpful in clarifying this choice. However, it should be combined with the use of stochastic modelling. This is to provide objective guidance on the chances of meeting the critical yield and what investments would be required without exposing the investor to unacceptable degrees of risk.

C Using risk profiling tools

Increasingly, many financial planners use computer-based risk profiling tools. Others rely on formal interviews. Very often it is a mix of these two approaches, with the output from the risk profiling tool forming the basis for discussion.

The risk profile of the client may be ascertained as much, if not more, from factors implicit in the fact-find. Past employment history and investment strategy may indicate a cautious approach, even though the client may say that they have a 'medium risk' or 'high risk' approach to investment. In such a case, the adviser needs to ask further questions; otherwise, there is a risk that investing in volatile equity-based funds will not be appropriate (despite the stated attitude of the client). The client may want to sell when the investment falls in value rather than hold on for an improvement.

The level of the client's wealth is likely to be a major factor. A relatively rich client may be in a better position to tolerate investment losses than a relatively poor client.

C1 Psychometric risk profiling

The aim of ***psychometric risk profiling*** is to assess the client's psychological risk tolerance or preference, rather than their objective financial capacity to take risks.

There are several ways to undertake psychometric risk profiling, but it will usually include questionnaires or surveys on how a client makes decisions or what kind of actions they feel comfortable with.

On the Web

An example of a psychometric risk profiling tool is provided by FinaMetrica, which gives further details and sample reports on its website, accessible at: *www.riskprofiling.com/Support*.

FinaMetrica's input is a 10- or 25-question online questionnaire, and the output is an instant report setting out the client's views about risk-based decisions and tendencies.

C1A Preferred portfolio

Under the FinaMetrica risk profiling tool, the client can choose their preferred investment mix from five or seven portfolios. Each of these holds a different proportion of investments characterised as low, medium or high risk/return. Cash deposits are described as examples of low risk/return investments, while shares and property are given as examples of high risk/return investments.

The results of the 25-question risk profiler categorise clients into one of seven broad risk groups (see the table that follows), which the planner can then use to determine an appropriate asset allocation.

Table 2.1: Risk/return mix

Portfolio	Low	Medium	High	
1	100%	0%	0%	Extremely risk averse – about 1% of clients.
2	70%	30%	0%	Very risk averse.
3	50%	40%	10%	Slightly more risk averse than the average.
4	30%	40%	30%	Typical levels of risk aversion/tolerance.
5	10%	40%	50%	More risk tolerant than the average.
6	0%	30%	70%	Very risk tolerant.
7	0%	0%	100%	Extremely risk tolerant – about 1% of clients.

Source: FinaMetrica

The majority of clients fall into categories 3, 4 and 5. The strength of this psychometric approach is that it allows clients to consider their attitude to investment decisions very carefully and to articulate this to the financial planner. The planner can then ask further questions and discuss the relationship of risk to the behaviour of different asset classes.

However, as FinaMetrica points out, the psychological profile is only one of the inputs into the investment decision-making process. Still, it is a good starting point for a discussion that could include the impact of the profile on potential outcomes for the client's different goals.

C1B Downsides to risk profiling

There are a number of downsides to computer-based risk profiling tools. These include:

- For joint clients, differing results for each party may require further discussion.
- Different tools may produce different results and are not client specific, casting doubt on reliability.
- Clients may misinterpret or not understand questions asked, skewing the results.
- Clients may have a different risk profile for each of their objectives, meaning the profile has to be done more than once, which can be time-consuming.
- Risk profiling tools are unsuitable where a client has a zero capacity for loss.

It is for these reasons that the most important part of the risk profiling process is generally considered to be the discussion between the planner and the client after the risk profiling questionnaire has been completed, rather than the questionnaire itself.

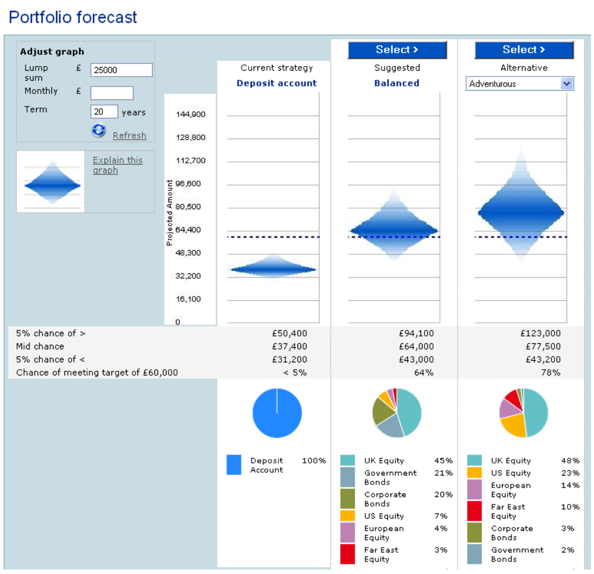
C2 Stochastic modelling

Another popular approach is asset allocation using ***stochastic modelling***. The intention of these models is to predict probable outcomes for different investments depending on a range of assumptions in an uncertain world. The word 'stochastic' means having a chance or random element.

An example of this kind of risk profiling in the UK is the model based on Willis Towers Watson Global CAP:Link software calibrated by EValue. This model is incorporated into several software companies' client management systems as well as their product provider/platform provider sets of online tools. The aim is to help explain investment risk to the client, compare alternative strategies, recommend a portfolio of suitable investments and then monitor and review their subsequent progress.

The stochastic model forecasts a range of possible returns from different portfolios of investments. This is shown in the following figure.

Figure 2.1: Portfolio forecast – 20 years



Source: Willis Towers Watson.

A stochastic model, such as the one shown, shows the range of possible outcomes from each portfolio and the probability of achieving those outcomes, enabling the client to choose those most appropriate for them. Each diamond shape shows both the range of possibilities and their likelihood; the widest part of the diamond is the most likely outcome. In the 20-year forecast shown in Figure 3.2, there is a target income of £60,000.

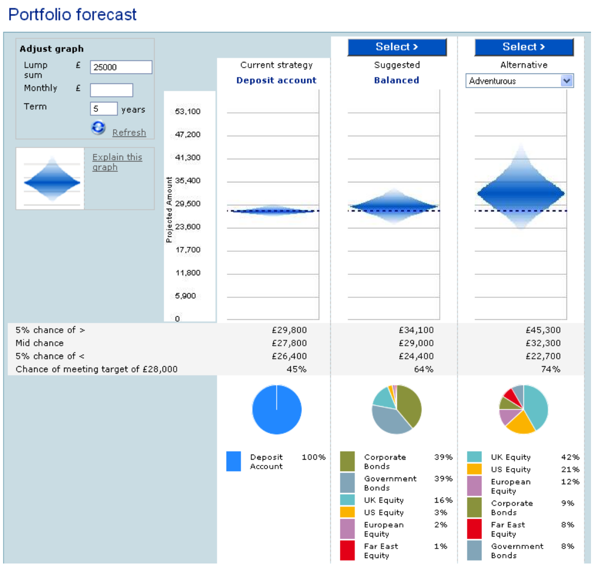
1. The model produces a projection of the most likely income returns from three different asset mixes. The current portfolio (deposit account) will probably produce an amount of £37,400 in 20 years' time, whereas if the client invests in the middle portfolio – characterised as 'balanced' – the most likely outcome is £64,000. The alternative 'adventurous' portfolio is estimated to produce a likely amount of £77,500.
2. The model also produces a pictorial illustration of the range of less probable outcomes that might happen. The width of the diamond and the intensity of the shading show the degree of likelihood that the model attaches to each level of outcome. The height of the diamond shows the range of probable outcomes.

   The high estimate (i.e. less than 5% probability of achieving more than this) shows the optimistic outcome; the low estimate shows a pessimistic return (i.e. less than 5% chance of achieving less than this). In the case of the client's 'current' portfolio, the lowest likely return is £31,200 and the high return at £50,400 is still well below the target.

   In contrast, the second portfolio could produce an optimistic high return of £94,100 and a pessimistic return of £43,000. For the 'adventurous' portfolio, there is a very wide range of possible outcomes (optimistic £123,000 and pessimistic £43,200) but, on balance, this is likely to be much better than either of the other alternatives.

3. Another way to help the client pick the appropriate asset mix is to consider the chances of reaching the target income of £60,000. The bottom line shows this as a percentage probability: less than 5% for the current portfolio, 64% for the balanced portfolio and 78% for the adventurous portfolio. This system of illustrating the possible outcomes shows how high equity exposure is likely to improve returns and does not involve high risk in the long term.
4. If the same forecast is performed over a shorter period of five years (as shown in the five-year forecast that follows), the probability of achieving the target (£28,000 in this case) still rises, as equity exposure increases. However, there is now much less of a shortfall risk at the lower end of the risk spectrum on account of the shorter term.

Figure 2.2: Portfolio forecast – five years



Source: Willis Towers Watson.

Stochastic models are based on modern portfolio theory and so they are open to the same criticisms. It is essential that a planner using this type of tool understands the key assumptions in the model and the effect of changing them.

Another criticism of stochastic modelling is that it cannot show the effects of specific future events on the client's financial position. Although useful for broad planning purposes and for illustrating potential outcomes based on known assumptions, stochastic modelling is just another tool in the process and should not be relied on entirely. In particular, it is well established that most people are not very good at probabilistic reasoning. Their understanding of a stochastic modelling process is also likely to be poor and, if such models are used, the planner will need to ensure these issues are explained.

C2A Assumptions underlying the modelling

When risk profiling and asset allocation models are delivered separately (i.e. not from the same source), there is a danger that different approaches may be used to assess the future risk/return behaviour of the various investment classes.

Despite the approach taken in helping clients to understand their attitude to risk and the resulting appropriate asset allocation, the aim should be to use the following assumptions:

- **Conservative**. They should not be excessively optimistic.
- **Consistent**. There are certain relationships that do not vary greatly. The yield on gilts is usually less than the yield on even the best commercial debt because the UK Government usually has a higher credit rating. Inflation rates should be consistent with assumptions about yields and dividend growth rates. Returns on property and other asset classes should be consistent with equity returns and bond yields, and there needs to be consistency between geographical markets. Consistency is also needed when applying the measure of the risk factors of the different asset classes because, without it, serious distortions can occur in the asset allocations based on the assumptions.

- **Realistic**. The assumptions should draw on past experience and well researched views about future trends. Excessive pessimism should be avoided.

Financial planners need to understand the nature of the assumptions underlying the model. These assumptions are many and complicated, reflecting the possible behaviour of a range of asset classes in a complex international world.

Some models essentially extrapolate future investment behaviour from past trends. Others draw on past experience but base their assumptions about future investment behaviour on a wide range of current trends and estimates of future developments.

The models that depend on assumptions entirely based on past trends have the advantage that they are rooted in fact. They do, however, have some drawbacks:

- Extrapolations from the past can vary greatly based on the time period used, e.g. the pattern of the last 15 years will differ greatly from a period which includes the volatility of the 1970s. External factors may have an effect, such as the perceived improvement in the UK economy following the 2008 global financial crisis. This may have been due to the quantitative easing carried out by the Bank of England rather than being a true reflection of economic conditions.
- Another drawback of extrapolating from the past is that we know the future will not be the same. Globalisation, the rise of China and other emerging markets, the 2008 global financial crisis and its aftermath, Brexit, COVID-19, the impact of climate change on policy-making, changing technology and the growth in the derivative markets will all help make tomorrow very different from yesterday.
- Consideration should also be given to the FCA's warning that past performance is not a reliable indicator of future performance.

Predictions about the future not rooted in past performance can vary even more, depending on the competence and perceptions of the forecasters. The financial world is highly complicated, and the experience of the 2008 global financial crisis and the COVID-19 pandemic should be enough to demonstrate that it is very difficult to predict future short-term investment performance. However, there should be greater confidence about the long-term performance and the relative attractions of different asset classes.

Willis Towers Watson's EValue system draws on a variety of approaches to forecast probable future investment trends and uses stochastic modelling to assess the likelihood of the various scenarios. The model is constantly updated as EValue develops its views about future trends. Key inputs relate to the relationships between short- and long-term interest rates, growth in real gross domestic profit (GDP), inflation and currency alignments, as well as returns on equities and other asset classes.

Relying on modelling

It is important not to place excessive reliance on modelled predictions of the future. They are only guidelines as to what might happen based on reasonable assumptions. Predictions are bound to vary as circumstances change.

There are also events that cannot be predicted, and different models and groups of forecasters may well come up with a range of predictions.

Example 2.4

Modelling assumptions

The long-term assumptions used in modelling and in other areas of financial planning, such as lifetime cash flow forecasting, might be as follows (they do not relate to any particular year and are for illustration purposes only).

Annual rates

- Inflation: 2.5%.
- School fees growth: 5%.
- Earnings growth: 4%.
- Sterling deposit interest: 0.5%.
- Ten-year gilt yield: 4%.
- Ten-year commercial bond yield: 5%.
- UK fixed-interest five-year volatility: 2%.
- UK dividend yield: 3%.
- UK equity growth: 4%.
- UK equity five-year volatility: 4%.
- Overseas equity dividend: 1%.
- Overseas equity growth: 4%.
- Overseas equity five-year volatility: 6%.
- Property yield: 4%.
- Property growth: 4%.
- Property five-year volatility: 3%.
- £ to € exchange rate: 1:1.16.
- £ to US$ exchange rate: 1:1.39.

All these assumptions need to be questioned and kept under constant review. Clients need to understand that the assumptions are best guesses based on the circumstances prevailing at the time of the financial planning. In principle, the assumptions are about long-term trends, but they have to be adjusted to reflect major shifts.

D Establishing and explaining the client's risk profile

It is important to record the result of the discussion about the client's risk profile in the financial planning report. This will allow the client to reconsider the agreed position and perhaps revise it further if necessary. It is also an important record to refer to later if needed.

The report should contain a statement, in terms that the client will understand, of what the level of investment risk means.

For example:

> You understand that in order to have a good chance of maintaining the real value of your capital in the medium to long term, you will need to accept a certain amount of investment risk. This means that the value of your capital can fall as well as rise. When you sell your investments, they may be worth less than the amount you originally invested.

If the client is educated in risk and knows what may happen over time, they are likely to be sanguine about the ups and downs of the investment markets. In addition, they are likely to react in a sensible way and avoid panic selling and panic buying.

All recommendations must be consistent with the client's attitude to investment risk. That does not necessarily mean that each individual investment product has to conform to the client's risk profile. What is important is that the overall investment portfolio reflects the client's attitude to investment risk and should be regularly reviewed and rebalanced to ensure that it remains so.

Key points

The main ideas covered by this chapter can be summarised as follows:

Explaining financial risk and volatility

- Types of risk to be aware of in financial planning are:
  - mortality and morbidity risk;
  - unemployment;
  - relationship breakdown;
  - litigation; and
  - loss of home or possessions.

The concept of investment risk and understanding a client's risk profile

- Risk can be categorised as systematic (market risk) or non-systematic (investment-specific risk).
- There are various types of investment risk, including:
  - inflation risk;
  - interest rate risk;
  - political risk;
  - regulatory risk;
  - taxation risk;
  - credit risk;
  - currency risk; and
  - liquidity risk.
- Financial planning involves managing risk rather than avoiding it altogether.
- The risk premium is the amount that investors require above the rate they can obtain in a safe investment in order to persuade them to invest in a riskier one.
- Diversification reduces non-systematic risk (risk arising from an individual company or sector failing).
- Risk profiling is the process of establishing the level of losses that a client is prepared to tolerate from their investments in return for the prospect of investment returns.
- A client's risk profile consists of:
  - objective factors, e.g. timescale, income and asset position; and
  - subjective factors, e.g. attitudes and aims.
- Volatility is the most frequently used measure of investment risk.
- Standard deviation and the Sharpe ratio are also convenient ways of measuring risk.
- Simplistic methods of risk profiling can be misleading in that they are open to misinterpretation.
- Critical yield is the level of return required from investments to achieve specific objectives.
- It is essential to consider capacity for loss when establishing a client's risk profile.

Using risk profiling tools

- While risk profiling has its downsides, discussion between the financial planner and the client can help overcome these.
- Psychometric risk profiling assesses the client's psychological risk tolerance or preference, rather than their objective financial capacity to take risks.
- Stochastic modelling predicts probable outcomes based on a range of assumptions which are reviewed regularly. It helps the client choose the appropriate portfolio based on a range of possible outcomes and the probability of achieving them.

Key points

- The assumptions underlying stochastic modelling should be:
  - conservative;
  - consistent; and
  - realistic.

Establishing and explaining the client's risk profile

- The client should understand the meaning of risk and how it can impact the achievement of their objectives.

3

Synthesising client information

Contents	Syllabus learning outcomes
A Fact-finding – overview	2.1, 2.2
B Fact-finding – the key areas	2.1, 2.2
C Methods of gathering client data	2.1, 2.2
D The regulator's findings of good and poor practice among firms	2.1, 2.2
E Identify actual or potential conflicts of interest	2.1, 2.2
F Working with other advisers	2.1, 2.2
G Compound interest and the time value of money	3.1, 3.2, 3.3
Case study: John and Margaret Williams – pre-meeting fact-find	
Case study: John and Margaret Williams – asking more questions	
Key points	

Learning objectives

After studying this chapter, you should be able to:

- conduct a fact-find;
- identify any potential errors and inconsistencies in information provided by clients;
- ask appropriate questions where additional information is required;
- determine any potential conflicts of interest;
- describe ways of working with other advisers; and
- explain the concepts of compound interest and the time value of money.

Key terms

This chapter features explanations of the following ideas:

Compound interest	Conflicts of interest	Domicile and residence	Ethical and religious considerations
Fact-finding	Hard facts	Intestacy	Lasting powers of attorney (LPA)
Outsourced investment services	Pension accumulation	Residence nil rate band (RNRB)	Salary sacrifice
Soft facts	Specialist advisers	Time value of money	Trusts

A Fact-finding – overview

It is essential for financial advisers to obtain enough information from their clients to ensure that their recommendations are suitable and relate to the client's aims, objectives and circumstances. ***Fact-finding*** is the process of gathering information about the client.

- The FCA has a number of rules and guidance points about fact-finding.
- The main headings on most fact-finds relate to questions that a financial planner might need to ask.
- The outcome of the fact-finding process is often a summary of the client's financial position, which should facilitate the objectives-setting process. It should lead to a full understanding of the client's situation and financial planning objectives.

It is often necessary to obtain detailed information about a client's investments or their financial position from product providers, professional advisers and various other third parties. The financial planner will therefore need appropriate letters of authority, signed by the client, to obtain this information.

The fact-finding process needs to be carried out by a skilled practitioner. The process is not simply one of asking a number of pre-set questions and writing down the answers; it is usually necessary to ask supplementary questions that are more probing. It is very important for the person asking the questions to understand their significance.

Usually, the fact-finding is done by the financial planner but, in some firms, it is the job of a paraplanner. Financial planners who do the fact-finding themselves may argue that the process offers an excellent opportunity to get to know the client. Those who delegate the responsibility may argue that they increasingly have to work in teams and that a skilled paraplanner can carry out the function just as well and at a lower cost, giving the financial planner time for other work.

B Fact-finding – the key areas

The following is a review of the key areas that have implications for financial planning, although it is not possible to give a fully comprehensive description of all the issues. Financial planners should always bear in mind that they need to understand all the aspects of a client's life that could affect their financial planning. This may involve knowing about highly confidential matters, such as relationships that have not been disclosed to other members of the family.

B1 The client's basic details

The aim should be to draw up a grid or family tree of all the client's family and important relationships. The key headings for each person should usually be:

- name;
- age;
- position within the family;
- financial dependence;
- state of health, family medical history, smoker status, dangerous hobbies, and insurability;
- ***domicile and residence*** status; and
- expectation of inheritances.

B1A Name, age, address, health and means of communication

To comply with anti-money laundering regulations, the identity of clients must be established – in particular, ensuring that they are who they say they are. If a government-issued document is used with a photograph and address (e.g. a photocard driving licence), this will be sufficient. If the government-issued document does not have a photograph or address, secondary evidence is also required, such as a recent utility bill. For politically exposed individuals, enhanced due diligence is needed.

The **Money Laundering and Terrorist Financing (Amendment) Regulations 2019** require firms to include additional high-risk factors when assessing the need for enhanced due diligence. This might be required, for example, when transactions are between parties based in high-risk third countries, where the customer is a beneficiary of a life policy or where the customer is a third-country national seeking residence rights in exchange for transfers of assets.

If the financial planner has any suspicions of criminal activities in relation to their client's finances, they must report them.

Date of birth/age, state of health, smoking habits and lifestyle choices affecting insurance need to be recorded. Engagement with high-risk activities, such as frequent travel or dangerous sports, should also be noted as these could affect the underwriting of financial protection products.

The financial planner should find out the client's preferred means of communication and the appropriate contact details, including mobile phone number and email address.

B1B Relationship status

The planner needs to know whether or not a couple is in a legally recognised relationship, i.e. married or in a civil partnership, as this has implications for issues such as responsibility for children's maintenance, inheritance tax (IHT), capital gains tax (CGT), income tax, State benefits and survivor's benefits under some pension schemes.

Since the passing of the **Civil Partnership Act 2004** in December 2005, same-sex partners are allowed to register their partnerships and receive the legal and financial advantages and features of marital status. This position has been further consolidated with the **Marriage (Same Sex Couples) Act 2013**. Civil partnerships were extended to mixed-sex couples in December 2019.

The legal position of partners who are neither married nor in a civil partnership is considerably less certain. There is no recognised legal position of common law husband or wife currently under English law.

Activity

What do you regard as the main legal and financial advantages of being married or in a civil partnership?

B1C Financial dependence

It is important to find out who is, or might become, financially dependent on the client. The issue of financial dependence can include either of the following:

- The person may be dependent or potentially dependent on another individual – this is especially important if the individual providing assistance is the client.
- The client or a close family member may be dependent or potentially dependent on the person, e.g. a grandparent may pay the school fees of the client's child.

Children are usually financially dependent on their parents (although this is not always the case), but there are various other people who are or might become dependent on a client. It is prudent to find out who they are, so as to plan for the eventuality or reduce the likelihood of the dependency arising (e.g. by ensuring that the individual concerned undertakes some financial planning).

Those who might be or become dependent on a client include:

- Elderly parents or other close relatives who have insufficient retirement income and/or who require long-term care.
- Adult children or other relatives with a disability or serious illness, or who are bereaved, and who need financial support.
- Relatives or others who are not fully capable of looking after themselves.

Refer to

See *Minor children* on page 3/5 for more on minor children.

The financial planner should aim to understand the circumstances, and quantify the degree of financial dependence and its likely duration. For children, it might be until they finish their education. For others, such as elderly dependants, it might be for their lifetimes. For spouses, mutual interdependence is usually assumed to be for life.

B1D Relationship breakdown

Where a client has been separated or divorced, or has had their civil partnership dissolved, the financial planner should find out the terms of the settlement and the chances of there being a revision in the terms:

- Where there has not been a clean break, one ex-spouse may be dependent on the other for maintenance, for themselves and/or for any children. It is important to understand the terms and the likely duration of maintenance payments.
- There may also be provisions in the settlement regarding the family home that are important to understand.
- A couple's pension arrangements may be subject to several possible settlement provisions. The financial planner should ask about the details.

B1E Residence and domicile

The tax implications of being either resident in the UK or domiciled outside the UK are considerable and can have a major impact on many aspects of financial planning. Therefore, it is important to find out the domicile and residency status of the client and the immediate members of their family.

Where an individual is domiciled outside the UK, it is important to find out how long they have been resident in the UK, because that can have a considerable impact on their tax position:

- Every individual, whether UK-domiciled or not, is entitled to the full nil rate band to be set against their estate that is subject to UK IHT.
- Transfers between spouses or civil partners are usually exempt from IHT. However, where one spouse/civil partner is UK-domiciled and transfers assets to the other, who is domiciled outside the UK, then the exemption is limited to a lifetime total of £325,000 – the same amount as the nil rate band. The potential maximum exemption is therefore £650,000 if the nil rate band of the UK-domiciled spouse is fully available.

- A non-UK-domiciled spouse can elect, on an annual basis, to be treated as UK-domiciled for IHT purposes and, in this way, may take advantage of the unlimited spouse exemption. However, an election also means that the spouse/partner is subject to IHT on their worldwide property rather than just property situated in the UK.
- Individuals who are not domiciled in the UK, but are UK resident in that tax year, can choose whether to pay tax on an arising basis on their foreign income and capital gains, or pay tax on a remittance basis.
- If they choose to be taxed on a remittance basis, they will be subject to an annual remittance basis charge of £30,000 where they have been UK resident in at least seven of the previous nine tax years. The charge increases to £60,000 once they have been UK resident in 12 or more of the previous 14 years.
- Since 6 April 2017, an individual who is not domiciled in the UK is deemed to be domiciled in the UK if they are:
  - resident in the UK in at least 15 out of the previous 20 tax years (with deemed domicile status applying from the 16th year of residence); or
  - born in the UK with a UK domicile of origin and return to the UK (becoming resident), having obtained a domicile of choice elsewhere. However, for IHT purposes, an individual will only be deemed domicile under this provision if they have also been resident in the UK for at least one of the two previous tax years.
- Individuals who are eligible to pay tax on the remittance basis, and who choose to do so, are not liable for tax on any foreign income or gains remaining outside of the UK. Any foreign income or gains that are subsequently brought into the UK are subject to UK tax, unless this money is used to invest in a qualifying business investment. There are strict eligibility rules for business investment relief.
- Individuals who choose the remittance basis lose the personal allowance for income tax and the annual exempt amount for capital gains for any UK income or gains.
- If the unremitted income or gains are below £2,000 a year (known as the de minimis limit), they are exempt. Under 18s are also exempt from this charge.

The general assumption for this study text is that clients are resident and domiciled in the UK.

Be aware

Advising US citizens
Under the **Foreign Account Tax Compliance Act 2010 (FATCA)**, US citizens are required to file US tax returns for life on worldwide income from all sources, regardless of where they live. There are significant penalties for both clients and advisory firms who do not comply with this requirement. It is therefore essential that advisers establish whether their client is a US citizen or not.

B2 Minor children

If a client is responsible for caring for children, this is likely to have a major effect on their financial planning.

It is important to know the names, ages, state of health and plans for the future of any children or dependants. It is also sensible to ask younger couples if they intend to have children in the future. Older clients might have, or be expecting grandchildren, which might also involve increased expenditure.

Minor children affect such issues as life and health insurance, short- and long-term saving, estate planning and other tax planning. Most of all, they will have a major impact on the client's current and future levels of expenditure.

The arrival or imminent arrival of children is a trigger for a substantial change in a client's financial planning, so it is important to find out about their position and intentions.

It is worth remembering that with multiple marriages and different types of family arrangement, a client may be financially responsible for children from more than one relationship.

B2A Income, expenditure and children

For a couple or a single person with one child or more, a substantial amount of their expenditure has to be devoted to the child, either directly or indirectly.

The cost of bringing up a child is considerable and will change the pattern of expenditure in most households. There could also be significant additional costs, such as moving home and childcare.

This can have a considerable impact on the family budget, with saving levels often being the first area to be sacrificed even though the need for saving may in fact be greater, especially if private education is being considered. More life and health insurance is usually needed, particularly if the potential cost of school fees has to be taken into account.

B2B Sources of funds

In planning for the maintenance and education of children, it is essential to find out the source of funds for the expenditure. In general, this may include:

- the earnings of the parents (in some cases, this will be the earnings of just one parent, but mostly the earnings of both parents will be needed to cover all the costs);
- the capital of the parents;
- the capital and/or income of the grandparents or other relatives; and/or
- trust funds of which the children are beneficiaries.

The financial planner should find out the details of all these, the intentions of the parties involved, the underlying investments and their tax position, as well as the robustness of the arrangements in the event of financial or other difficulties.

B2C Costs of schooling

The financial planner should aim to find out the parents' plans for the education of their children. These could have a major effect on the pattern of the family's budgeting and financial planning generally.

- If the children are to attend a State-funded school, there will be no tuition fees, but the costs connected with schooling – such as uniforms, equipment, trips, extra lessons and tutoring – can be considerable.
- If the plan is for the children to attend private school, it is important to understand the types of school that they may attend, the current cost, whether the children are to be day pupils or if they are likely to board and, if so, from what age. The costs of these items need to be converted into a projection of future expenditure.

As with all financial planning, the financial planner should be aware that these plans can change, especially if a child turns out to need a different type of education from the one originally envisaged. Children may switch from the State sector to the private sector and vice versa. A child may board continually from ages 8 to 18, or there could be changes back and forth. Planning therefore needs to be flexible.

Refer to

See *Providing for the costs of education* on page 6/10 for more on providing for the costs of education.

The financial planner should find out if the parents' intention is to fund all or some of the school fees in advance. Full advance funding is reasonably rare, but many parents understand the value of having a cushion against financial difficulties and are prepared to save for this purpose.

Parents should be made aware of the rapid rise in the cost of private education. As more than three-quarters of the budget of most private schools consists of staff costs, the long-term trend is likely to be for fee increases to at least match the rise in average earnings. In recent years, they have exceeded this level considerably.

Activity

Using a search engine, search 'cost of private education in the UK'. Read the key sites/articles you find and summarise the main points.

B2D Higher education

Just over half of all school leavers go on to some form of higher education. University costs are an increasingly important issue particularly in England, where there have been dramatic increases up to the maximum allowable of £9,250 for the 2022 entry cycle. The other costs of higher education – accommodation, study materials, other living expenses – are also potentially substantial and should be budgeted for.

The financial planner should find out whether it is likely that the client's children will enter higher education and, if so, what the parents' plans are for helping with the funding. When a child is very young, the issue is so far in the future that higher education costs simply need to be built into the lifetime cash flow model. Otherwise, the planning may have to be relatively vague, e.g. a general intention to save for the costs. As the child progresses through school, the question of higher education may become clearer.

The issues with higher education may include:

- The extent to which the parent(s) thinks it is desirable for the student to work during term time and/or the holidays.
- The intention to help with accommodation. Some parents aim to buy a property in the university town to help the child onto the property ladder as early as possible.
- The possibility of saving in advance to help cover some or all of the costs of higher education. Given the uncertainty about long-term costs, both expectations and planning need to be fluid.
- The attitude of the parents towards their child taking on a student loan.

B2E Trusts for children

Refer to
See *Trusts* on page 3/19 for more information on trusts.

Relatively few children are beneficiaries of active ***trusts***. Where trusts do exist, the financial planner should know about them, with details of the type of trust, their settlor(s), trustees and the trust provisions.

It is also necessary to understand how the parents, the settlors (if they are not the parents) and any other relevant people aim to use the trust assets if they are available to them. In many cases, they can be used to provide for children's maintenance and education. There may also be IHT and other tax complications.

B2F Children's income, investments and tax

It is important to find out about the financial position of minor children:

- The source of a child's income affects the way it is taxed. If it is derived from some kind of a settlement from their parents, it is generally taxable on the parents; otherwise, it is taxable on the child. The position applied will help determine the suitability of different kinds of tax wrapper for an investment for a child.
- The parent or carer of a child may be eligible for either the child element of Universal Credit (UC) or Child Tax Credit (CTC). This may be payable in respect of children under the age of 16 and young persons aged 16 to 19 (UC) or 20 (CTC) in full-time education. Eligibility is based on a couple's joint taxable income before allowances, whether or not they are married or in a civil partnership. Families with lower incomes and childcare costs, or families with a parent/carer or child with a disability may be entitled to additional elements. The financial planner should ask whether a couple with children is claiming either of these or any other tax credit.
- Junior individual savings accounts (ISAs) are available to UK resident children who were not eligible for their predecessor, the child trust fund (CTF). Children are allowed to hold two Junior ISA funds, with one investing in cash and the other in stocks and shares, as long as the total contributions do not exceed £9,000 per year (2022/23). The funds are locked into the Junior ISA until the child is aged 18, when the contract will become an adult ISA. Children aged over 16 can also take out an adult cash ISA as well as a Junior ISA. The financial planner should ask how the Junior ISA is invested and whether any members of the family contribute to it.

- Existing CTFs can continue until the child reaches age 18. The annual investment limit mirrors the Junior ISA limit. It is possible to transfer existing CTFs to Junior ISAs.
- Maturing CTFs retain their tax protection until encashment. Where a CTF is transferred into an adult ISA, the amount transferred will not affect the individual's annual ISA subscription limit.

B3 Income and employment details

It is essential to know the client's income from their employment and from all other sources. The fact-find should distinguish between gross income before income tax and National Insurance contributions (NICs), as well as net income after these deductions. NICs are charged on almost all earnings above the starting point for NICs.

Be aware

Under the **Criminal Finances Act 2017**, it is now a corporate criminal offence if a firm fails to prevent an employee from facilitating tax evasion. Firms should ensure their advisers know that if they discover during the fact-finding process that a client is engaged or intends to engage in tax evasion, turning a blind eye to this could result in a criminal prosecution leading to unlimited fines, regulatory scrutiny and reputational damage.

Other aspects of the client's employment to note include length of service, earnings and benefits, details of previous employments and pension entitlements. A range of issues arises around the client's employment position:

- **Job security**. Unemployment benefits have become far less generous in many respects during the last few decades. It is not always easy to gauge how secure a person's employment is, but some preparation for unemployment and an insight into a client's ability to find another job is very helpful.
- **Taxable employee benefits (benefits in kind)**. Company cars have become much less tax-efficient in the last few years, although for certain people they have become more attractive, e.g. if they are willing to drive vehicles with zero CO_2 emissions. Clients should review their remuneration package to see if the tax cost of their company car is impeding the achievement of their other financial goals.
- **Employee share option schemes**. Share schemes can form a substantial element of remuneration, especially (but not exclusively) for directors and senior employees. The tax rules governing these schemes have changed considerably over time, making them generally more attractive.
  - Their impact and value need to be taken into account in the planning process; in many cases, this can only be done by contacting the employer for information about the structure, value and tax consequences.
  - Some clients build up very substantial holdings in their employers' companies in relation to the value of their other assets. Clients should be aware of the risk of having shareholdings in a single company. There is a danger of 'familiarity bias', a well-established behavioural finance phenomenon, which can reduce the apparent risk factors of such investments. If the company were to encounter difficulties, the employee might lose both their employment and investment.

B4 Self-employed people and controlling directors

Businesses of any complexity are outside the scope of detailed consideration in this study text.

The aspects to record about any business are:

- ownership;
- date of establishment;
- structure, e.g. sole trader, partnership, limited company;
- accounting date;
- two or three years of financial information, including:
  - assets and liabilities, i.e. the balance sheet (statement of financial position); and

  - income and expenditure, i.e. the profit and loss account (statement of financial performance); and
- a statement of plans for the business in the next few years and in the long term. It is important to find out whether the business is reasonably stable and well established.

Income from self-employment, either as a sole trader or partnership, is taxed via self-assessment and is subject to income tax as well as Class 2 and Class 4 NICs. The earnings of directors of limited companies who are categorised as employees are taxed under pay as you earn (PAYE) and are subject to income tax and Class 1 employee NICs. The limited company itself will be subject to corporation tax on its net profits and Class 1 employer NICs.

B5 Expenditure

The starting point for understanding a client's needs and aspirations for the future is to look at their current levels of expenditure. It is worth using a detailed expenditure analysis, preferably in conjunction with several recent bank statements and credit card statements.

Some clients may be reluctant to provide this information. Clients should be made aware that it is very helpful to have the analysis, especially where it is important to try to control expenditure levels. The financial planner could offer to carry out the analysis from the source documents. Where the client cannot be persuaded to provide the necessary data, it is important to have at least the total income and expenditure.

Some clients experience very large fluctuations in their income and expenditure, with their income being paid, say, once or twice a year and perhaps very large bills arising from time to time. These fluctuations should be noted in the summary – generally, by showing the top and bottom cash balances.

From this, it is possible to derive (with discussion and then through various adjustments) what their expenditure needs would be:

- if one or both partners became unemployed;
- if either partner or both could not work through ill health;
- if either partner or both died in the near future;
- after one or both partners have retired; and/or
- after one of the partners has died in retirement.

There is a growing practice of using IT solutions to provide an automated analysis of client income and expenditure using the information from bank and credit card statements. These solutions can be used to stress-test a number of 'what if' scenarios, which can be useful in the financial planning process.

B5A Fixed and discretionary expenditure

It may also be possible to help clients identify areas in which they can reduce expenditure if they decide to increase their level of saving or make some other financial provision.

One way to achieve this is to ask clients which items of expenditure are fixed or core and which are discretionary.

Whole items can be discretionary, e.g. eating out, but most areas will be a mix of fixed and discretionary, such as food, where it will be possible for some people to reduce their expenditure.

'Fixed' and 'discretionary' are not absolute descriptions; much depends on the context. There is the discretionary expenditure that would be very easy to cut back – say, a couple of short-break holidays. This might be the expenditure that clients would reduce in order to save to meet certain future goals. Then there is the expenditure that they might reduce or eliminate if they were unemployed. Generally, it is the former, less drastic approach to reducing discretionary expenditure that is required for financial planning.

B6 Assets

The key information to obtain regarding assets is:

- **Ownership**. In the case of spouses and civil partners, are the parties willing to transfer ownership or to gift assets in order to benefit from tax savings?
- **Use**. Is the asset used (e.g. the home) or is it an investment or business asset?
- **If ownership is shared, is the asset held under a joint tenancy or tenancy in common?**
  - Joint tenancy (where ownership of the asset passes automatically to the survivor when one of the owners dies) can have adverse consequences if one of the partners is receiving long-term care and they aim to prevent the total value of the property being used to pay for the care of the surviving partner.
  - Tenancy in common can be used in estate planning as a means of passing down the value of half the main residence to the next generation or into a discretionary trust through the nil rate band when one of a couple dies. It may also prevent a client's home from being sold if they need to go into long-term care accommodation.
- **The dates that assets were acquired**. Dates of acquisition of assets such as investment bonds can be important in determining the level of tax payable on disposal.
- **Purpose and use as security**. There can be different reasons for holding investments and other assets, e.g. to generate an income now or in the future. In some cases, a client may hold investments that have been earmarked to provide for a known liability at a future point, such as a wedding or school fees.

  Some assets are used as security for loans and cannot be disposed of without the consent of the lender. They might also be in danger of being lost if the loan is not repaid.
- **Future assets**. Is there an expectation of further assets being inherited in the future?
- **Income and tax position**. Investments often produce income. It is important to know:
  - the type of income;
  - for dividend income, whether the shares are listed on the main market or the alternative investment market (AIM), or are not listed at all;
  - whether it is secure and, if it is not, how volatile it is; and
  - how, if at all, it is taxed, e.g. as rental income, savings or dividends, and whether it is paid net or gross of tax.

    Dividends are paid gross. Income from purchased life annuities is paid net, but savings income is paid gross from:
    - banks;
    - building societies;
    - National Savings and Investments (NS&I) products; and
    - interest distributions from open-ended investment companies (OEICs) and unit trusts.
- **The CGT position and status of the assets**. CGT on nearly all assets is now taxed at a flat rate of 10% for gains falling within the basic-rate tax band and at 20% for gains falling within the higher- and additional-rate bands. There is a surcharge of 8% for residential property. There are valuable exemptions and reliefs, and financial planners need to understand the client's position to make the most of them.
  - **The base value of investments and other assets**. This may be one of the main determinants of any CGT liability. If the asset was acquired before 31 March 1982, it is important to know the value at that date, as this will be the figure used as the base value. In many cases, it will be necessary to obtain this information from the client's investment or tax adviser. For single company shares, the original price paid is also required.
  - **The availability of losses to offset gains.** Losses arising on the disposal of other assets in the current or previous tax years can be used to offset gains on disposals in the current tax year. Disposing of loss-making assets in the current tax year should be managed carefully to ensure that any loss arising only reduces the chargeable gain to the amount of the CGT annual exempt amount (£12,300 in 2022/23). This is because, while losses from previous years only have to be used to the extent that they reduce a

chargeable gain to the annual exempt amount, any loss arising in the current tax year has to be used to fully offset any gains if sufficient losses are available to do so.
  - **Exempt assets**. Some assets are exempt from CGT, notably the main residence in most circumstances. If the client has more than one property, the financial planner should know which one is the main residence.
  - **Business asset disposal relief**. This is available on the disposal of a material interest in business assets. If certain qualifying conditions are met, the first £1 million of gains will be taxed at 10%. It is important to know whether the assets and the owner qualify for the relief.
- **The IHT status of assets**. Some assets qualify for IHT reliefs and exemptions. Qualifying business assets, for example, can benefit from 100% relief (known as business relief), effectively taking them out of the tax net. The fact-find should record whether the client intends to retain the asset throughout their lifetime; the cash proceeds from the sale of a business do not count as business assets. Enterprise investment scheme (EIS) shares, seed enterprise investment scheme (SEIS) shares and AIM shares also qualify for business relief once they have been held for two years. There is a relief for agricultural property (agricultural land, growing crops and farm buildings, but not the animals or equipment). This relief is up to 100%.
- **Investments generally** need to be fully analysed.
  - A client's expectations of the risk and potential reward from a particular investment can help provide an insight into their investment attitude, as well as gaining information about the investment itself.
  - Where the investment has an element of complexity – for example, a 'structured' product, a 'guaranteed' equity-linked income (precipice) bond or growth bond – it is essential to know the original terms, its interim history and its likely maturity value.
  - It is worth asking the client why they originally made the investments, because the circumstances and rationale may have since changed. Many investors have 'legacy' products, such as with-profit bonds, that may no longer be appropriate for the intended purpose or be performing satisfactorily. If a client has an investment that the planner would not now recommend to a client, its continuing suitability needs to be carefully considered.
- **Single premium investment bonds**. These bonds have several features that should be recorded, including provider, fund links and number of segments:
  - Ownership is not necessarily the same as the lives assured.
  - The date the bond was originally taken out could affect the tax liability on encashment.
  - Whether the bond is onshore or offshore affects its tax position while it is retained and on encashment.
- **With-profit products** need particular attention. The with-profit market has changed considerably since the years in which very large numbers of these investments were sold. Some may still be performing well and may be suitable for clients, but others may be performing poorly and may no longer be suitable. Some are substantially equity-based investments; some are mainly fixed-interest-based. The financial planner should:
  - Establish the amount that has been invested, when it was invested and whether any withdrawals have been made (including their dates).
  - Find out the exact name of the fund to establish its underlying investments and its charges, because many companies have several funds with very different characteristics.
  - Read the Principles and Practices of Financial Management (PPFM) for that fund, or obtain expert advice or research on it. The aim should be to find out the profile of the fund in terms of its current composition and its prospects for future growth.
  - Review the life office's financial strength and the fund's underlying performance, including its history of paying out reversionary and terminal bonuses.
  - Discover whether a market value reduction (MVR) currently applies on surrender, and if and when there are times such a penalty would not apply to the client's investment.
  - Discover whether there are any underlying guarantees – e.g. to annuity rates.

Activity
Obtain a PPFM for the with-profit fund of a leading life office. What is its current composition and what are the prospects for future growth?

B7 Liabilities and guarantees

An analysis of a client's liabilities (debts) is essential when assessing their protection needs.

It is essential to know the type of loan, interest rate, term, repayment levels and security given for any borrowings, from mortgages to credit cards, as well as details of the lender and any special terms or conditions.

- If the interest on the loan qualifies for income tax relief (e.g. on a loan to buy certain let property), it is worth knowing the circumstances.
- Some liabilities are contingent, such as the guarantee of a lease for a business, a business overdraft or loan, or someone else's loan or mortgage.
- Many people – especially if they are self-employed – have substantial income tax and National Insurance liabilities because their payments are deferred until they have completed their self-assessment. These should be taken into account, especially for protection purposes.
- Some liabilities may be covered by life and/or health insurance on the life of the borrower and possibly also given as security to the lender.
- It is a very good idea to ask the client to obtain their credit reports from the credit rating agencies. The cost for the basic report, which is perfectly adequate for the purpose, is minimal (and sometimes free). This allows the financial planner to understand how lenders might consider a loan application and to see if there are any credit issues that the client has forgotten or does not know about. It also gives the client the opportunity to check whether the information the agencies hold is accurate and ask for changes if it is not.
- Given the increasing concern about the environment and a sustainable future, some clients may be interested in green mortgages. A green mortgage is one that rewards the borrower for buying an energy-efficient home by offering them more favourable terms than come as standard, such as a slightly lower interest rate, or cash back when they take out the mortgage, or both. Such deals may, however, be restricted to new-build homes.

B8 Protection policies

A full analysis of existing protection policies should be undertaken to assess their continuing suitability.

Lives assured, sums assured, premiums, start and end dates, and any review periods or dates should be recorded. Also important are:

- how the policy is held. In particular, whether the policy is:
  - in trust and, if so, the type, terms and the date of the trust, as well as its beneficiaries;
  - held for the policyholder's own benefit if it is not in trust;
  - arranged on a life of another basis; or
  - assigned, e.g. to a lender;
- index-linking of cover;
- whether the premium rates are guaranteed or reviewable;
- options to:
  - increase the cover;
  - extend the term;
  - add in or change lives assured;
  - convert to permanent policies; and
  - use any other worthwhile features;
- whether the policy is a relevant life policy, which:
  - is a policy taken out by an employer on the life of an employee;

  - provides lump sum death benefits only and is written under trust for the benefit of the employee's beneficiaries; and
  - is designed to provide death-in-service benefits for individual employees; and
- where it is a relevant life policy, the name of the employer funding the plan and if the plan can be assigned should the client leave service.

It is also useful to know whether the policy is written under personal pension rules. This is particularly relevant in light of the lifetime allowance for pensions and the fixed protection regime for pensions, as any future payment into this type of plan would invalidate the fixed protection. It is no longer possible for individuals to claim tax relief for their contributions to fund new pension-related personal term assurance. However, tax relief is still available for policies taken out prior to 6 April 2007 and not 'varied' after that date, or where the contribution is paid by the employer.

These various features can be particularly attractive if the terms are advantageous or if it has subsequently become expensive or impossible to cover the insured individuals in other ways:

- In the case of critical illness insurance, the conditions covered by the policies need to be reviewed.
  - Policies sold several years ago or by smaller companies may cover fewer illnesses than the products of today's leading providers. This is because, in April 2006, the publication of the Association of British Insurers (ABI) *Statement of Best Practice for Critical Illness Cover* (which is updated regularly) extended the conditions needed to be covered by new critical illness policies.
  - However, it may be the case that the definition of the circumstances in which an existing policy will pay out in the event of critical illness is less restrictive than policies available today. This is a result of life offices seeking to limit the circumstances in which their policies will pay out because of higher than expected claims.
- In the case of income protection insurance, it is important to check the restrictions of the existing policy to see if it might need to be replaced.
- Where there is an investment element to the policy, it is necessary to establish the choice of fund, the estimated surrender value and the estimated value at maturity.
- The financial planner should check whether the policy was underwritten on normal terms and, if not, whether the insured person's circumstances or health have changed to such an extent that the insurance company might reconsider the underwriting.
- It is important to determine if the policy is a 'qualifying' policy and has been taken out on or after 21 March 2012 (or effected earlier and 'varied' on or after that date). If so, the chargeable event rules may apply to that policy and need to be taken into account.

B9 Pension details – accumulation phase

This is the stage before retirement when pension funds are being built up. It is important to know if the client is likely to have a high income in the foreseeable future. Tax relief on pension contributions is very valuable, but is effectively not available on contributions in excess of the individual's relevant UK earnings or their annual allowance (plus any unused relief for the previous three tax years, as long as the client was a member of a registered pension scheme for the tax year in question), whichever is lower.

For most people, the annual allowance is £40,000 (2022/23). However, this is tapered down to a minimum amount of £4,000 if an individual's adjusted income (including the value of any employer pension contributions) for the tax year exceeds £240,000. The rate of reduction is £1 for every £2 that adjusted income exceeds £240,000.

The lines between ***pension accumulation*** and the decumulation stage are not always clear, and a member may have accessed their pensions yet still plan to continue making contributions. It is therefore worth noting that where the client has already flexibly accessed their pension benefits, they will have triggered the money purchase annual allowance (MPAA), which will limit their contributions into defined contribution (DC, also known as money purchase) schemes to £4,000 before an annual allowance charge is incurred.

B9A Defined benefit pension schemes

If the client is employed in the public sector (e.g. in the civil service), it is likely that they will continue to enjoy the benefits of defined benefit (DB) scheme membership. However, as a result of the Government accepting the recommendations of the Hutton Report, these benefits will not be as generous as they have previously been. Elsewhere, and even on the fringes of the public sector, DB schemes are in retreat and this could affect planning.

- It is advisable to obtain a copy of the pension scheme booklet to check the benefit figures and relate them to the client's details. It is worth finding out what the client thinks their expected benefits are under the scheme, as this may not correspond with reality.
- The scheme may be fully operational or at some stage of being phased out, e.g. open to existing staff but closed to new entrants. It is important to know this position and consider with the client the likely future of the scheme.
- If the client is concerned about the security of the DB pension scheme, it is important to refer the case to a specialist who can advise on pension opt-outs, unless the financial planner is qualified and competent in this area.
- The financial planner should find out the position of death benefits under the scheme and whether the client has provided the scheme with a letter of wishes recording what they would like to happen with any lump sum death benefits.

B9B Defined contribution pension schemes

Defined contribution (DC) schemes are now dominant in the market. Very often, the contribution rates and financial commitment for the employer are much lower than for the DB scheme. The financial planner needs to record the details of the scheme as well as the client's understanding of it.

- It is important to know the type of scheme, the level of member and employer contributions, death-in-service benefits, the value of the fund and how it is invested. It is also worth finding out what the client expects the benefits to be under the scheme, as it can be a helpful test of the client's understanding of their pension provision.
- If it is likely that a client will have a low income in retirement from non-State pensions and savings, or if they are unlikely to qualify for a full State Pension, they should understand the probable impact of pension credits on their income. The savings credit part of pension credit closed for clients reaching State pension age (SPA) on or after 6 April 2016. If, however, they reached SPA before 6 April 2016, depending on their circumstances, they can still get savings credit regardless of when they apply.
- Advisers should be aware of employers' duties regarding automatic enrolment. Employers are required to contribute 3% of qualifying earnings for certain employees to a qualifying workplace pension. Employers who offer a suitable alternative pension scheme are exempt.
- As mentioned earlier, the maximum tax-efficient payment that an individual can make to all pension schemes during the accumulation phase is limited by the annual allowance, which is currently £40,000 (less if the tapered annual allowance applies and/or the member has flexibly accessed their pensions and withdrawn in excess of their pension commencement lump sum (PCLS) triggering the MPAA). The annual allowance relates to pension input periods (PIPs), which run alongside the tax year. It must not be forgotten that the overriding limit for tax relief is 100% of relevant UK earnings for an individual's contributions.
- While employers can make unlimited contributions, they are effectively restricted by the annual allowance, as contributions above this level will incur an annual allowance charge on the member at their marginal rate of tax. Employers are also restricted by the need for expenditure to be wholly and exclusively incurred for business purposes in order to be allowable as a deduction for tax purposes.
- It is possible to carry forward any unused allowance from the three previous tax years (up to £40,000 for 2019/20, 2020/21 and 2021/22), as long as the individual was a member of a registered pension scheme for the year in question. For individual payments, there is still the overriding limit that any payment must not exceed 100% of relevant UK earnings in order to obtain tax relief.

Example 3.1

Lewis

Lewis earns £80,000 a year. He contributes to a self-invested pension plan (SIPP) and, in previous tax years, has contributed the following amounts:

- £35,000 in 2019/20;
- £28,000 in 2020/21; and
- £22,000 in 2021/22.

The amount of unused annual allowance that Lewis can carry forward to 2022/23 is therefore:

2019/20	£40,000 − £35,000	£5,000
2020/21	£40,000 − £28,000	£12,000
2021/22	£40,000 − £22,000	£18,000
Total		**£35,000**

In 2022/23, he can therefore make a gross contribution of up to £40,000 (the annual allowance for the 2022/23 tax year) plus £35,000 carried forward from the three previous tax years = £75,000. This is all within his relevant UK earnings (£80,000) for the 2022/23 tax year.

- The lifetime allowance decreased at the start of the 2016/17 tax year from £1.25m to £1m. It has since risen to £1,073,100; however, it was announced in the March 2021 Budget that it will be frozen at this amount until April 2026.
  - **Fixed protection 2016** allowed individuals to fix their lifetime allowance at £1.25m. Application for this could be made from 6 April 2016, but no further pension contributions or pension accrual could occur after this date.
  - Those with pension funds in excess of £1m on 5 April 2016 could apply for **individual protection 2016**. This gave a protected lifetime allowance equal to the value of an individual's pension rights at 5 April 2016 (subject to a maximum value of £1.25m) and allowed further contributions to be paid.
- It is important to be aware of any previous protections in place for large pension pots, such as enhanced, primary, fixed and individual protection. The eligibility requirements of these protections should be understood to ensure that no actions are taken that would invalidate the existing protection in place.
- For benefits held in occupational DC pension schemes, even with small pots of money, particular attention should be paid to any protected tax-free cash amounts that the client may be entitled to on pre-2006 benefits. In some cases, this can be in excess of the 25% allowable for any benefits accrued post-April 2006 and, in most cases, this benefit will be lost on transfer to another pension scheme.
- Where a personal pension is invested in a with-profit fund, then any transfer value quoted may be higher than the current value of the fund. This is because a terminal bonus could apply when benefits are taken or, possibly earlier, on switching to a different fund. The terminal bonus can represent a large portion of the fund. However, terminal bonuses change on a daily basis and can be removed at the actuaries' discretion. They should therefore be monitored. If the pension fund is potentially subject to a market value reduction factor, the adviser should establish if there are circumstances in which it will not apply (for example, penalty-free dates). Consideration can then be given as to whether to switch funds and/or crystallise the terminal bonus.
- If a waiver of contribution is incorporated into the personal pension or retirement annuity, the details need to be recorded, as this type of benefit is now restricted.
- The fact-find should record the death benefits under the scheme and whether they have been written in trust or if other arrangements have been made to express the member's wishes in relation to their beneficiaries.

On the Web

Pensions are in a constant state of flux. Go to the Moneyhelper website to ensure you are up to date with the latest information at: *www.moneyhelper.org.uk/en/pensions-and-retirement*.

B9C Salary sacrifice

Salary sacrifice agreements allow employees to accept a lower salary in exchange for their employer making a pension contribution on their behalf. This results in NIC savings for both the employee and the employer. These savings can then be recycled back into the pension, as a larger contribution can be paid in at no extra cost to either party. Planners need to be aware of such agreements because salary sacrifice will affect other areas of financial planning – for example, the resulting reduction in salary could affect the amount of mortgage a lender will consider.

Table 3.1: Advantages and disadvantages of salary sacrifice

Advantages	Disadvantages
• Employee pays less NICs. • Employee receives a lower level of earned income meaning that they will pay less income tax: – For those who would otherwise have adjusted net income of between £100,000 and £125,140, this may mean regaining some or all of their personal allowance. – For those who would otherwise have adjusted net income in excess of £50,000, they would no longer be subject to the High Income Child Benefit Charge. • Employer can pay their saved NICs into the scheme, boosting its value. • Alternatively, the employer can retain the NIC saving within the business.	• Salary reduction may affect the employee's capacity to borrow. • The process itself is complex and difficult to understand and it results in increased administration. • Salary reduction will reduce the value of the employee's death-in-service benefits, income protection benefits and redundancy pay-outs. • Salary sacrifice is not binding on the employer.

B10 Wills, gifts and trusts

The details of the will should be recorded, as well as the existence or otherwise of any general power of attorney, enduring power of attorney (EPA) or lasting power of attorney (LPA), significant gifts made and received, and relevant trusts and their details.

B10A Wills

If the client has not made a will, they should be encouraged to do so.

In some cases, the ***intestacy*** rules are adequate, perhaps because virtually all assets of any value are held either as a joint tenancy or in trust, and the clients are satisfied with the outcome of such a situation. However, in most circumstances, having a will is highly preferable to dying intestate.

Refer to

See *Wills* on page 6/31 for the reasons why it is important to have a valid will.

The presence of children or other dependants in a family means that clients should have considered this implication for their wills. Financial planners should find out if clients have made suitable arrangements in the following main areas:

- Have the client and their spouse/partner made wills? It may not be possible to change the position after, say, the death of a parent, because deeds of variation cannot usually be varied to deprive minor children of their entitlements under a will.
- The provisions of the intestacy rules might be wholly inappropriate where there are children in a family. The surviving parent may have inadequate provision and the children would become entitled to their shares at age 18, which many parents would consider too early.
- Most parents prefer to nominate guardians for their children in case both of them die. The absence of such a nomination can lead to considerable practical difficulties, especially if the surviving family or friends cannot agree on who should take on the responsibilities.
- An old will, e.g. written before the arrival of children, may miss out on planning opportunities and may be inadequate for many of the same reasons as intestacy.

Wills and intestacy
If the parents have made wills, the financial planner should find out if they have made appropriate provision for the survivor and the children. A mirror will, where the parents leave all their estates to each other initially, is probably better than intestacy – at least for the survivor – but the lack of arrangements for the children and the loss of IHT planning opportunities may be just as serious. However, the transferable IHT nil rate bands mean that the IHT consequences of mirror wills are not as damaging as they used to be.

For any existing will, it is worth asking whether it still reflects the client's wishes. Circumstances might have changed since the will was made, rendering it inappropriate. For example, one daughter might have taken over the family business and the parent may wish to pass it on to her and compensate the others in some other way. Another change may have been in the relative valuation of assets, which has unbalanced the will.

One change that might be appropriate is a will that passes down the value of the IHT nil rate bands directly to children at the first death of a couple. This may not be desirable or necessary after the introduction of the transferable nil rate bands, but the use of a nil rate band discretionary trust at the first death may still be appropriate in certain circumstances, e.g. where one of the spouses has inherited nil rate bands from a deceased spouse from a former marriage.

B10B Gifts and loans

If they can afford to, a client may be able to reduce their potential IHT bill by gifting during their lifetime. A financial planner needs to be aware of prior gifting so that this can be taken into account when determining whether life cover is required on the gifts, on the estate, or on both. Gifts come under one of the following three categories:

- **Exempt transfers**. Gifts, such as the £3,000 annual exemption, £250 small gift exemption, gifts out of normal expenditure and gifts to charity or for the nation's benefit, reduce the value of the estate on death with immediate effect.
- **Potentially exempt transfers (PETs)**. Gifts, such as the gift of a valuable family heirloom or a gift into a bare trust, reduce the value of the estate providing that the client survives for seven years. If the client dies within seven years, the value of the gift is included in the estate, although any IHT due on the gift may be reduced through taper relief.
- **Chargeable lifetime transfers (CLTs)**. Most gifts into trusts are CLTs. Where their value exceeds the available nil rate band, there is a lifetime charge of 20% on the excess. If the client survives for seven years, the value of the estate will be reduced and no further IHT will be payable on the CLT. If the client dies within seven years, then IHT is charged at the full death rate of 40% and taper relief applied if appropriate. The 20% deducted at the outset is deducted from the resultant IHT bill.

Loans are repayable on death, which means that they are not an effective means of IHT planning on their own. However, specialist loan trusts do exist, enabling the client to reduce the value of their estate while maintaining some access to their assets.

B10C Nil rate band

Every resident in the UK is entitled to an exemption from IHT for part of their assets. With the current death rate of IHT at 40% (or 36% where 10% of the net estate is gifted to charity on death) and at 20% on CLTs above the available nil rate band, this is an extremely valuable allowance which should be maximised where possible.

The nil rate band is frozen at £325,000 until the end of 2025/26. This amount is transferrable between spouses and civil partners where they are married or in a civil partnership at the date of death (whenever this occurred).

Therefore, the estate of the surviving spouse or civil partner could potentially have a nil rate band of up to £650,000. In order to establish the amount available for IHT planning, it is important to record details about anything that may affect this, including:

- A full history of lifetime gifts (whether chargeable or not) made in the last 14 years. Any gifts to a relevant property trust will be classed as CLTs and, where they are within the nil rate band, no immediate IHT is payable.
- A full history of PETs made in the past seven years. It is important to establish the date, amount and recipient of the PET to determine how much of the nil rate band has been used to establish any potential IHT charge on death, should the PET fail.
- Details of any transferrable nil rate band. This should include the name of the deceased, the date of death and a copy of the deceased's will and grant of probate to show how much, if any, of the nil rate band may be available.
- Confirmation of any surplus income that could be used for IHT planning and mitigation.
- Details of any assets that may qualify for business relief. This could include qualifying business assets, investments in EISs, SEISs or most stocks listed on the AIM.
- Any unused annual allowances available.

B10D Residence nil rate band

The planner should also take note of the availability of the ***residence nil rate band (RNRB)*** as this will reduce the amount of the estate liable to IHT and consequently affect the amount of protection needed to offset the IHT bill. The RNRB is frozen at £175,000 until the end of 2025/26 and is available in addition to an individual's standard nil rate band.

The RNRB is transferable in exactly the same way as the standard nil rate band, providing the second death occurs on or after 6 April 2017 (when the RNRB was introduced). The RNRB that a surviving spouse or partner inherits is based on the percentage (not amount) of the RNRB that was unused on first death. This percentage of unused RNRB is then applied to the RNRB in place at the date of the second death. Where the first death occurs prior to 6 April 2017, the estate would not have used any of the RNRB as it was not available. 100% of the RNRB will therefore be available to bring forward in these circumstances. The following example illustrates how this works in practice.

Example 3.2

Hanna and Brian

Hanna's husband Brian died on 1 April 2016. At that time, their home was worth £450,000. It was owned on a joint tenancy basis.

When Brian died, his share of the property passed directly to Hanna under the survivorship rules. Hanna also inherited the rest of Brian's estate. There was no IHT to pay as the spousal exemption applied. As Brian died before 6 April 2017, his estate could not have used any of the RNRB, so 100% is available to bring forward.

When Hanna died on 1 July 2022, she left her estate to her daughter Evie. At the date of Hanna's death, the value of the family home was £550,000 and the value of her other assets was £500,000.

The following nil rate bands are available to set against Hanna's estate:

- 100% of Brian's nil rate band (£325,000).
- 100% of Brian's RNRB (£175,000*).
- 100% of Hanna's nil rate band (£325,000).
- 100% of Hanna's RNRB (£175,000).

*The unused percentage on Brian's death is 100%. If we apply this unused percentage to the RNRB for 2022/23, Hanna receives a brought forward RNRB from Brian's estate of £175,000.

The total estate exempt from IHT is therefore £1m.

As Hanna's estate is worth £1,050,000, there is an IHT liability of £20,000 (i.e. £1,050,000 − £1,000,000 = £50,000 at 40%).

Without the benefit of Hanna and Brian's RNRBs, the IHT bill would have been £160,000 (i.e. £1,050,000 − (2 × £325,000) = £400,000 × 40%).

The RNRB is usually only available where a 'qualifying residential interest' is 'closely inherited'. Generally speaking, this means where a property that the deceased occupied as their residence is left to a direct descendent, e.g. a child (including a stepchild, adopted child or foster child), grandchild, the spouse or partner, or survivor of a child or grandchild. The RNRB is also available to the estates of those who downsized or ceased to own their home after 7 July 2015, and assets of an equivalent value are passed to their direct descendants on death.

For estates with a net value of over £2m, the RNRB is withdrawn at a rate of £1 for every £2 over the £2m threshold. Individuals with estates in excess of the threshold may wish to consider gifting income or assets that are surplus to their needs to protect their RNRB.

On the Web

For more information on the RNRB, go to:
www.gov.uk/guidance/inheritance-tax-residence-nil-rate-band.

B10E Trusts

If the client is the settlor, trustee or beneficiary of a trust, the financial planner should note this together with a broad outline of the terms of the trust. A copy of the trust deed is very desirable.

The following should be recorded in the fact-finding process:

- The settlor – the person who created the trust.
- The amount settled into the trust and date of payment – necessary to establish any available nil rate band.
- The trustees – the legal owners who hold the property and administer it for the beneficiaries.
- The beneficiaries – the people who benefit (or might benefit) under the trust.
- The date of the trust – this is particularly relevant with the changes in the taxation of trusts introduced in the **Finance Act 2006**.
- The property held in the trust, including base costs, current value, income yield and costs of administration.
- The general purpose of the trust (e.g. parental transfers to pay for school fees, university fees or home purchases).
- The terms of the trust and its type, including the nature of the beneficiaries' interests (e.g. income or capital interest).

The following table gives a brief description of some of the main types of trust clients may have.

Table 3.2: Types of trust

Bare trust (absolute trust)	• The beneficiary has an immediate and absolute right to both the capital and income from a trust. • Someone who sets up a bare trust can be certain that the assets they set aside will go directly to the beneficiaries they intend. Once the trust has been set up, the beneficiaries cannot be changed. • The trust assets are held in the name of the trustees, who have no discretion over the amount of income or capital to pass on to the beneficiaries. • Bare trusts are commonly used to transfer assets to minors. Trustees hold the assets on trust until the beneficiary is 18 in England and Wales, or 16 in Scotland. At this point, beneficiaries can legally demand that the trustees transfer the trust fund to them.
Interest in possession trusts	• A beneficiary has an immediate and automatic right to the income from the trust. • The trustee must pass all of the income received, less any trustees' expenses, to the beneficiary. The beneficiary who receives income is known as the life tenant and often does not have any rights over the capital held in such a trust. • The capital normally passes to a different beneficiary, known as the remainderman, in the future (usually after the death of the life tenant).
Discretionary trust	• The trustees have 'discretion' over distribution of the trust's income. They may also have discretion over how to distribute the trust's capital and may be able to 'accumulate' income – i.e. add it to the capital. Trustees may be able to decide: – how much income and/or capital is paid out (if any); – which beneficiary(ies) will receive payments; – how often the payments are made; and – what, if any, conditions to impose on the recipients. • Under the terms of the deed that creates the trust, there may be situations when the trustees have to use income for the benefit of particular beneficiaries. However, they may still retain discretion about how and when to pay. The extent of the trustees' discretion depends on the terms of the trust deed.
Trusts for vulnerable beneficiaries	• A vulnerable beneficiary is either a person with a disability or a 'relevant minor' child, i.e. a child under 18 who has lost at least one parent through death. • For persons with a disability, the trust's assets can be used only to benefit the person with a disability. They must be entitled to all the income or, if they are not, none of the income can be applied for the benefit of anyone else. • For relevant minors, the assets and income must be used only for the relevant minor and, when they reach 18, they must get all of the trust's assets. • The settlor must not be able to benefit from the trust in any way. • If these conditions are met, then the trust is effectively charged at the beneficiary's rate of tax on income and gains rather than at the trustee rate, which is generally higher.

B10F Lasting powers of attorney

The fact-finding process should include details of any general power of attorney, enduring power of attorney (EPA) or ***lasting powers of attorney (LPA)***, including the names of the nominated attorneys and the circumstances in which the power of attorney is activated.

- A **financial decisions LPA** allows the attorney to act on the donor's behalf in relation to their property and affairs at a time when they are no longer able or lack the mental capacity to make decisions themselves, or before such a time if that is the donor's stated wish. In either case, it can only be used once it has been registered at the Office of the Public Guardian (OPG).
- A **health and care decisions LPA** allows the attorney to act on the donor's behalf in relation to their personal welfare. It can include the power for the attorney to give or refuse consent to medical treatment if desired. It can only be used once the form is registered at the OPG and the donor has become mentally incapable of making decisions about their own welfare.

B11 Establishing the client's risk profile

One of the key purposes of the fact-finding process is to establish each client's risk profile.

Refer to

See *Establishing and explaining the client's risk profile* on page 2/16 on establishing the client's risk profile.

B12 Socially responsible investing

Client objectives for investments do not always include purely economic goals; there may be ***ethical and religious considerations***. Many people have strong ethical reasons for choosing or excluding certain types of investment. It is therefore important to find out whether the client has such views or affiliations that could impact on investment, borrowing or any other aspect of their financial affairs.

Broadly, socially responsible investing (SRI) reflects the ethical, moral, religious or socially responsible beliefs of the client and can heavily influence their choice of investments.

In the investment world, the expressions 'ethical investment', 'environmental investment', 'green investment', 'responsible investment', 'sustainable investment' and 'socially responsible investment' are often used interchangeably. It is increasingly common for clients to be concerned about the environmental, social and governance (ESG) factors that will affect the sustainability and ethical impact of any investment. Also included in this group are a growing number of Sharia investments, which meet the strict rules of Islamic finance.

Sustainable finance

Sustainable finance is the process of taking ESG considerations into account when making investment decisions, leading to more long-term investments in sustainable economic activities and projects.

ESG refers to a set of criteria (material factors) used to assess a company's practices that investors can use to screen their investments:

- environmental factors include climate change and pollution;
- social factors include human rights; and
- governance includes factors such as the quality of the company's management.

These material factors are the financial elements deemed fundamental to the long-term success of a company's ESG strategy. Significantly, better company ESG performance has been shown to improve economic growth and is associated with a positive effect on living standards in the country concerned.

It is worth remembering that partners may not share identical views on this subject, so it may be necessary to work out some kind of special arrangement for each partner's assets where it is not possible to achieve a compromise.

Most of the issues arise with respect to investment decisions. In addition to the usual factors that need to be taken into account when recommending an investment strategy, when it comes to recommending a sustainable one, the adviser should also consider:

- How strong the client's beliefs are and the extent to which the client wishes to build them into their portfolio.
- Incorporating the client's values and views into the investment process.
- Recommending products and funds that are the most appropriate for the client from both a financial and personal perspective.
- Whether their beliefs will lead to a restricted choice of funds and less diversification.
- Whether the funds chosen have higher charges than their non-sustainable equivalents.
- Whether the funds chosen are likely to perform differently and with more or less volatility than their non-sustainable equivalents.

Sustainable and ESG investment approaches
There are a number of sustainable and ESG investment approaches:

- Positive screening – Firms are only 'screened in' if they take social responsibility seriously and make a positive contribution to society and the environment.
- Negative screening – Firms that are involved in activities deemed to be harmful, such as tobacco firms and arms manufacture, are 'screened out'.
- Norms-based screening – This is similar to negative screening. Firms are assessed against specific standards of ESG performance. Firms that do not meet the required standards are excluded from the portfolio.
- Best in class – A fund may invest in firms in sectors such as energy production, but only if a particular firm has better records on the environment and human rights than other firms in their sector.
- 'Shades of green' – This is similar to positive and negative screening in that firms that qualify for the former may be described as 'dark green', whereas some companies that are normally screened out may be described as 'light green' if they have a decent record in other socially responsible factors.
- ESG integration – The explicit and systematic inclusion of ESG issues in investment analysis and investment decisions. Here, the investment manager will:
  - analyse financial information and ESG information;
  - identify material financial factors and ESG factors;
  - assess the potential impact of material financial factors and ESG factors on economic, country, sector and company performance; and, finally
  - make investment decisions that include consideration of all material factors, including ESG factors.
- Impact investing – This seeks to generate financial returns while also creating a positive social or environmental impact. Investors will consider a firm's commitment to corporate social responsibility or the duty to serve society as a whole.
- Thematic investing – This allows investors to address ESG issues by investing in specific solutions to them, such as renewable energy, waste and water management, sustainable forestry and agriculture, health products and inclusive finance.

On the Web
For more information on how the Government intends to grow a culture of social impact investment and savings in the UK, go to: *www.impactinvest.org.uk/*.

Ethical and SRI funds are run with a number of key issues in mind. The main ones include:

- environmental issues;
- war and arms manufacture and trade;
- social policies – e.g. avoiding excessively high remuneration policies or exploitation of labour;
- animal welfare; and
- tobacco and alcohol.

The financial planner should discuss with their clients whether they wish for these issues to affect their investment policy. Some religions, notably Islam, have precepts against charging or receiving interest, which can affect borrowing as well as investment and savings decisions. If the client is Muslim, it is important to ask whether this will affect their financial planning. Where the client wants to use Islamic financial products, it may be necessary to use the services of a specialist.

Performance of ethical and SRI funds
There is some controversy about whether SRI and other such values-based financial planning can have an adverse effect on performance and cost. These issues should be discussed with clients.

The case against SRI is as follows:

- SRI, by definition, involves restricting investment choice. For example, tobacco companies generally have high yields and are strong defensive holdings. By excluding them from a portfolio, the potential for dividend income is reduced.
- Many SRI funds exclude many of the world's largest companies and are therefore confined to relatively smaller companies, whose investment performance is typically more volatile.
- SRI generally involves active investment and higher costs than passive index-tracking funds.
- It can be difficult to screen some companies effectively, particularly those that are very large and those with less than transparent business structures.

The case for SRI, however, is as follows:

- SRI generally means choosing companies that have forward-thinking and progressive policies. In the long term, such companies tend to prosper.
- Many of the areas in which SRI companies operate – e.g. the environment – are very promising and should form the basis for future investment success.
- In 2020, Morningstar reported that six out of ten sustainable funds had delivered higher returns than equivalent conventional funds over the past decade.

Some Islamic borrowing and deposit arrangements may be more expensive or involve other drawbacks compared to their counterparts. These potential drawbacks should be set against their religious and other advantages.

One way of discussing SRI with clients is to ask them whether it is more important to them than investment performance, in respect of returns or volatility. It is also helpful to ask them to complete a fact-find that specifically addresses ethical concerns.

'Greenwashing' – where companies exaggerate their green credentials – is a potential concern. In DP21/4, the FCA consulted on new Sustainability Disclosure Requirements (SDR). The aim of the SDR is to provide an industry-wide standard for key sustainability-related information, e.g. how the investment firm is managing sustainability risks, opportunities and impacts, and the sustainability characteristics of investment products.

On the Web
For more information you can visit: *www.fca.org.uk/publications/discussion-papers/dp21-4-sustainability-disclosure-requirements-investment-labels*.

C Methods of gathering client data

C1 Sources of information

Even in simple cases, the fact-finding process may involve using a number of sources from which to gather information. In complex cases, the information-gathering process may be intensive.

The sources of information about a client may include:

- **The client and their partner/spouse**. The financial planner may meet them on several occasions in the fact-finding process and see them together or separately. The client might complete a fact-find in advance of the main meeting, or all the fact-finding questions might be asked at the face-to-face encounter.
- **Documents produced by the client or others**. The financial planner should ask for documents and records that provide details of the client's income, assets and other issues. These may be well or poorly organised, and complete or inadequate. It is likely that the financial planner will need to obtain a letter of authority to ask the client's advisers, product providers and others for full and up-to-date information.
- **Other advisers and relevant people.** There may be a need to talk to the client's other advisers, such as their accountant, lawyer or investment adviser. This can be especially important if the client has entered into complex arrangements that they do not fully understand. Other sources of relevant information might include the pension advisers to the client's employer or the human resources department, trustees, other family members and business partners.

It may take time for the financial planner to build up a complete picture of the situation, and inconsistencies can emerge from the process. For example, the client may turn out to have a weaker pension scheme than they thought or a will that has provisions that the client has forgotten about or never fully understood.

At the end of the fact-finding process, the financial planner should perform a synthesis to pull the facts together. After that, it becomes possible to carry out the analysis and produce some solutions to the main problems.

C2 Timing of data collection

All fact-finds have the same purpose: to record information that will enable the planner to gain a detailed understanding of the client.

- Some planners ask clients to provide personal and financial information in advance of the initial meeting. This is usually on a fact-find form or in the form of a statement of holdings, income and expenditure.
- Many planners prefer to complete the fact-find with their client at the meeting and use this as a part of the questioning process. When used in this way, the fact-find can be a very useful *aide-memoire* and can give the client confidence in the planner's ability to capture all the relevant detail.
- Some planners prefer the client to complete the questionnaire after the first meeting.
- One approach is to ask a paraplanner to complete the parts of the questionnaire form that cover the gathering of hard facts, leaving the soft fact gathering and, in particular, the aims and objectives and risk profiling to the planner.

C3 Hard and soft facts

There are two broad types of information: ***hard facts*** and ***soft facts***.

Hard facts are objective, often quantitative, information about a client's circumstances.
For example:

- where the client was born;
- the client's employment status; and
- the investments held by the client.

Soft facts relate to the client’s preferences, objectives and aspirations. For example:

- the client’s attitude to risk;
- when the client hopes to retire; and
- the client’s wish that their child be privately educated.

Refer to
See *Questioning techniques* on page 1/15 for further details of questioning techniques.

C4 Questioning techniques

Financial planners need to ask clients many questions, some of which are complicated and about sensitive subjects where it is important that they obtain useful answers. It is usually advisable to use a questionnaire or checklist of questions.

- The questionnaire helps to ensure that no areas are omitted from the fact-finding process, although, of course, most cannot include the full range of supplementary questions that might arise in some situations.
- It also helps to make sure the questions are asked in a logical order.
- The financial planner becomes familiar with the process, which should be reasonably relaxed.

Some financial planners complete a paper questionnaire that corresponds to a computer-based software questionnaire, and the information is typically transferred to the computerised records after the meeting. However, many financial planners input the data straight into the computerised system without causing any delay to the interviewing process.

C5 Phrasing questions

The manner in which questions are phrased to clients is important in the following three respects.

1. **Obtaining information**
   The phrasing of questions can influence the financial planner’s success in obtaining all the necessary information, particularly the appropriate use of open- and closed-ended questions.

   Open-ended questions permit the client to respond widely and they generally elicit soft facts. In contrast, closed-ended questions typically elicit hard facts and generally provoke ‘yes’ or ‘no’ responses. For example, when asking a client whether they have made any pension arrangements, a closed-ended question would be: ‘Are you a member of a pension scheme?’ In contrast, an open-ended question would be: ‘What plans have you made, or do you intend to make, to provide yourself with an income in retirement?’

   Open-ended questions are not better than closed-ended questions, or vice versa. The two types of question have different objectives and effects. The adviser needs to use both correctly.
2. **Client understanding**
   Clients may not understand questions about financial issues unless they are clearly posed and free of jargon. Sometimes jargon is inescapable, but it is essential to explain it in plain English.

   For example, a client might be baffled by a question like: ‘What type of scheme is your company pension – DB or DC? With some clients, it might be better to ask: ‘Please may I see the scheme booklet of your employer’s pension scheme?’
3. **Thought-provoking questions**
   Some questions should encourage the client to consider areas of financial planning that had not previously occurred to them.

   For example, a client could be asked: ‘If you had an accident or a serious illness that meant you were off work for at least six months, what benefits would your employer provide for you?’ This would probably lead to a discussion of income protection needs.

C6 Recognising potential errors and inconsistencies in information provided by clients

At all stages of the financial planning process, it is essential to check information and look out for inconsistencies that can arise in a range of situations. Clients can make mistakes, not understand financial issues or products, or have mutually incompatible aims.

An unusually high or unusually low tax bill may indicate other sources of income, or possibly that a substantial amount of 'income' represents bond withdrawals or ISA income. Another possibility is that the client has made a substantial pension contribution or has incurred a business trading loss.

An inconsistent attitude to investment risk or particularly high expectations of investment returns should be a prompt for further discussion.

For example, a client who professes to have a cautious attitude to investment risk but who expects annual investment returns of 5% or 6% in real terms is demonstrating a degree of inconsistency. The planner should explore this with the client in greater detail and bring their expectations more into line with their declared attitude to risk.

Some information from clients will probably be out of date. It is therefore sensible for the planner to try to verify all data with source material, either in the form of the original documents or photocopies.

For example:

- life assurance, investment or pensions documentation;
- the client's will, trusts and similar documents, such as EPAs or LPAs, together with any letters of wishes; and
- in the case of a business, the accounts, memorandum and articles of association, and details of the website to provide a general understanding of the activities of the business.

Obtaining accurate information about clients' investments, as well as other financial assets and entitlements, is an essential part of the financial process. It can also be very time-consuming, so many aspects of it are best carried out by a paraplanner.

D The regulator's findings of good and poor practice among firms

Financial planners may find it useful to see the regulator's examples of good and poor practice in relation to 'know your customer' fact-finding. The findings have been slightly adapted and are set out in the following table.

Table 3.3: Client's goals and objectives explored fully

Initial fact-find and objective setting	
Good practice	• The financial planner takes account of the client's future goals and aspirations including plans for the future (e.g. having children or paying for higher education). • The planner then assesses the client's current circumstances (including income, expenditure, protection, retirement plans, savings and investments) and compares this to the client's requirements over a period of time (e.g. what they want to do in retirement and how much pension income they will need).
Poor practice	• There are non-existent or incomplete fact-find documents. • Inadequate records of clients' objectives have been kept. • There was a failure to fully consider the implications of clients' tax positions.
Information updated at subsequent review meetings	
Good practice	• Information obtained about the client is extensive and updated on an annual or biannual basis. • This information includes updating wills, attitude to risk, dependants/beneficiaries, portfolio valuations, State Pension benefits, projected cash flow analysis, personal and health details, detailed personal tax computations and details of clients' other professional advisers.
Poor practice	• The information held on file had not been updated for seven years, yet advice was given on the strength of the original details.
Attitude to risk	
Good practice	• The firm recognises that when advising couples and/or people with a number of needs, they can have different attitudes to risk for each.
Poor practice	• The fact-finds contained contradictory information relating to clients' attitudes to risk.
Existing arrangements	
Good practice	• A firm discusses and records all existing plans the clients have in place and builds these into its subsequent recommendations wherever appropriate.
Poor practice	• A failure to record or update information on existing policies, plans and investments resulted in a client being recommended two equity ISAs in the same tax year.

E Identify actual or potential conflicts of interest

A conflict of interest arises when a person or organisation has multiple objectives or interests and, as a result, has conflicts about the best course of action to take. ***Conflicts of interest*** can present ethical dilemmas for financial planning firms, especially where inducements or payments are received in return for providing a service to clients, and can potentially lead to unethical behaviour. This could also be deemed to be in contravention of the **Bribery Act 2010**.

It is inevitable that, from time to time, conflicts of interest will arise. It is important to identify them and take action to deal with them. Some minor potential conflicts of interest can be managed by simply declaring to all the clients concerned that they exist and asking the clients if they have any objections to or difficulties with the situation. However, in many cases, the conflict can mean that either the financial planner or the firm cannot act for a client or cannot advise on a particular aspect of their affairs.

E1 The regulatory basis

Dealing with actual and potential conflicts of interest is one of the central aspects of the FCA's requirements relating to the fair treatment of customers.

There are also several specific provisions in the Conduct of Business Sourcebook (COBS) rules to ensure that clients are treated fairly in this respect:

- Where a firm currently receives a fee or some other remuneration from an investment purchase or switch, the firm should make sure that this is in the best interests of the client.
- A financial planner may be acting as a broker-fund manager and be receiving remuneration for acting as adviser to both the client and the product provider. The FCA would usually need the firm to obtain an acknowledgment from the client that they understand this dual role.

The regulator has taken this a step further and now expects firms to establish effective frameworks to identify, control and review potential and actual conflicts of interest. Furthermore, it expects that this should be a high-level principle built into the core systems and controls of the business.

Some preventative steps a firm can take include ensuring that the remuneration package of its employees does not intentionally or unintentionally lead to a bias against clients. Where employees receive a bonus, the FCA prefers that this is not entirely linked to performance and profitability. Instead, it could, for example, include some element of reward for the quality of the business or be based on key performance indicators (KPIs), the level of complaints or customer satisfaction.

The FCA expects the senior management of a firm to ensure that their business model demonstrates a credible long-term commitment to serve their customers' best interests. This model should therefore avoid a situation where short-term business goals conflict with the long-term interests of customers.

E2 The main types of conflict of interest

The main types of conflict of interest are between the interests of:

- the financial planner personally and the client;
- the financial planner's firm and the client; or
- a client and another client.

Each of these conflict types is explored further in the following sections.

E2A Conflicts between the financial planner personally and the client

Financial planners may encounter situations where there is an actual or potential conflict of interest with a client on a personal basis. This may arise because the client is a member of the planner's family or because some situation arises in which the impartiality of advice is compromised.

eg

Example 3.3

Jo's conflict of interest

Jo is a financial planner who is advising a member of her own family. She has identified that there is a potential conflict of interest between her and other members of the family – notably her brother and her cousins – in three main areas:

- the provisions of a trust set up by her grandfather;
- the advice she is giving her parents about their wills; and
- the loan that her brother Ron has requested from their parents for his business.

As a financial planner, Jo is in a position of trust and could use undue influence to affect the outcome of a decision in order to benefit herself and her own children. Jo decides that, in this case, she needs to hand the case over to another financial planner who can take a more dispassionate view of the situation.

Financial planners need to be alert to these situations and bring them to the client's attention. At the very least, the position should be recorded in writing to the client. In some cases, the planner may feel the need to pass the case to a colleague or even another firm.

E2B Conflicts between the financial planner's firm and the client

In general, any kind of remuneration structure can lead to a potential conflict of interest and to the client possibly paying excessive amounts for the services provided. The answer to this general issue is to provide good value for money (which is not synonymous with low-cost services), as well as clarity and transparency of remuneration.

The Retail Distribution Review (RDR) went some way to eliminating this potential bias by banning the payment of commission on all retail investment advice. However, there is still a potential for overcharging on fees and failing to follow through with promised levels of service. Fees charged should be fair, equitable and commensurate with the work that has been undertaken for the client. Where an ongoing adviser charge is levied, the firm should ensure that it follows through with all the services promised within the specified timescales.

Firms also need to be aware of the potential for a conflict of interest in dealings with third parties who provide investment services, such as discretionary fund managers and platform providers. Firms are expected to prevent (rather than just identify and manage) conflicts of interest where third parties are used to carry out critical functions.

In some cases, the planner's firm may be promoting a product in which it or its parent company has an interest. The position must be made clear to the client. One area of concern highlighted by the regulator is where a firm has a shareholding in the platform it is recommending to its clients.

Refer to

See *Distributor-influenced funds* on page 3/34 for more on DIFs.

Another area that has come under increasing scrutiny from the regulator is the use of distributor-influenced funds (DIFs) offered by some firms as a centralised investment proposition. The regulator's main concern is that adviser firms with DIFs generally receive a direct financial benefit from the product on which they are making recommendations. It sees this as a conflict of interest between the financial incentive for the firm to recommend the DIF and the client's best interests. This was somewhat addressed with the introduction of adviser charging, although the regulator has warned that it will keep a close watch on the quality of advice in this area.

Following the Financial Advice Market Review (FAMR), the FCA announced its intention to consult again on its inducement rules in order to 'make it clear that advisory firms cannot continue to receive significant hospitality (or other inducements) from product providers and claim this is compatible with the rules on the grounds that the relevant benefit is not in connection with services provided to individual clients' (FCA policy statement 17/14).

Firms providing independent or restricted advice to retail clients in the UK cannot accept any payment, commission or benefit of any kind which is paid or provided in connection with their business of advising, except for:

- any form of charge payable by, or on behalf of, a retail client in relation to the provision of a personal recommendation (i.e. adviser charges); and
- acceptable minor non-monetary benefits.

The rules do not prevent firms from organising or attending conferences, providing their actions comply with the applicable rules.

On the Web

Download and read the FCA's latest guidance on inducements and conflicts of interest at: *www.fca.org.uk/publication/policy/ps18-10.pdf*.

E2C Conflicts between clients

Conflicts between clients mainly arise in a family or business context.

Families

Many families work reasonably harmoniously together and may be prepared to use a single financial planner to handle all their financial affairs. However, some situations might lead to a conflict, such as a will or a trust where one family member might gain at the expense of another.

Example 3.4

Jack and Marlene

Jack recently died but had set up a trust with an income beneficiary – his widow, Marlene. The capital beneficiaries are his children, who expect to benefit after Marlene has died.

This has led to a conflict between the two sets of beneficiaries. Marlene wants the maximum possible income from the trust fund and has asked the trustees to invest in funds that seem to produce a steady capital loss in most years but a relatively high income for her.

It should be possible for George, the financial planner, to advise the trustees, who have a duty to be fair to both classes of beneficiaries. However, it has proved impossible for George to advise all the beneficiaries as well. He tried working for the whole family with a specific written agreement and statement about the situation that they had all signed, but it did not work and now he acts just for Marlene.

Relationship difficulties can also lead to conflicts of interest between clients for whom a financial planner has acted in the past. It may be possible to continue working for both parties and even act as some kind of bridge between them with their explicit agreement but, generally, it is better to act for just one party.

Businesses

In a business context, conflicts of interest can arise between employer and employee. Financial planners often find themselves acting for both, especially when looking after a group pension arrangement. There is always a potential conflict of interest but, as long as clients are aware of this and respect the need for confidentiality for both sides, there are usually no problems.

If there is a disagreement leading to a termination of the employment, it may be possible to agree to confine the planning work for the employee to non-contentious issues, although this can be difficult.

Where a financial planner acts for the owners of a business, similar considerations arise. It should generally be possible to act for all sides while things are going well and everyone is clearly made aware of the situation in writing. However, if there is a split or serious difference of opinion, it might be more difficult to act for all parties.

Consider this…

Have you been in any situations as an adviser where there was a conflict of interest? If so, how did you deal with it? What would you do differently next time?

F Working with other advisers

Financial planners must generally be prepared to work with other advisers in the formulation and implementation of a plan that covers all aspects of the client's finances.

Many financial planners are also specialists working within banks, building societies, legal and accountancy firms, and stockbroking or fund management businesses. Other specialists may be colleagues within the same organisation or group, or they may be external.

F1 When the need to work with other advisers may arise

Most clients who have a significant level of income or assets are likely to have a variety of other professional advisers and will want to continue to work with them, even if the financial planner can provide specialist services in certain areas.

For example, the financial planner may have a tax compliance practice within their firm, but the client may wish to continue using their own existing advisers in this area.

- Financial planners should be aware of their limitations and recognise situations where they should refer to other experts. These include where:
  - the planner does not have the training or expertise to provide all the services needed (e.g. legal advice);

   - the planner does not have the specialist in-house facilities (e.g. for arranging mortgages); and
   - the planner is not allowed to offer advice or services in a particular area. For example, the company may not be regulated to provide investment advice generally or in a particular area, such as individual stocks and shares.
- The financial planner may be within a team of ***specialist advisers*** helping a client, each of whom must know their limitations and when to call on the expertise of the specialists.
- In some cases, the financial planner overtly coordinates the other professionals directly, issuing instructions and holding meetings; in many cases, the client takes the lead, relying on the planner's advice. The specialists need to be aware of the big picture and contribute in their areas, but it is the financial planner who should pull it all together. The written financial plan can act as the coordinating document.
- It is important that the financial planner makes sure the professional they recommend is competent and reliable. Recommending a poor adviser can lead to serious problems: the direct impact will be on the client and how their affairs will be handled; and there could be an indirect reflection on the person who made the recommendation's judgment. It is always worth checking an adviser's reputation with other professionals – and other clients, where possible. Of particular importance is knowing that the adviser is genuinely knowledgeable and skilful in the specialist area required. For example, an employment lawyer is unlikely also to be a specialist in trusts.
- The financial planner should always be aware that specialists tend to see client problems and solutions in terms of their particular speciality. While a life assurance specialist may see an estate planning problem in terms of a life assurance solution, a lawyer may see it in terms of a trust or a will. In reality, estate planning could involve aspects of either speciality, or even both, depending on the circumstances.

Financial planners may come from a variety of backgrounds and different types of firm. Where the financial planner is a potential competitor with the specialist, there is a possibility for a conflict that will need to be resolved. Either the specialist adviser should be made to feel that there is no threat to their position, or they should be replaced.

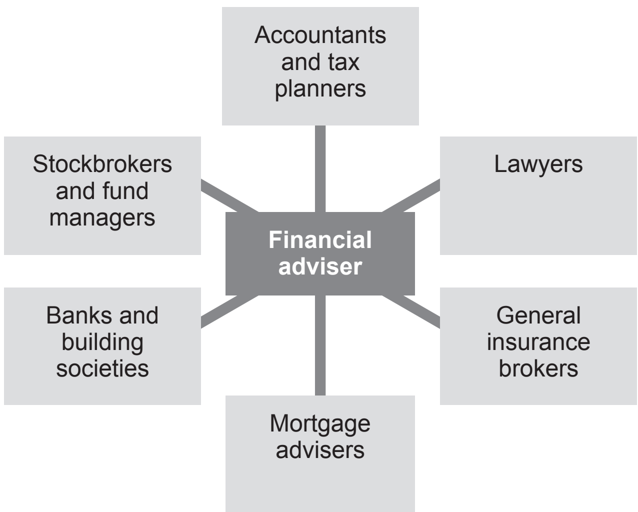
F2 Special considerations with specialist advisers

Specialist advisers have strengths in their own areas of expertise, but they might tend to see a client's affairs exclusively from their own (possibly one-sided) perspective rather than the client's overall position or objectives.

For example, a tax adviser might regard the tax aspects of a person's investments as supremely important and all other aspects of investment as being of a secondary nature. The best specialist advisers should guard against this type of tunnel vision, and all advisers should be holistic to an extent and contribute to the financial planning process.

The illustration that follows shows the main areas of speciality that a financial planner is likely to encounter and these are described in the following sections.

Figure 3.1: The network of advisers



F2A Accountants and tax planners

The main areas of expertise provided by accountants are as follows:

- Most of the tax advice in the UK is provided by accountants, and their advice on specialised issues (as well as general tax compliance) is likely to be required by many of the people who also want to engage the services of a financial planner.
- Drawing up accounts for use by management in the business and at the business year-end requires accountants with specialist expertise in the presentation of financial information. Many of the rules and general approaches to the choice and layout of financial information used by accountants will be relevant to financial planners coming from other specialities.
- An area in which specialist forensic accounting services are often required is relationship breakdown. The ability to value assets and present financial information clearly and effectively is very useful and can have a marked effect on settlements.
- Administering estates and trusts, as well as managing assets, is a natural province for many accountants because of the tax implications and the need for regular and accurate financial information.

Accountants have sometimes been accused of focusing on the history of a client's affairs at the expense of planning for the future. This is understandable in the light of their auditing, tax compliance and reporting functions. Increasingly, however, accountants are aiming to provide more planning services and many do practise forms of financial planning, both with and without direct involvement in providing specific investment advice.

F2B Lawyers

The type of lawyers who private clients see most often are solicitors, as barristers are almost exclusively used for very specialist advice and advocacy in court. Good lawyers necessarily take a rounded attitude to their clients' affairs: legal issues are seldom clear-cut and many other aspects of a person's situation have to be taken into account when giving sound legal advice. It is therefore not surprising that lawyers have traditionally been regarded as advisers whom many families depend on.

The main reasons for specifically consulting a lawyer are:

- Making or amending a will. Even a relatively simple will should be drafted by a qualified person, as there are many pitfalls and the amounts of money that could be at stake make it imperative to avoid expensive mistakes. The more complicated the will and the higher the value of the potential estate, the more important it is that a specialist is chosen.
- Administering the estate of a deceased person.
- Setting up an LPA.
- Setting up and administering a trust. Many financial planners would suggest that it is unwise to set up any trust without taking the advice of a lawyer. Where a person has set up several trusts, it is worth taking into account the possible effects of a new trust, even if it is a relatively straightforward life assurance trust. Trust law is complicated and not necessarily familiar territory for all lawyers. Even trust lawyers can encounter difficulties with specialist insurance trusts.
- Buying and selling property.
- Arranging divorce or civil partnership dissolution financial settlements.
- Arranging a loan or mortgage.
- Specialist tax advice.
- Litigation. A court action can be ruinous for most people and there is a good case for suggesting legal protection insurance to clients.

Some solicitors have moved from their legal specialities to provide investment and general financial advisory services, and appear to find themselves in a very strong position to provide comprehensive financial planning for clients. Many solicitors have established links with financial planners, who are either in-house or external, often because they find the compliance structure too costly to operate and monitor.

The Solicitors Regulation Authority (SRA) now allows solicitors to refer clients needing financial advice to any financial adviser that offers the best outcome for the client. Previously, solicitors had only been allowed to refer to independent financial advisers.

F2C General insurance brokers

Adequate cover of property and other assets is essential for financial resilience. If a client were to lose a valuable asset such as their home, a lack of adequate insurance cover would be a major financial disaster. For business clients, employers' liability, public liability, professional indemnity and business interruption insurance are correspondingly important.

F2D Banks and building societies

The main functions of banks and building societies are to accept deposits and to make loans. Most clients need both these services for much of their lives. The choice of the best arrangements for deposits and loans is an important aspect of financial planning. This involves having access to information about the terms offered by deposit-taking and lending institutions.

Their core activities have led banks and building societies into most other types of financial services, which may be complementary to, or competitive with, those offered by the financial planner.

F2E Mortgage advisers

Mortgage lenders and brokers must offer advice and recommend the most suitable mortgage to their clients. They must assess each client's ability to afford a mortgage, both now and in the future if interest rates were to rise, prior to recommending it by taking into account the client's income and expenditure.

Clients can refuse the advice given and proceed on an execution-only basis but, in doing so, they lose the protection offered by the Financial Ombudsman Service.

F2F Stockbrokers and fund managers

Some clients invest directly in shares and fixed-interest securities. For this service, they need a stockbroker or a fund manager. The management services can be provided on either a discretionary basis, leaving the stockbroker or fund manager to make the investment decisions within an agreed strategy, or on an advisory basis, i.e. not making any sales or purchases without consultation. Alternatively, they may offer an online execution-only service with no ongoing management.

The investments can be wholly in direct holdings of shares and/or can include investment trusts and collective investments, such as unit trusts, OEICs or life assurance-based products.

Inevitably, financial planners who provide investment advice are likely to see stockbrokers or fund managers as direct or indirect competitors for the investment of the funds.

Nevertheless, there are many clients for whom direct investment is appropriate. For them, the important aspects of the financial planning process are:

- explaining the advantages and drawbacks of this type of management;
- helping with the choice of the stockbroker or investment manager; and
- developing the investment strategy for the client.

F3 Centralised investment propositions

Many firms have a standardised approach to investment advice. This is categorised by the regulator as having a centralised investment proposition (CIP). Portfolio advice services, discretionary investment management and distributor-influenced funds are all examples of CIPs. The main driving force of CIPs is to add value for clients and to provide a framework for the delivery of any ongoing services promised.

F3A Portfolio advice services

These are model portfolios designed to match a specific risk profile and asset allocation model.

The advice services related to model portfolios include an ongoing review and, in some cases, rebalancing of the holdings on a regular basis, although any changes will be on an advised rather than a discretionary basis. Ensuring the ongoing suitability of a model portfolio is the responsibility of the planning firm, even where the research and fund selection is outsourced to a third party.

Be aware
Any changes to an advised model portfolio can only be completed with the client's consent. To do otherwise would require additional permissions from the regulator and more onerous reporting requirements.

Where a firm uses model portfolios, the regulator expects it to have adequate systems and controls to complete the necessary due diligence in relation to the initial selection of the underlying funds, and to review the continued suitability of these investments. The regulator also expects to see robust systems and controls to deliver the promised level of ongoing service required and see evidence that the suitability of the use of a model portfolio has been assessed for each client, as model portfolios will not be appropriate for some clients.

F3B Discretionary investment management

Discretionary investment firms provide bespoke investment solutions where they are able to buy and sell investments within a portfolio without the express consent of the client.

In other words, a discretionary investment manager (DIM) has full authority to act on behalf of a client in relation to the money held in the portfolio under management. Therefore, they require additional permission from the FCA to hold client money.

A recommendation for a DIM should be considered in the context of the client's other personal circumstances, objectives and needs. Where this recommendation does not relate to one or more specific financial instruments offered by the DIM, it will not be considered a personal recommendation. The standard for independent advice only applies to personal recommendations, so the recommendation of a DIM on this basis should not infringe on the standards for independent advice.

Where an adviser has an ongoing relationship with the client alongside the DIM, it is important to clearly establish the exact responsibilities of the two parties and the nature of the services offered. An adviser may be involved in establishing the discretionary mandate or providing information to the DIM in relation to the client's risk profile and investment needs and objectives. In addition, the investments managed by a DIM may only form part of the client's overall assets that the adviser includes in their periodic reviews.

F3C Distributor-influenced funds

DIFs are funds that individual intermediary firms set up in conjunction with a product or fund provider for the intermediary's exclusive use, and in which the distributor firm takes a more active role than in a wholly independent fund.

They are commonly arranged as OEICs, but can also take other structures such as insurance funds, all of which enable the intermediary firm to offer their own in-house range of funds. They can provide investors with the shelter of a fund if an adviser is to undertake regular portfolio rebalancing without incurring CGT, and there can be economies of scale.

F3D Benefits and potential problems

There are clear benefits for both the advisory firm and its clients where a CIP forms the core of their business model. Clients can benefit from more structured and thoroughly researched investments, with a focus on closer ongoing reviews and, in some cases, rebalancing. From the firm's perspective, there are efficiencies in the management of risks associated with investment selection.

The regulator has, however, identified a number of potential issues with CIPs, which have been the subject of a number of publications.

These issues are:

- **Shoe-horning**. The regulator is concerned that advisers are not adequately considering the suitability of CIPs for each individual client, who may be pushed into a 'one size fits all' solution. Whether independent or restricted advice is given, there must be adequate analysis and justification to ensure that the CIP solution offered adequately meets the client's needs and objectives. An adviser should tailor a CIP where appropriate, or not recommend it where it does not adequately meet the client's needs.
- **Charges**. The layers and complexity of charging structures of some CIPs can be confusing to a client and may not provide value for money. The charges and the services provided in return should be clearly determined. Firms advising on DIFs should only

receive an advice charge and should not receive any benefit for their role in the fund's governance. Adviser charges for recommending DIFs should not vary inappropriately compared to competing retail investment products.

- **Conflicts of interest**. This is more specifically when DIFs form the core solution for advisers. Given the conflicts of interest involved with DIFs, the FCA would question whether an independent firm could meet its obligations to act in the best interests of the client and provide advice in an unbiased manner if it recommends a DIF.
- **Blurring of responsibilities**. Where investment advice is outsourced to a third party, it is important to ensure that the responsibilities of all parties are clearly defined at the outset, as there is the potential for these to become blurred. This could lead to potential liabilities for all parties involved.

F4 Outsourced investment services

Many adviser firms have ***outsourced investment services***. There are many reasons why a firm would choose to outsource; for example, it may not have the skills or tools to enable the firm to do the job effectively in-house.

F4A Discretionary fund managers

Discretionary fund managers (DFMs) provide a highly specialised service, using their expertise to read market changes and make decisions about investment placement with a view to growing their clients' portfolios as well as protecting them from losses in times of market instability.

Traditional DFMs build bespoke portfolios for clients and typically require at least a £250,000 minimum investment. Others offer risk-rated discretionary model portfolios, which are cheaper and have much lower minimum investment amounts, making them more accessible for the majority of clients.

A recommendation to use a DFM is not usually considered as a personal recommendation, and therefore a firm does not generally need to demonstrate that it has picked a DFM based on the full standards required for independent advice. However, the firm should complete sufficient due diligence on the DFM to enable it to make a judgment on the suitability of the DFM for that particular client.

Where the advice relates to a specific investment offered by a DFM, such as a specific risk-rated portfolio, then this does constitute a personal recommendation and so the related rules and regulations apply, including those for the provision of independent advice.

F4B Multi-managers

These funds are either:

- funds of funds, which invest in a portfolio of other funds already offered by a range of different investment managers; or
- manager of managers funds, which use the services of different investment managers to manage specific sectors/asset classes within the overall multi-manager portfolio.

The choice of funds/managers available to the portfolio manager can be either without restrictions (unfettered) or limited in scope (fettered). They are similar in some respects to model portfolios; however, rather than being individual, separately held portfolios, they are more comparable with large collective or pooled investments, which enable individuals to participate in larger scale investments than they could afford individually.

The benefits of multi-managers are the diversification of risk not only between sectors but also between different investment houses, as well as benefits from the skill and investment expertise of a range of leading professional fund managers.

The overall multi-manager or management team reviews the constituent parts of the fund to ensure that they continue to meet the investment mandate. As with any other type of fund, the investment objective can be specific to a particular sector or asset class, and can include a risk control mandate.

The benefits of multi-manager funds are the same as for any other outsourced solution in that there are economies of scale and a level of investment expertise involved. The flip side is that charges tend to be higher on these funds and usually include the underlying investment charges of the constituent funds and the management charge levied by the multi-manager. With these higher charges, it will be much more difficult to provide outperformance.

Another important aspect for consideration is that multi-managers tend to not be very transparent about the make-up of the fund. This means that it is more difficult for an adviser to complete sufficient due diligence to prove suitability for each individual client.

G Compound interest and the time value of money

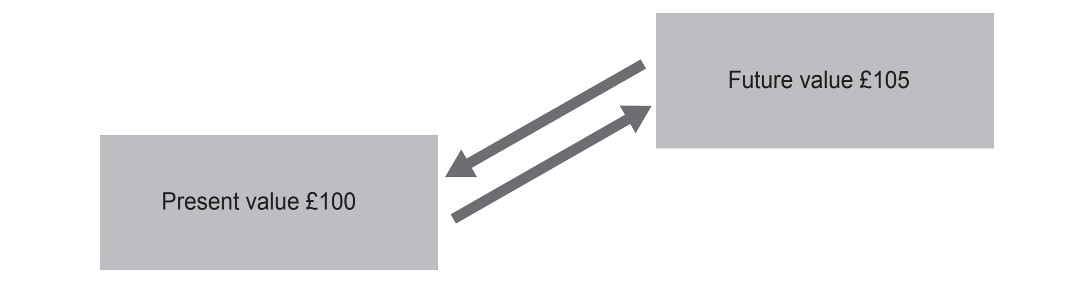
In order to carry out the synthesising and analysing process, it is helpful to have an understanding of the concepts of ***compound interest*** and discounting and the ***time value of money***.

G1 The time value of money

Money that will be received in the future is worth less than the same amount of money received now. In a very real sense, time is money. In the intervening period between now and that future point, the money could have earned interest or received some kind of return.

For example, if the annual rate of return on offer to investors is 5%, then £100 now will be worth £105 in a year's time, and the promise of £100 in a year's time will be worth £95.24 now. The current value of a future payment is called the **present value (PV)** and the value of an amount in the future is known as the **future value (FV)**.

Figure 3.2: Present and future value



G2 Simple and compound interest

The interest may be simple or compound:

- If the holder of a bank account spends all of their interest at the end of the year and then receives another payment of interest at the end of the following year (which is also spent), the interest is simple.
- If the investor leaves the interest in their account, there is a compounding effect and, in future years, interest will accrue on the combined interest and capital.

In the early years, the interest on the interest is a small proportion of the overall return but, as time goes by, the proportion grows considerably.

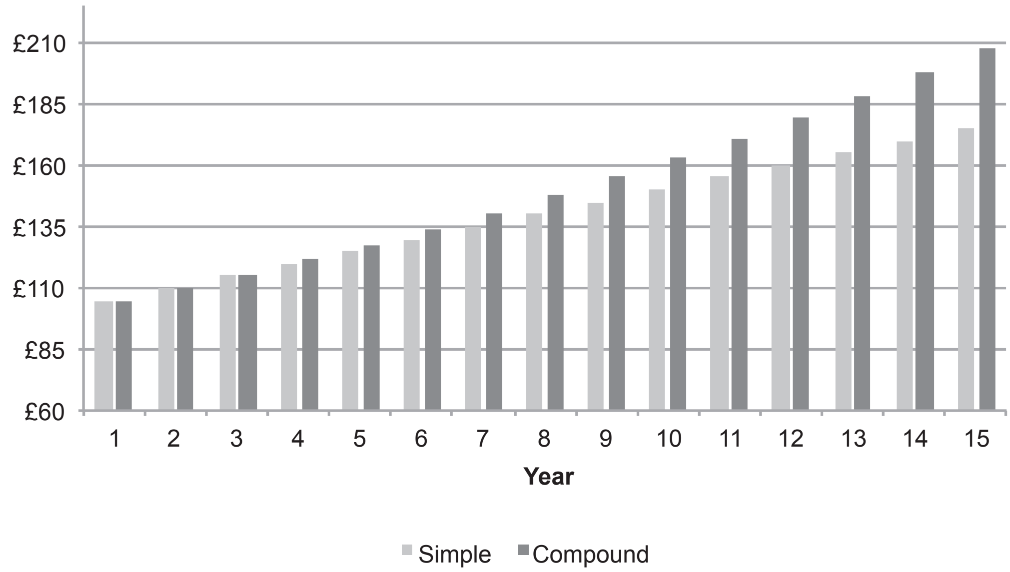
The process of calculating the growth with compound interest is called 'compounding'. The calculation of the PV is called 'discounting'.

Refer to

See *Formulae for compound interest and discounting* on page 3/42 for worked examples of calculations.

The graph that follows shows 15 years of 5% compound interest on £100, which grows to £207.89. In other words, the PV of £207.89 in 15 years is £100, assuming an interest rate of 5% compounded annually. Simple interest at 5% on £100 is £100 × 5% × 15 years = £75, so the £100 has grown to £175.

Figure 3.3: Simple and compound interest



G3 Calculations

There are three main ways to carry out compound interest and discounting calculations:

- use the formulae plus a calculator;
- use a spreadsheet with the formulae embedded; or
- use compound interest tables.

Be aware

In the R06 examination, candidates are expected to use the appropriate formulae and a calculator.

G4 Using compounding and discounting

Compounding and discounting calculations lie at the heart of much financial planning. If the client agrees that they need a retirement fund of £1m in 20 years' time, this kind of calculation can be used to estimate how much capital and/or annual savings would be needed to provide that sum.

The key issues for this investor might be:

- What rate of interest or investment return could reasonably be assumed?
- How important is it that the target amount is reached in exactly 20 years?

The main determinant of the rate of return will be the choice of investment and how that investment behaves in the future.

Different investments tend to provide different rates of return:

- **Cash** might seem straightforward, yet interest rates fluctuate considerably.

  In 2008, it would have been reasonable to have assumed a long-term average interest rate of, say, 4% to 5% a year. By 2022, however, with a base rate of 0.75% and high-street fixed-term deposit interest rates at around 2%, this would be unrealistic. The potential difference in outcomes is substantial, especially over a long period like 20 years. An investor would need a capital sum of £456,387 growing at 4% now to generate £1m in 20 years' time. However, if the return is assumed to be only 2% a year, the investor would need to start with an initial investment of £672,971. The increased investment needed now to reach the same target is £216,584.

- **Fixed-interest** returns seem to offer more certainty, as the returns are fixed.

  The only uncertainty about future interest rates would be the rate of return on the reinvested annual interest payments, which will vary according to the returns that are available at the time. It might be reasonable to assume that the rate on reinvested interest would be 3% a year but, in practice, it could be higher or lower depending on the degree of risk being undertaken with the securities. Assuming 3% returns, the PV of £1m in 20 years is £553,676.
- **Equities** are the most volatile and therefore difficult to predict, although long-term returns over periods of 20 years or more are more stable than those over much shorter periods.

  Over 20 years, it might be reasonable to assume an annual return of 8% including reinvested dividends, although, again, that could be lower or higher. Assuming an 8% annual return, the PV of £1m in 20 years is £214,548.

Refer to

See *Stochastic modelling* on page 2/13 for more on stochastic modelling.

Predicting future investment returns is not easy. One approach is to consider the most likely outcome based on a possible range of returns, roughly what stochastic modelling does.

- The financial planner may judge that a return of 8% a year is the most probable outcome, but may also think that there is a range of both higher and lower possible returns, perhaps up to 12% and down to 4%.
- The rates of return that are higher than 8% are less probable, with 12% being possible but unlikely.
- Equally, rates of return that are less than 8% become less likely the lower they are. So, for example, a sustained 2% annual rate of return is relatively unlikely over a period of several years.

G4A The impact of time on investment returns

Time makes a big difference on investment returns. The following table shows the returns (rounded up to the nearest whole number) from £1,000 invested over different time periods at various interest rates.

Table 3.4: Returns on £1,000 at various interest rates

Years	1%	2%	3%	4%	5%
10 years	£1,105	£1,219	£1,344	£1,480	£1,629
20 years	£1,220	£1,486	£1,806	£2,191	£2,653
30 years	£1,348	£1,811	£2,427	£3,243	£4,322
40 years	£1,489	£2,208	£3,262	£4,801	£7,040

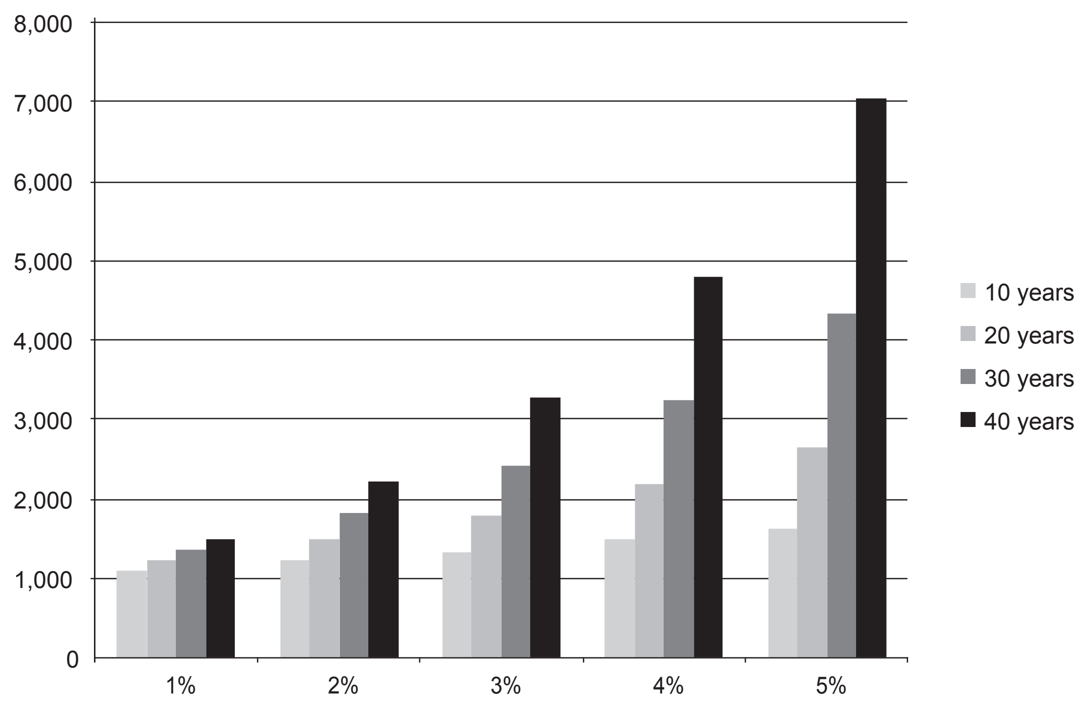
A small increase in average annual returns over a long period makes an enormous difference to the final outcomes. Over a 20-year period, a 5% annual investment return is worth one-fifth more than a 4% return. Accepting a higher rate of volatility to capital in return for a likely higher return makes a very substantial difference, especially with long-term planning for retirement.

The differences in outcomes are even greater with longer periods, as the compound interest graph that follows shows.

- After ten years, the difference between 4% and 5% is a little over one-tenth.
- After 20 years, the difference is over one-fifth.
- After 30 years, it is a third.
- By 40 years, it is nearly half.

This is another reason for investing in higher volatility and higher growth investments over long periods. It is also an argument for starting to invest as early as possible.

Figure 3.4: Compound interest



Differences in returns also arise because of investment costs. Substantially better performance can be achieved by cutting management charges by 1%.

The rate at which investments double in value is another way of looking at the impact of compound interest:

- At 2%, it takes about 35 years for £1,000 to double.
- At 4%, it takes about 17.5 years.
- At 8%, it takes about 9 years.
- At 16%, it takes about 4.5 years.

G4B Investing for longer

The other key issue is the degree of importance that the client attaches to retiring at their target date. A client who is prepared to defer retirement would be able to build up a larger fund. By postponing retirement for, say, five years, a fund of £500,000 growing at 5% would increase by around 28% to just over £638,000 (£500,000 at 5% for five years). In addition, if the client wished to buy an annuity they would probably benefit from higher annuity rates and five more years' contributions.

G4C Inflation and uncertainty

There are two other reasons why £1,000 now has a greater value than £1,000 payable in ten years' time. The first reason is inflation. Increasing prices means that the purchasing power of cash tends to drop over time. So, if inflation is running at 2% and the client receives a 5% return, the post-inflation return is 5% – 2% = 3%. In this case, the nominal rate of return is 5% and the real rate of return is 3%. In many instances, it makes sense to set a target amount in 'real terms' or in 'today's money'.

Example 3.5

Robert

The target retirement fund for Robert is £1m in 2022 values. The expected nominal rate of investment return is 8% a year and the projected rate of inflation is 2.5% a year. The real rate of return to be used in the projections will be 5.5% a year.

The situation is different for periods of deflation or falling prices. This increases the value of cash year on year. If the nominal rate of investment return is 1% and prices are falling at the rate of 2% a year, the total real return is 1% + 2% = 3%.

Investment uncertainty is another reason why money now is worth more than money in the future. There may be some doubt about the repayment of the capital as well as the investment return. The bank might fail, interest rates might fall or investments might deteriorate. All of these might lead to a further discount against the FV, depending on the evaluation of the level of uncertainty.

G5 Annual savings

The impact of interest rates or investment returns on annual or monthly savings is rather less than on a one-off investment, because of the shorter amount of time in which the interest compounds for most of the investment.

The interest on £500 invested for 50 years at 4% is £3,053 (£3,553 − £500), whereas for savings at £10 a year at the start of each year for 50 years at 4%, the interest is £1,088 (£1,588 − £500).

The early years' contributions are the most important in terms of returns. A delay of five years would cut the accumulated fund to £1,259, of which £809 is interest.

G6 Borrowing

Financial planners also have to consider strategic issues around borrowing and the impact on investment and other aspects of financial planning.

G6A Borrowing and investing

Gearing or leverage is a way to increase both investment returns and risk. Borrowing to invest is common among residential property investors.

Borrowing is a simple way to magnify potential return and risk, as the following example shows.

eg

Example 3.6

Esther and Matthew
Esther and Matthew have bought a flat to let out to tenants. The flat cost a total of £200,000 including all the incidental expenses.

The rent is £1,000 a month, with the tenants responsible for council tax and all other outgoings apart from redecoration and property repairs. So, the gross rent is £12,000 or 6% of the value. The rate of interest on the buy-to-let mortgage is 6%.

Esther and Matthew have borrowed £120,000 or 60% of the property value, and their monthly payments on an interest-only basis are £600 a month or £7,200 a year. In theory, at least, they are making an annual return before tax of £4,800 (£12,000 rent less £7,200 interest) on their outlay of £80,000 (£200,000 total purchase cost less £120,000 mortgage). However, there may be extra costs of redecoration, management, loan interest and voids that might reduce this yield, possibly to nil in some years. So, borrowing 100% of the value of the property is risky from an income point of view.

The return and risk mainly arise from capital growth (or losses). Esther and Matthew have laid out a net £80,000 rather than the whole £200,000 cost of the flat. If the flat increases in value by 20%, this provides them with a profit of £40,000; but the profit on their net outlay, taking into account borrowing, magnifies to 50%. This is one reason why most people regard their homes as good investments. Of course, if Esther and Matthew's flat reduces in value by £20,000, the borrowing or leverage magnifies their loss in the same way.

G6B Borrowing and rolling up interest

Interest that rolls up increases the level of a person's debt at compound rates, and the debt can grow alarmingly quickly.

The impact can be seen over very short periods with consumer debt, where interest rates can be at toxic levels of around 30% a year. After three years at 30% a year, a debt of £1,000 can more than double to nearly £2,200.

Rolling up debt is also a feature of lifetime mortgages. A lump sum lifetime mortgage of £100,000 at 6% will double in just under twelve years. If the home on which it is secured grows in value much more slowly, the owner's equity could be reduced or even eliminated.

G7 Profits and losses

The use of percentage returns can sometimes confuse clients when investments show losses followed by profits or the other way around.

For example, a 40% profit followed by a 20% loss does not mean that the client has made a profit of 20% over the period in question. Suppose the client invested £1,000 in fund A. This promptly increased by 40% (or £400) to £1,400. The investment then fell in value by 20% (or £280), leaving the client with an investment in fund A worth £1,120 – a profit of £120 (or 12%). The client would be in the same position even if the order had been reversed and the 20% loss had been followed by the 40% profit.

G8 Compounding and inflation

The rates at which income and expenditure increase make a substantial difference to long-term cash flow projections. If the client's income and expenditure are roughly equal when they retire and the pattern does not greatly change, there is a reasonable chance that they will remain in balance for the long term.

One difficulty is that a client's income and expenditure and the value of their investments may not all increase at the same rate. In fact, the absolute increase in income and expenditure is less important than the relative rates of growth. It is possible to map the differences using the 'one-unit principal' compound interest tables.

Example 3.7

Mary

Mary has retired with an annual income of £20,000 that increases at 2% a year, but her expenses of the same amount increase at 3% a year. Even with a difference of 1% a year, the gap could grow very quickly.

	Income £	Expenditure £	Gap £
Year 1	20,000	20,000	0
Year 10	24,380	26,878	−2,498
Year 20	29,719	36,122	−6,403

G9 The impact of decumulation on capital

Decumulation of capital occurs when sums are withdrawn, usually regularly, from existing funds. It is typically associated with clients who need to supplement their retirement income.

Care must be taken if capital erosion is to be avoided. If withdrawals are taken from a fund at a faster rate than the investment grows, then not only will the original capital be eroded but future returns will be reduced, as demonstrated by the following example.

Example 3.8

Client's cash flow

A client needs to have £10,000 a year from a cash pool of £50,000 that generates net interest of 3%. It is essentially a simple interest calculation based on the balance at the start of the year.

The cash flow is simple, assuming withdrawals and interest are taken and received annually in arrears, and interest is compounded annually rather than more frequently.

	Opening balance £	3% interest £	Withdrawal £	Closing balance £
Year 1	50,000	1,500	10,000	41,500
Year 2	41,500	1,245	10,000	32,745
Year 3	32,745	982	10,000	23,727
Year 4	23,727	712	10,000	14,439
Year 5	14,439	433	10,000	4,872
Year 6	4,872	146	5,018	0

The main consequences of this are:

- The cash fund runs out about halfway through the sixth year.
- The pool runs down at a faster rate in the later years than in the initial years because of the reduction in interest received from the declining balance.
- Volatile investments should be avoided in these circumstances because the very short timescale allows very little time for them to grow sufficiently to replace the loss. A £5,000 loss in year one would be 10% of the fund; however, the following year, the fund would have to grow by around 14% to recoup the £5,000 loss. Then, each year, the gain would have to be an even larger percentage of the remaining fund.

Real-life examples of this type of situation include elderly people in long-term care, whose expenditure on care home fees is greater than their income.

G10 Formulae for compound interest and discounting

Percentages

$$\text{Percentage change} = \frac{\text{Change in price of units}}{\text{Original price of units}} \times 100$$

Example 3.9

Units in a Japanese fund are bought at £1.10 each and rise in value to £1.60. What is the percentage increase in value?

$$\text{Percentage increase} = \frac{(£1.60 - £1.10)}{£1.10} \times 100$$

$$= 45.45\,\%$$

Simple interest

$$I = \frac{P \times R \times N}{100}$$

Where I = interest;

P = principal;

R = interest rate per payment frequency; and

N = number of years (or frequency of payment).

Example 3.10

What is the simple interest if £2,000 is invested for three years at 4% interest per year?

$$I = \frac{£\ 2,000 \times 4 \times 3}{100}$$

$$= £\ 240$$

Alternatively, the standard equation can be inverted to give the formulae for *P*, *R* or *N*, thus:

$$P = \frac{100 \times I}{R \times N} \quad R = \frac{100 \times I}{P \times N} \quad N = \frac{100 \times I}{P \times R}$$

Example 3.11

What sum of money (*P*) must be invested at 4% simple interest to give interest of £240 after three years?

$$P = \frac{100 \times 240}{4 \times 3}$$

$$= £2,000$$

Compound interest

When compounding, the interest is reinvested each year or compounding period:

$$A = P\left[1 + \frac{r}{100}\right]^n$$

Where *A* = total amount accumulated;

P = principal (the original sum invested);

r = interest rate per year; and

n = the number of years invested.

Example 3.12

What sum is accumulated if £5,000 is invested at 5% per year compound interest for eight years?

$$A = £\ 5,000\left[1 + \frac{5}{100}\right]^8$$

$$= £\ 7,387.28$$

Notes

1. Compound interest tables give the differing values for an amount invested of £1 with the variable factors being *r* and *n*.
2. Factor *n* represents the compounding frequency. For example, if the sum is compounded four times a year, *n* equals four times the number of years. In such cases, *r* should be based on the compounding period.

Alternatively, the standard formula can be inverted:

$$P = \frac{A}{\left[1 + \frac{r}{100}\right]^n}$$

Example 3.13

How much money must be invested to give £8,000 total in six years' time at 4% compounded annually?

$$P = \frac{£\,8,000}{\left[1 + \frac{4}{100}\right]^6}$$

$$= £\,6,322.52$$

Or the standard formula can be changed to:

$$r = 100 \quad \left[\sqrt[n]{\frac{A}{P}} - 1\right]$$

Example 3.14

What is the compounding rate of interest if £10,000 has been accumulated over twelve years with an original sum invested of £6,000 (assuming there are no changes in interest rate)?

$$r = 100 \quad \left[\sqrt[12]{\frac{£\,10,000}{£\,6,000}} - 1\right]$$

$$= 4.35\,\%$$

Phased investment, compounded

If a regular sum is invested annually in advance, and the resulting aggregate sums compounded, then the following formula applies:

$$A = P \quad \left[\frac{(1+r)^{n+1} - (1+r)}{r}\right]$$

Where A = the final aggregate sum;

P = amount invested each year;

r = interest rate; and

n = number of years of payment.

Example 3.15

A person puts £100 into a regular savings scheme every year for five years. Each year, the investment yields 3%. How much will be in the fund at the end of year five?

$$A = 100 \quad \left[\frac{(1.03)^6 - (1.03)}{0.03}\right]$$

$$= £\,546.84$$

Annual percentage rate/annual equivalent rate

The cost of borrowing must sometimes be stated as an annual percentage rate (APR). Similarly, the true rate of interest on an investment is now commonly stated as the annual equivalent rate (AER).

To calculate the APR or AER, the following formula can be used for period rate transactions, where the credit charges are expressed as a constant period rate of charge in respect of periods of equal length:

$$APR = 100 \left[\left(1 + \frac{x}{100}\right)^{y} - 1\right]\%$$

Where x = the period rate charge expressed as a percentage; and

y = the number of periods in one year.

Example 3.16

What is the APR if a person has a loan on which interest is charged at a rate of 2% a month?

$$APR = 100 \left[\left(1 + \frac{2}{100}\right)^{12} - 1\right]\%$$

$$= 26.82\,\%$$

Note: Costs of establishing the loan (e.g. arrangement fees) will also be taken into account for calculating APR where appropriate.

Discounted rates of return

If P is the PV, equivalent to a FV of F_t received t years in the future, at annual rates r_1 for the first year, r_2 for the second year, etc. then:

$$P = \left[\frac{1}{(1 + r_1)\ \ (1 + r_2)\ \dots\ (1 + r_t)}\right]\ F_t$$

Or:

$$P = d_t \times F_t$$

Where d_t is the discount factor for year t.

Or:

$$d_t = \left[\frac{1}{(1 + r_1)\ \ (1 + r_2)\ \dots\ (1 + r_t)}\right]$$

Example 3.17

What is the PV of a FV of £5,000 at an annual rate of 12.5% for three years?

$$\frac{1}{(1.125)^3} = \frac{1}{1.423828} = 0.702332;\ \text{and } 0.702332 \times £\,5{,}000 = £\,3{,}511.66$$

Chapter 3

Case study: John and Margaret Williams – pre-meeting fact-find

As completed by John and Margaret Williams before meeting the financial planner.

Part 1 Personal details

Name:	John Williams Margaret Williams
Private address:	1 The Wide Road Broad Town Fairmount BX3 6RT
Home telephone:	01234 567890
Work telephone:	09876 543210
Mobile telephone:	07123 456789
Email address:	jmwilliams@jmwilliams.co.uk
Age:	John 59, Margaret 35.
Tax status:	Both UK resident and UK domiciled.
Relationships:	Married to each other – just over five years ago.
Health:	Both in good health and both non-smokers. No hazardous hobbies.

Part 2 Family details

Children:	Victoria, daughter, aged three, in good health. Sean, son, aged two, in good health. We plan to send them both to private schools.

Part 3 Employment details

John:	• Senior marketing manager of Morgan Reeves Ltd. • Salary currently £60,000 a year, with £20,000 bonus last year. • In addition, a company car worth about £25,000. • Life cover provided by the employer of £320,000 based on four times earnings. • The normal retirement date in the company is age 65.
Margaret:	• Full-time mother.

Part 4 Professional advisers

None listed.

Part 5 Income and expenditure

Total earnings from employment are £80,000 plus benefits.

Net income before tax from property (see part 6):

- **John**: £18,000.
- **Margaret**: £15,000.

The expenditure schedule comes to a total of just over £51,000, excluding pension contributions and tax.

Current expenditure schedule

Expense – current schedule	£	%
Mortgage	2,115	
Council tax and water rates	3,200	
Property expenses including insurance	7,000	
Gas and electricity	2,320	
Home help	1,920	
Total home-related expenses	**16,555**	**32**
Food and household	9,400	
Satellite TV, phone and broadband	710	
Clothing	4,500	
Other household	500	
Total household	**15,110**	**30**
Car running	1,500	
Fares	650	
Total travel	**2,150**	**4**
Dentist, optician	1,300	
Alternative medicines	750	
Total medical	**2,050**	**4**
Children – clothing and equipment	2,400	
Childcare	350	
Total childcare	**2,750**	**5**
Eating out	2,400	
Other sport and entertainment	1,200	
Holidays	5,000	
Total leisure and entertainment	**8,600**	**17**
Life and health insurance	**3,940**	**8**
Total expenses	**51,155**	**100**

Part 6 Assets

- The main home is jointly owned and is worth £625,000.
- Estimated value of possessions, including some family antiques: £50,000.
- John has an investment property currently worth £300,000. It consists of two small offices in the nearby town of Fairmount. The rent is currently £18,000 a year after expenses but before tax.
- Margaret owns a flat that she lets for about £15,000 a year after expenses but before tax. It is conveniently located very near the home.
- John has about £1,000 in his current account.
- Margaret usually has about £5,000 in her current and deposit accounts.
- John has £11,000 in a cash ISA.
- Margaret has £4,500 in a cash ISA.

Part 7 Liabilities

- Mortgage with the Wessex Building Society for £53,000.
- Interest-only mortgage repayable from the proceeds of a pension.
- Taken out for a 25-year term, 20 years ago.
- Monthly payment is approximately £176 based on an interest rate of 3.99%.

Part 8 Life assurance

Policies on John's life:

1. Sum assured £53,000, premium £200 a year to age 65. Term policy assigned to the mortgage lender.
2. Sum assured £100,000, premium £200 a month guaranteed to age 65. Flexible whole of life policy not in trust. Started five years ago when John and Margaret married.

Part 9 Health insurance

- Income protection on John's life paid by John – provides an income of £500 a month.
- Private medical insurance for all the family, premium of £1,100 a year paid by John – provides band 2 hospital cover.

Part 10 Regular savings

About £7,000 in savings was accumulated last year in addition to the pension contributions.

Part 11 Pensions

John's pension plans are listed in the following table:

Provider	Type	Plan details
Ideal Insurance Co	Retirement annuity plan	• Current value £100,000. • Managed fund. • Retirement date age 75 with option to draw earlier without penalty. • Not currently contributing.
Acme Life	Personal pension plan	• Current value £110,000. • Managed fund. • Retirement date age 75 with option to draw earlier without penalty. • Currently contributing at £27,000 a year gross (monthly contributions £1,800 net of basic rate tax).
Acme Life	Retirement annuity plan	• Current value £50,000. • UK equity fund. • Retirement date age 65 with option to draw earlier without penalty. • Not currently contributing.
ABC Funds	Personal pension plan	• Current value £140,000. • Fixed interest fund. • Retirement date age 75 with option to draw earlier without penalty. • Not currently contributing.
Acme Life	Personal pension plan	• Current value £110,000. • Managed fund. • Retirement date age 65 with option to draw earlier without penalty. • Not currently contributing.

Acme Life is said to have good annuity rates on its pension policies.

State Pension entitlement
John has a full contribution history and expects to receive the full new State Pension, less a deduction for time spent contracted out.

Part 12 Inheritance

- Both Margaret and John have made wills in the last three years leaving everything to each other on the first death and then in trust for the children to age 25 in equal shares.
- Both have not settled any trusts and do not expect any inheritances.

Part 13 Risk profile and capacity for loss

- John is happy to invest in equities and is used to taking business and investment risks.
- Margaret is more cautious and needs reassurance before considering equity-based investments.

Part 14 Ethical investments

- John is ‘not interested’.
- Margaret might be interested in investing in ‘good causes’ but would like to learn more.

Notes on concerns

- To provide for the situation if John dies in the next 15 years.
- To keep our affairs simple.
- We are not very concerned about inheritance tax (IHT).

Case study: John and Margaret Williams – asking more questions

Question

John and Margaret Williams have completed the attached fact-find as far as they are able in advance of their meeting with their financial planner, who aims to produce a comprehensive financial plan for them.

Based on the answers they have provided:

a. What further questions should the financial planner ask them, their lawyer, their accountant or the product providers in each of the following areas?

b. State whom the financial planner should ask.

c. Briefly explain why the question may be relevant.

In the exam, you will be asked to comment on the client's aims and objectives, as well as the information provided in the case studies.

Part 1: Personal details

1. Do you know what is meant by 'domicile'? Are you sure that you are UK-domiciled?	
Ask	Clients
Reason for asking	• If either of the clients is not UK-domiciled, there could be an IHT liability if the UK-domiciled spouse died and left assets worth more than £325,000 to the non-UK-domiciled client. This figure is increased to £650,000 if the UK-domiciled spouse's nil rate band of £325,000 is fully available. • There might be scope for long-term IHT planning through an excluded property settlement. • The non-UK-domiciled spouse might be able to use the remittance basis, potentially saving income tax and capital gains tax (CGT), although, depending on the length of time of residency in the UK, a remittance charge might apply.

2. How long have you been resident in the UK?	
Ask	Clients
Reason for asking	If a person is non-UK-domiciled, their residence position will affect their tax position.

Reinforce

Non-UK-domiciled people can elect to be subject to the remittance basis of taxation on their overseas income and gains are subject to certain conditions. The remittance basis means that they are not subject to UK income tax and CGT unless they remit the funds to the UK. The conditions are as follows:

- The client has been resident in the UK in no more than six out of the previous nine tax years.
- If the client has exceeded the six-year residence period, then they will need to make an annual tax payment of £30,000 (£60,000 if they have been resident in the UK in 12 or more of the past 14 years), unless unremitted foreign income and gains are less than £2,000.

A person who is in this situation may wish to invest via a tax shelter like an offshore bond, which they can encash when they leave the UK.

A person is deemed UK-domiciled for all tax purposes if they are resident in the UK in at least 15 out of the previous 20 tax years.

Where a spouse is not UK-domiciled, then the IHT spousal exemption on assets passing to them is £325,000, though this would be in addition to the £325,000 nil rate band (if unused) of the deceased UK-domiciled spouse (£650,000).

Non-UK-domiciled individuals who are married to, or in a registered civil partnership with, a UK-domiciled person can elect to be treated as UK-domiciled for IHT purposes. Making an election will avoid the cap on exempt transfers to the non-UK-domiciled spouse, but it will also mean that the spouse is taxed on their worldwide property rather than just property situated in the UK.

It may be necessary to set up a life policy to cover the tax liability until the spouse achieves UK domicile for IHT purposes. John and Margaret have said that they are not very interested in IHT planning, but if this issue had affected them, their attitude might have been very different.

3. Have you been married before?	
Ask	Clients
Reason for asking	• If the former spouse is still alive, there might be a further call on the client's income and assets. • If the former spouse has died, the survivor might have inherited their nil rate band and RNRB, in which case they should probably amend their will to pass their nil rate bands to their children or other beneficiaries.

Reinforce

Following divorce, a former spouse may be entitled to a proportion of their ex-spouse's current earned income and/or their future pension income as part of a maintenance agreement. This is in addition to any child maintenance that the ex-spouse may also be required to pay to meet the needs of any dependent children.

Spouses and civil partners each have their own nil rate band and RNRB. When a person has died, any unused bands are transferable to their surviving spouse or partner and can be used if that survivor died after 8 October 2007 (6 April 2017 for the RNRB). The amount of the unused band is the proportion that was not used when the first spouse or partner died, and it does not matter when that death occurred. It is not possible to inherit more than 100% of each band; so, if a client has inherited full bands from one spouse, it is not possible to benefit from more. In these circumstances, it is important to make sure that all possible bands are used.

For example, Joan has inherited 100% of her deceased first husband's nil rate and RNRBs. She has now married Dan. She should make sure that she leaves at least one of her nil rate and RNRBs (if it is practical to do so) to beneficiaries other than Dan. If Dan dies first, he should leave an amount equal to his nil rate and RNRBs to other family members.

If he leaves his nil rate bands to Joan, they will be wasted.

4. Have you ever been a smoker? If so, when did you give up?	
Ask	Clients
Reason for asking	If they gave up smoking very recently, this might affect the cost of life/critical illness cover or annuity rates available. There might be non-disclosure issues with underwriting.

5. Would you like us to communicate by email or by post?	
Ask	Clients
Reason for asking	Emailing clients can be an efficient way to communicate. If they choose to communicate by email, this could be an indication of their willingness to use other web-based tools, such as online investment valuations and portfolio trackers.

Part 2 Family details

1. Do you expect to have any more children?	
Ask	Clients
Reason for asking	If they expect to have more children, this will affect their future expenditure and protection needs.

2. Are there any children from previous marriages or relationships? If so, please supply details.	
Ask	Clients
Reason for asking	The answer could affect their future pattern of expenditure, and they may also need to have different wills.

3. Can you be more precise about the plans you have for the children's education?	
Ask	Clients
Reason for asking	If the plan is to send them to private school, it will have a major impact on the family's expenditure and protection needs. It will be helpful to find out what kinds of school are envisaged, how much the fees are currently and when the children are expected to attend them. The cost of school fees can vary greatly according to the length of time they expect to educate the children privately and the kinds of school they would like them to attend.

Part 3 Employment details

1. John, how long have you been employed by Morgan Reeves Ltd?	
Ask	Client
Reason for asking	• This may provide an indication of job stability and redundancy rights. • It might be helpful in calculating accrued pension rights if he has a defined benefit pension scheme, although, in this case, John only has defined contribution pensions and so this is not an issue.

Reinforce

Redundancy pay is capped at 20 years of service. In most cases, the actual compensation would be greater than the statutory redundancy pay (which is a maximum of £17,130 in 2022/23). In this instance, the client's closeness to his retirement age will almost certainly limit the compensation he could expect to receive.

Redundancy pay of up to £30,000 is tax free at present.

2. John, how long do you expect Morgan Reeves Ltd to continue to employ you?	
Ask	Client
Reason for asking	John is approaching retirement, so it is important to know for how many years he will be earning a salary and contributing to/not drawing from his pension. It is also relevant for his mortgage, which is currently set up to be repaid from the tax-free lump sum proceeds of his pension scheme in five years' time.

3. John, when would you like to retire, and how fixed is the date from your point of view? Could you work longer and would you want to?	
Ask	Client
Reason for asking	Given the school fees position, the longer he could work, the easier it would be to provide enough income for school fees and retirement.

4. John, is a there a possibility that your employer might offer you early retirement?	
Ask	Client
Reason for asking	This could substantially reduce the family income.

Part 4 Professional advisers

1. Do you intend to engage any other professional advisers in the future?	
Ask	Client
Reason for asking	To establish if there are other professionals who would need to be involved in the financial planning process in the future.

Part 5 Income and expenditure

1. After you have retired, John, do you think you might want to carry on with some freelance or consultancy work? If so, how much do you think you might earn?	
Ask	Client
Reason for asking	• Finding out the answer to this and gauging its likelihood would also be useful in determining whether John could find other employment if he were offered early retirement. • If John could find an extra source of income in retirement, it would be very helpful, especially given the potential school fee commitments.

2. John, do you have any shares or options in the company that employs you?	
Ask	Client and possibly employer
Reason for asking	• It is important to find out what value any shares and/or options might have and see the documentation agreeing the basis on which John could sell his shares or exercise his options. Base values will be needed for any CGT calculation. • The shares or options may have some value that could be added to the retirement and education funds. If he has at least 5% of the voting shares in the company, he may qualify for business asset disposal relief, in which case, any gain would be taxable at 10%.

Reinforce

Business asset disposal relief applies to disposals of trading businesses by sole proprietors or partners, and to disposals of shares in qualifying trading companies. The relief can also apply to associated disposals by such business owners, e.g. of property used by the business or company.

Any gains subject to the relief are taxed at 10% regardless of the individual's tax status. To claim the relief, the following conditions have to be fulfilled:

- The taxpayer must have owned the asset for at least two years.
- There is a cumulative lifetime limit of £1m of qualifying gains made since 6 April 2008.
- In the case of a company, the investor must have been an employee or a director of the company, or a member of the group, and must have owned at least 5% of the voting rights in the company. This 5% threshold means ordinary employees participating in share schemes rarely benefit from this relief. They must also be entitled to at least 5% of the distributable profits and net assets of a company.

3. Margaret, what job did you have and how much did you earn before you married and had the children? Do you think you will want to return to work when the children are older?	
Ask	Client
Reason for asking	• She may be able to go back to work when the children are older and help boost household income. • The amount of her potential earning capacity should be quantified. • She may be able to support herself if John – who is much older – dies first. • She may have some accrued pension benefits.

Reinforce

The minimum period of NIC payments/credits to qualify for a full new State Pension is 35 years. A minimum of ten qualifying years is required to be eligible for the pension.

Those people who had not reached their SPA on 6 April 2016 had a foundation amount (also known as the starting amount) calculated as at 5 April 2016 using their NIC record at that date. The amount is the higher of:

1. the amount they would have received under the previous rules, i.e. the basic State Pension plus any additional State Pension(s) accrued; and
2. the amount they would have received under the new State Pension had it been in place at the start of their working life.

A deduction was then made from their foundation amount if they were contracted out of any of the additional State Pensions at any point during their working lives.

4. John, your bonus is reported as £20,000. How is your bonus calculated? Is it likely to be maintained in future years? 5. How much of the bonus is discretionary?	
Ask	Client and possibly employer
Reason for asking	• This information is necessary in order to know the current year's pensionable remuneration. • It is important to understand whether the bonus is sustainable for future expenditure and pension planning. • It should also help the planner know the scope for future bonus sacrifice to make pension contributions.

6. John, you say in the fact-find that you are provided with a company car valued at £25,000. Is that its current value or its list price when new? 7. Do you know the company car's CO_2 emissions level that determines the tax charge on the benefit and is the car petrol or diesel?	
Ask	Client and possibly employer
Reason for asking	• This information is necessary in order to know the current year's pensionable remuneration. • The costs of replacing the company car and its running costs will need to be accounted for in the retirement budgeting.

Reinforce

The taxable benefit of having an employer provide a car for private use is based on the list price of the car when it was new and the official level of its CO_2 emissions. The minimum benefit in kind charge is 0% of the list price and the maximum is 37%. There is a special scale charge for 'free fuel' provided for private motoring.

8. John, you say in the fact-find that you have £320,000 life cover at four times your earnings. Can you confirm the basis for the amount of cover? 9. If you were to leave the company for any reason, do you know if you could continue the cover, e.g. by taking out a replacement policy with the company, regardless of your state of health at the time?	
Ask	Client and possibly employer
Reason for asking	John may need to get replacement life cover if he left his employer. Also, it is important to check that the life cover is based on salary plus bonus, not simply salary.

10. Based on the schedule you have completed in the fact-find, your total expenditure at present, excluding pension contributions, is a little over £51,000 a year. Is that roughly how much you actually spent last year? **11. In other words, how much could you economise on if you really had to?** **12. How would the pattern of expenditure change if John did not go to work each day?**	
Ask	Client
Reason for asking	The aim is to calculate expenditure in retirement, if John died or could not work because of illness or accident.

Part 6 Assets

1. Your home is worth £625,000 according to the fact-find. When did you last consider its value? **2. How do you own your home – as a joint tenancy or a tenancy in common?** **3. If you were to retire, would you stay in your present home or would you move, e.g. to another and possibly less expensive area?** **4. Who benefits from the value of the house on your death?**	
Ask	Client
Reason for asking	• Even though John and Margaret have indicated they are not concerned about IHT, it is still good practice to understand their potential IHT liability. It will also help to understand the total available resources. • To establish the availability of the RNRB.

Reinforce

Where two people own a property under a joint tenancy, they own equal shares. When one of them dies, their share automatically passes to the survivor, regardless of the provisions of the will or intestacy.

If a property is owned under a tenancy in common, the owners may have unequal shares. If one of the owners dies, their share will pass as directed by their will or the laws of intestacy.

Severing a joint tenancy and creating a tenancy in common can be accomplished easily and without stamp duty land tax (where the property is being divided equally and each owner owns each part separately) or other tax costs.

5. Tell me more about your investment properties: **a. When did you buy them?** **b. How much did you pay for them?** **c. Have you spent any money on improving them since you acquired them?** **d. How strong financially are the tenants?** **e. How long are the tenancies?** **f. When was the last rent review and when will the next review be?** **g. Do you expect the rent to rise in the next review? Is there a strong retail/investment demand for each of the properties?** **h. Will either of the properties need money spent on it in the foreseeable future?** **i. Is the interest on the mortgage offset against the rental income?** **j. How much are your annual property letting expenses?**	
Ask	Client
Reason for asking	These are the clients' largest investments, apart from their pensions and home. The capital value and the level of current and future income are very important for them.

Reinforce

All of an individual's property income is pooled together. The expenses are also pooled together and deducted from the income.

Income tax relief for finance costs is given as a basic-rate tax reduction.

There is an annual £1,000 property allowance, which means that property income is exempt from tax and does not have to be declared on a tax return if it is less than £1,000 (before deducting expenses). If it is more than £1,000, as it is for John and Margaret, then the £1,000 allowance can be claimed against income – instead of deducting actual expenses. It is for this reason that we need to know how much actual expenses are.

It may be worth exploring whether all the possible expenses are being claimed. There may be an advantage if John and Margaret jointly owned and ran their properties. Alternatively, Margaret could continue to own her property but have a share in John's as well, since Margaret is a basic-rate taxpayer while John currently pays tax at the higher rate. Either of these changes could result in them paying less tax.

If they do not employ an accountant to help them, the clients should be advised to obtain specialist tax advice.

Part 7 Liabilities

1. You have an interest-only mortgage with Wessex Building Society. How would you feel about paying that off now if you found you had some spare cash? **2. Is this the best available deal from your lender?** **3. Are there any penalties for redeeming the loan now?**	
Ask	Client
Reason for asking	It is worth considering whether to repay some or all of the mortgage, or to switch mortgages or the mortgage provider. However, there may only be a few providers willing to remortgage on an interest-only basis for a property that is their main residence in the current lending climate.

4. On which property is the mortgage secured and which property was it used to purchase?	
Ask	Client
Reason for asking	The aim is to see if the mortgage is arranged in the most tax-efficient way.

Part 8 Life assurance

1. Why did you decide to buy a whole of life policy? **2. What was the basis for deciding on cover of £100,000?** **3. Are you sure the policy is not written in trust?** **4. John, who would you like to benefit from the policy if you died?**	
Ask	Client
Reason for asking	• The proceeds would fall within John's estate if the policy is not written in trust. • If the policy were written under trust, the proceeds would be available on the production of the policy documentation, the trust and a copy of the death certificate, rather than having to wait for probate to be granted.

5. Is there a surrender value on the policy?	
Ask	Insurer
Reason for asking	• There may be a need to stop the policy. • The policy may need to be written in trust, although the transfer of value for IHT at that time would be the greater of the market value (which is likely to be the same as, or very similar to, the surrender value, as John seems to be in good health) or the premiums paid.

6. Are you sure the term policy is assigned to the lender?	
Ask	Client and insurer
Reason for asking	If it is not assigned, it could be placed in trust for Margaret and the children under a discretionary trust to speed up payment and introduce additional planning flexibility.

Part 9 Health insurance

1. John, how long would your employer continue to pay you if you were seriously ill and could not work?	
Ask	Client and possibly employer
Reason for asking	This is to establish suitability of the existing income protection insurance (IPI) policy.

2. What is the deferral period before the IPI benefits become payable? 3. Does the IPI benefit increase in value once it starts to be paid? 4. When does the IPI cover stop? 5. What conditions are excluded from the IPI policy? 6. What is the definition of occupation under the IPI policy? 7. Does this IPI policy give you peace of mind?	
Ask	Client and insurer
Reason for asking	• It may be worth considering whether to stop or switch the IPI policy (although John only has a short time to go before normal retirement date). • It is also necessary to check if the IPI policy would cover him until retirement from the company.

8. How important is the private medical insurance to you?	
Ask	Client
Reason for asking	• Private medical insurance may not be affordable in retirement. • It helps to find out whether they view this cover as an 'essential' or a 'nice-to-have', enabling them to prioritise accordingly.

Part 10 Regular savings

1. Is the regular saving on a monthly basis, or is it whatever is left over at the end of the year or from time to time? 2. Which account is normally used for the savings and who owns this account? 3. Is it subject to any restrictions?	
Ask	Clients
Reason for asking	• This should help them review the spending and saving patterns. • It also helps the planner find out about the accessibility of the accounts and the tax position.

4. Have you used your ISA allowances for the year? 5. Have you used your Junior ISA allowances for the year?	
Ask	Clients
Reason for asking	They should check the availability of their ISA and Junior ISA allowances for the year.

Reinforce

The ISA landscape has changed considerably over the years. Savers can now split their £20,000 annual limit between four types of ISA:

- the cash ISA (which includes the Help to buy ISA for existing savers);
- the stocks and shares ISA;
- the innovative finance ISA; and
- up to £4,000 of the £20,000 annual limit can be saved into a Lifetime ISA by those eligible to open one.

Part 11 Pensions

1. What is the breakdown of asset classes within each of the managed funds?	
Ask	Pension provider
Reason for asking	This is to find out about their asset allocation.

2. What is the charging structure for each of the pension policies and what are the transfer values?	
Ask	Pension provider
Reason for asking	This is to find out whether any of the pension policies should be switched on the grounds of costs and the basis for making transfers.

3. Are all the pensions based on full return of fund if John died?	
Ask	The product provider
Reason for asking	This is to find out whether any of the pension funds should be switched or converted because the death benefits are poor. The two retirement annuity plans, in particular, may not pay a return of fund on death.

4. Are any of the death benefits written in trust? If so, for whom? Has John completed an expression of wishes form in favour of Margaret for each of his pensions?	
Ask	Pension provider
Reason for asking	IHT and estate planning issues should be considered, even if they are not a major concern to the clients.

5. Is the £27,000 contribution being made by John personally? **6. Would the company be prepared to operate salary sacrifice for the pension contribution and invest some or all of the saved employer's NICs into the pension plan?**	
Ask	Client and possibly the employer
Reason for asking	It is worth seeing if the potential NIC saving on salary sacrifice could be invested directly into the pension plan as employer's contributions.

7. Does Margaret have any accrued pension rights with a previous employer? **8. Have you both checked your pension benefits with the Department for Work and Pensions (DWP) either online or via form BR19?** **9. Do you have projected pension benefits from the providers?** **10. Do either of John's retirement annuity plans have guaranteed annuity rates built in?**	
Ask	Client
Reason for asking	This is needed to estimate future pension benefits from all sources.

11. How have the pension investment funds performed?	
Ask	Providers and specialist third-party organisations
Reason for asking	It is important to assess the performance of the funds.

12. Have any of John's pension providers adopted (or do they intend to adopt) the flexible pension access rules? **13. How does John anticipate taking his pension benefits?**	
Ask	Pension providers and client
Reason for asking	To establish whether John could benefit from the greater flexibility offered by these rules and, if so, whether he wishes to do so.

Reinforce

The flexible access pension rules enable members of DC schemes to access their benefits in any way they choose, with any benefits taken in excess of the tax-free PCLS being taxed at the member's marginal rate. If John wishes to take advantage of these rules, the financial planner will need to discuss with him the benefits and risks associated with doing so.

Part 12 Inheritance

1. Have you appointed a guardian for your children if you both die prematurely or become incapacitated? **2. Who have you nominated to be the trustees for the children for your estates if you both die?** **3. Why did you choose age 25 as the age for the children to benefit?** **4. Have you set up an EPA or LPA and, if so, what are the details?** **5. Have you considered the issue of IHT?** **6. Are you aware of the availability of the IHT nil rate and RNRBs that you will each be entitled to, and the impact these could have on your estate's liability to IHT?** **7. If you have enough income and capital to be secure in your retirement, would you make gifts to your children in order to reduce the IHT liability on your estate?**	
Ask	Client and possibly lawyer
Reason for asking	• The aim is to determine whether the parents have made arrangements for their children in the event of their own premature deaths or if either of them became incapable. • It will also reveal whether the clients may be prepared to undertake IHT planning and in what circumstances.

Part 13 Risk profile and capacity for loss

1. John and Margaret, what is your understanding of the term 'risk' in relation to financial planning? **2. What would be most worrying about the outcome from any investment in relation to your financial goals?** **3. What level of losses are you prepared and able to tolerate from your investments in return for the prospect of investment returns?**	
Ask	Clients
Reason for asking	• To find out what risk means to John and Margaret. • To begin to establish their risk profile so that an appropriate spread of asset classes can be recommended depending on their likely risk factors and the need to diversify investments.

Part 14 Ethical investments

1. Margaret, what does investing in 'good causes' mean to you? **2. How important is this to you in relation to your financial goals?**	
Ask	Client
Reason for asking	To establish the strength of Margaret's beliefs and the extent to which she wishes them to be built into the financial planning process.

Key points

The main ideas covered by this chapter can be summarised as follows:

Fact-finding – the key areas

- Fact-finding is the process of gathering information about the client.
- The key areas that have implications for financial planning are:
  - basic details, e.g. name, age, address, health, relationship status, financial dependants, domicile and residence, and expectation of inheritance;
  - impact of minors on financial planning:
    - effect on income and expenditure;
    - any costs for private school and higher education;
    - trusts for the children;
    - receipt of child benefit, Universal Credit and Child Tax Credits;
    - taxation of children's income and investments;
  - income and employment/self-employment details;
  - expenditure – what is fixed and what is discretionary;
  - assets;
  - liabilities and guarantees;
  - protection policies;
  - pension details;
  - wills, gifts and trusts;
  - powers of attorney;
  - risk profile; and
  - impact of any ethical or religious outlook.

Methods of gathering client data

- The fact-finding process may involve using a number of sources from which to gather information, for example:
  - the client and their partner/spouse;
  - documents produced by the client or others; and/or
  - other advisers and relevant people.
- The financial planner needs to gather both hard and soft facts:
  - hard facts are objective and quantitative; and
  - soft facts are the client's preferences, objectives and aspirations.
- The financial planner should check for errors and inconsistencies in the information provided by the client.

The regulator's findings of good and poor practice among firms

- Financial planners may find it useful to see the regulator's examples of good and poor practice in relation to 'know your customer' fact-finding.

Identify and explain actual or potential conflicts of interest

- Dealing with conflicts of interest is one of the central aspects of the FCA's requirement that organisations deliver fair treatment to customers.
- Financial planners should bring any conflict of interest to the client's attention and, if necessary, not act on their behalf.

Working with other advisers

- Financial planners should know their own limitations and when to call on the knowledge and expertise of specialists.

Key points

- Specialist advisers will include:
  - accountants and tax planners;
  - lawyers;
  - general insurance brokers;
  - banks and building societies;
  - mortgage advisers;
  - stockbrokers and fund managers;
  - discretionary fund managers; and
  - multi-managers.
- All advisers should avoid seeing the client's affairs exclusively from their own specialist perspective and should contribute to the client's overall position or objectives.

Compound interest and the time value of money

- Money received in the future is worth less than the same amount received today.
- Compound interest is where interest is reinvested and then earns interest itself.
- Inflation is where the purchasing power of cash drops over time.
- Gearing (borrowing) increases risk but can magnify potential returns.
- Interest that rolls up will result in the debt growing very quickly.
- Financial planners should be aware of the impact of taking withdrawals from a fund at a faster rate than the rate at which the investment grows.

4

Analysing the client situation

Contents	Syllabus learning outcomes
A Main aspects of the financial planning process	*3.1*, *3.2*, *3.3*
B Summary and analysis areas	*3.1*, *3.2*, *3.3*
C Current cash flow statement	*3.1*, *3.2*, *3.3*
D Net assets statement	*3.1*, *3.2*, *3.3*
E Risk assessment and protection	*3.1*, *3.2*, *3.3*
F The tax position	*3.1*, *3.2*, *3.3*
G Retirement review	*3.1*, *3.2*, *3.3*
H Lifetime cash flow projections	*3.1*, *3.2*, *3.3*
I The estate	*3.1*, *3.2*, *3.3*
J Identifying the priority areas	*3.1*, *3.2*, *3.3*
Case study: John and Margaret Williams – completed fact-find	
Case study: John and Margaret Williams – summary and analysis	
Key points	

Learning objectives

After studying this chapter, you should be able to:

- synthesise and analyse key data about the client to establish their overall financial position;
- identify gaps in the client's current financial provision and how this could be improved;
- explain the options available given the client's current financial provision, including their respective advantages and disadvantages; and
- prioritise and adjust the client's aims and objectives based on the analysis of the above information, and in further consultation with the client where necessary.

Key terms

This chapter features explanations of the following ideas:

Analysis	Assumptions	Cash flow statement	Dependent relationships
The estate	Gap analysis	Income and expenditure	Inflation protection
Lifetime cash flow	Net assets statement	Prioritisation	Protection
Retirement review	Risk assessment	Synthesis	Tax position

A Main aspects of the financial planning process

The purpose of a financial plan is to clearly set out the client's current position, analyse it, show how it compares to their objectives and then recommend solutions to make up any shortfall.

This part of the process has three main aspects:

- The ***synthesis*** or summary is simply the bringing together of the information in a clear summary of the main aspects of the client's financial position. The main facts about the client should be concisely expressed for rapid understanding of the overall situation. A clear set of summaries makes the analysis much easier. It can also be used to brief other members of the financial planner's team or outside specialists.
- The ***analysis*** is the identification of the strengths and weaknesses in the current situation, and the quantification of gaps and shortfalls between the client's needs/wants and their existing provision. The financial planner can then proceed to draw up plans for the resolution of these issues in the recommendations stage.
- The ***prioritisation*** is the ordering of the importance of issues. This is necessary because it is not usually affordable to fulfil all the objectives or, at the very least, there may need to be some compromises. This may need to be changed as a result of the client's reactions to the initial presentation.

The immediate purpose of the synthesis and analysis is to provide as clear a view as possible of the client's current financial position, the expected situation for the remainder of their life and the contingent position if the client or some other relevant person were to die or become unemployed or seriously ill.

It is worth making a few cautionary comments about what follows. The examples in this chapter are intended to illustrate the principles rather than the detail of laying out the information. A particular client's circumstances may lead to different ways of summarising and analysing the situation. Very often, the example of a single client is used, although, in practice, it is appropriate for financial planners to produce joint reports for couples.

In the final report for clients, the summary, analysis and recommendations for each part of the client's affairs would be brought together. This stage may be presented to clients separately from the recommendations or it might be put to clients with the recommendations.

Gap analysis

Gap analysis can be a very simple and powerful tool for identifying and quantifying shortfalls and even components that are entirely missing in a client's financial planning.

It is especially useful in such areas as:

- low levels of short-term savings and liquidity;
- inadequate financial protection cover;
- insufficient income and capital to cover the costs of a child's education;
- poor provision for retirement; and
- inadequate provision for suitable long-term care.

B Summary and analysis areas

The next stage in the planning process is to take the data, turn it into comprehensible information and subject it to analysis, then build on this analysis in order to make the planning recommendations.

The main areas to be considered are:

- current cash flow statement;
- net assets statement;
- risk assessment and protection;
- tax position;
- retirement review;
- lifetime cash flow projections; and
- the estate.

C Current cash flow statement

The aim of a current ***cash flow statement*** should be to summarise and analyse income and its relation to expenditure, both in terms of the amounts and the timing:

- There may be an excess of expenditure over income, leading to a build-up of debt. This can be identified by comparing net income with expenditure and looking at the resulting reduction in cash balances and/or rising overdraft or credit card balances. The aim should be to increase income and/or reduce expenditure.
- Where there is a surplus of income over expenditure, there could be opportunities to fill other gaps.
- The current cash flow can then be used as the basis for calculating and analysing future cash flows (e.g. in retirement) and contingent cash flows (e.g. if the client is seriously ill and cannot work).

C1 Summarising income

The main difference in the types of income that clients may have is between earnings and investment income, and it is important for the financial planner to understand both. To a considerable extent, the client’s earnings are the source of their future investment income.

The current cash flow is made up of different types of income as well as the schedule of expenditure, and should separate the client’s income into earned income and investment income. It simplifies the process if the summary and analysis are separated, and then brought together in the summary of ***income and expenditure***.

C1A Earned income generally

Earnings are generally a client’s main source of income until retirement.

A summary of earned income should set out:

- the level of income – in the case of self-employed clients or business owners, this should be based on, say, three years’ earnings;
- the source of the earnings;
- employment status – e.g. employed or self-employed;
- the volatility of earnings – e.g. how much is commission or bonus-related;
- the client’s perceived job security;
- employee benefits;
- the pension position; and
- the tax position.

An analysis of earned income should consider:

- the security of the income;
- the stability of the income;
- inflation protection;
- the degree of dependence on a single source of income; and
- the contingent income position.

In using the analysis of the client's income in relation to financial planning, the following are some issues to consider:

- Job insecurity and income variability generally increase the need for high levels of liquid savings.
- Flexible mortgages are more attractive to people with volatile income and varying cash balances.
- Low job security affects the amount that would be prudent for the client to borrow.
- The timings of advice and reviews should be considered, e.g. to discuss how much to invest in retirement planning each year.
- Self-employment or limited sickness benefits from an employer means income protection insurance (IPI) is a high priority.
- Business owners tend to regard their business as an alternative source of retirement income and often overestimate the capital value.

C1B Investment income

Strictly speaking from a tax point of view, pension income is treated as earnings but, in financial planning terms, it is more accurately seen as a type of investment income.

Pensions in payment
The summary should include:

- the total value of the pension income;
- the sources of the pensions (e.g. State, employer, pension provider);
- any inbuilt inflation linking;
- the extent to which the pension income is variable or insecure – either based on investment returns or because the employer is in financial difficulty and, for example, their defined benefit (DB) scheme is seriously underfunded; and
- the survivor pensions payable to spouses/civil partners and dependants, and the levels at which they are payable.

Flexi-access drawdown or existing capped drawdown withdrawals from a defined contribution (DC) scheme should be summarised separately because of the complex issues involved. Details should include:

- the value of the fund;
- how the fund is invested;
- risk-adjusted fund performance and the extent to which the investment strategy and past performance are compatible with the client's risk profile;
- the reasons for using flexi-access drawdown rather than purchasing a standard lifetime annuity, e.g. the health or lifestyle of the client;
- the timescale to annuity purchase if it is the client's intention to purchase an annuity in the future;
- the implications of and the client's attitude towards the possibility of their pension fund running out during their lifetime if they do not purchase an annuity;
- costs of administering the scheme; and
- any other issues.

Income from investments

Where clients have substantial investment income, it might need to be summarised in several schedules:

- The income from investments should be detailed together with the assets from which the investment income is derived, showing the different relative returns from each type of investment.
- Assumptions usually need to be made about the level of income. In general, it is safest to show the income that has arisen recently (e.g. in the previous year) but, for some cases, this is inappropriate, such as for:
  – deposit interest, especially where rates have declined, when it is probably safer to use current or lower rates; and
  – rents, where there is about to be a change. The new higher (or lower) rent should be used. Where there is doubt, the lower or underpinning figures should be used.
- In some cases, the 'income' plan investment includes a return of capital (e.g. withdrawals from investment bonds). Where these are shown as part of a client's income, it should be noted so that the client is clear about their nature.
- It is appropriate in some instances to assume that investments will generate a return comprising both capital and income, with capital disposals topping up a cash pool used for providing income. In these cases, the overall level of income return is important and sustainable income should be calculated using different overall rates of return (e.g. no growth and 4% growth).
- Some income, e.g. from equities, may reasonably be expected (although not guaranteed) to grow in the long term. Other income, e.g. from fixed-interest securities and deposits, is bound to remain more or less static unless it is reinvested in part. The two should be distinguished. Where there is undue long-term dependence on fixed-income investments, the possible consequences should be shown in the analysis.
- In general, income from investments should be shown gross, i.e. before tax, to make it broadly comparable.
- Withdrawals from life policies should not be grossed up.

Example 4.1

Bernie

Bernie lives in England. He is a company director and has freelance earnings from self-employment, as well as having investment income. Bernie's gross income for 2022/23 is as follows:

Source	Gross amount £	% of total income
Earnings as a director	60,000	60
Company car benefit	3,000	3
Freelance earnings net of expenses	15,000	15
Total earnings	**78,000**	**78**
Dividends from UK equities (value £400,000)	9,000	9
Interest from cash deposits (value £500,000)	5,000	5
Rent from buy-to-let property net of expenses	8,000	8
Total investment income	**22,000**	**22**
Total income	**100,000**	**100**

C1C State benefits

There is a wide range of State benefits available from the Government, and they affect both the need and desire for making further financial provision. For some clients, they highlight the need for financial planning, especially given the low levels of benefits typically paid. For others, they can be a barrier to recognising that need. The belief that 'the State will look after me' still prevails with some people.

Whichever view is taken, the limitations of State benefits must be understood by the adviser and their client. The level of benefit available may not be enough for the client to maintain their desired lifestyle, particularly as there is a cap on the amount of weekly benefit people of working age can receive.

Also, not all clients who would expect to be eligible for a certain benefit actually are. There may be tight eligibility definitions or means testing, or they may only be available to those with sufficient National Insurance contributions (NICs) or credits.

State benefits, therefore, cannot necessarily be relied upon to provide an adequate income in times of need, but they can be taken into account in reducing an income shortfall, providing the client is happy to do so.

Table 4.1: List of the main State benefits

Benefit	Description
• Child Benefit. • Child Tax Credit (CTC). • Statutory Maternity, Paternity, Adoption and Shared Parental Pay (SMP, SPP, SAP and SSPP). • Maternity Allowance.	For families and children.
• Income Support. • Jobseeker's Allowance. • Employment and Support Allowance (ESA). • Housing Benefit. • Statutory redundancy pay.	For people who are unemployed or on a low income.
• Attendance Allowance. • Carer's Allowance. • Disability Living Allowance/Personal Independence Payment (PIP). • Employment and Support Allowance (ESA). • Statutory Sick Pay (SSP).	For those incapacitated through sickness or accident and those who care for them.
• New State Pension – reached State pension age (SPA) on or after 6 April 2016. • Basic State Pension – reached SPA before 6 April 2016. • Additional State Pension – reached SPA before 6 April 2016. • State Pension Credit.	Retirement benefits available to those who have attained SPA.

The following benefits have been replaced by Universal Credit for the majority of new claimants:

- CTC;
- Housing Benefit;
- Income-based Jobseeker's Allowance;
- Income-related ESA;
- Income Support; and
- Working Tax Credit (WTC).

Refer to

Please see chapter 2 of R01 or chapter 3 of R05 for further information on State benefits.

C2 Analysing income

Issues might include:

- **The security of the income** – the client may be concerned about their employment or even their employer. This should be noted and might indicate the need to build up more liquid investments, and reduce spending commitments and habits.
- **The type of income** – a business owner may be self-employed (either alone as a sole trader or with others in a partnership) or be running a limited company.
    - For self-employed owners, profits after expenses are taxed as earned income and are subject to Class 2 and Class 4 NICs.
    - Where a company is incorporated (i.e. a limited company), it pays corporation tax on its taxable profits and the owner is not taxed as self-employed but as a director (i.e. under pay as you earn (PAYE)). Income tax and Class 1 employee NICs are therefore payable on any salary they draw (Class 1 employer NICs would also be paid by the company), and any dividends they pay themselves are taxed as dividend income. The £2,000 dividend allowance can be used against this income; once this has been used, dividends are subject to income tax at 8.75% for basic-rate taxpayers, 33.75% for higher-rate taxpayers and 39.35% for additional-rate taxpayers.
- **The stability of the income** – some clients have incomes that fluctuate considerably. The extent of the fluctuations should be considered and might prompt changes to mortgage or banking arrangements.
- ***Inflation protection*** – most earnings are likely to be protected against the impact of inflation to a greater or lesser extent. Investment income and pensions are very often not protected against inflation.
- **The degree of dependence on a single source of income** – someone with a single source of income (e.g. from their job) is in a higher risk position than a client like Bernie (in the earlier example) who has several sources of income. A person with just one source of income should consider risks such as illness or unemployment.
- **The contingent income position** – there might be a considerable gap between a client's expenditure needs and income if they were made redundant. In the example, Bernie has other sources of income if he were to be made unemployed from his main job. Other clients might be less fortunate.

C3 Summary of tax position on income

Example 4.2

Bernie (continued)

Analysis of where tax is currently paid can highlight planning opportunities. Bernie's net income after income tax and NICs is:

Income source	**£**	**£**
Employment earnings	60,000	
Company car benefit	3,000	
Freelance earnings	15,000	
Total rental income	8,000	
Total savings income	5,000	
Total dividend income	9,000	
Total gross income		**100,000**
Personal allowance £12,570	0	
Tax at 20% on the first £37,700	7,540	
Tax at 40% on the balance of earned income of £27,730	11,092	
Tax at 40% on rental income of £8,000	3,200	
Tax on savings income (£5,000 − £500*) at 40%	1,800	
Tax on dividend income (£9,000 − £2,000**) at 33.75%	2,362.50	
Total income tax		**25,994.50**
NICs on a company director's employment earnings of £60,000 at 13.25% of band earnings between £11,908 and £50,270 (£5,082.96) and 3.25% on earnings from employment above £50,270 (£316.22)		5,399.18
Class 4 NICs on freelance earnings above £11,908 (lower profits limit) at 3.25%***		100.49
Total tax and NICs		**31,494.17**
Net income		**68,505.83**

* As a higher-rate taxpayer, Bernie is entitled to a £500 personal savings allowance.

** All taxpayers are entitled to a £2,000 dividend allowance.

*** Whilst HMRC practice is to round down income to the nearest pound for the purposes of their tax computations, NICs are rounded to the nearest penny, with half a penny being round down.

*** Bernie will have no Class 2 or main rate Class 4 NICs to pay on his freelance earnings as he has already reached the annual maximum as a result of his earnings from employment. He will, however, still have to pay the 3.25% Class 4 NIC additional rate on his freelance earnings in excess of the lower profits limit of £11,908 per annum (i.e. £15,000 − £11,908 = £3,092, at 3.25% = £100.49).

C3A Analysis of the tax position on income

The amount of income that falls within the higher rate tax band is £49,730 in this case. This could be significant, because it suggests the optimum upper limit on payments that might be subject to tax relief during the year. If Bernie made pension contributions (subject to the maximum limit of the lower of 100% of earnings or £40,000 (plus any available carried forward relief)), qualifying interest payments or charitable donations that exceeded £49,730, he would only benefit from 20% relief, rather than 40%. So, any excess should probably be deferred to a later year.

If Bernie has a partner or spouse who is a basic-rate taxpayer or non-taxpayer, it would be worth considering transferring some of the income-generating assets to them, particularly those in excess of the personal savings and dividend allowances, so that some of the income would be taxed at a lower rate or not at all.

C4 The current cash flow statement of income and expenditure

The current cash flow statement is the total income less total expenditure for the current period, bringing all the data on income and expenditure together.

Expenditure may have many more components than income, but it is essentially simpler to understand and is – or should be – related to income.

C4A Summary – current cash flow

Based on the information in the fact-find, the financial planner should produce a summary of the client's current income and expenditure on an average monthly and annual basis, showing the main categories of income and expenditure.

Under the income heading, the summary should show:

- earned income;
- investment income; and
- the tax position on income.

As people's expenses vary widely according to circumstances, the actual headings used can be very different depending on the client.

Where cash flow variations are extreme, perhaps because of irregular income payments or large items of expenditure like school fees, it might be necessary to provide quarterly or monthly statements of cash flow, income and expenditure, and cash balances.

The summary could also show how much expenditure is fixed and how much is discretionary – either as part of the more detailed summary or as a separate item.

Some summaries show tax and NICs as a separate heading. This is especially appropriate for clients who have to pay tax under self-assessment in January and July because they are self-employed.

Example 4.3

Ben and Trish

Ben and Trish live and work in England. Their children attend a private school. The summary of their cash flow is as follows:

Summary of current cash flow	**Annual £**	**% of total expenditure***
Ben's net salary	60,000	49
Trish's net salary	65,000	53
Total income	**125,000**	**102**
Mortgage repayments	25,000	20
Other household	7,000	6
Food	10,000	8
Leisure and eating out	8,000	7
Car and travel	12,000	10
Clothing etc.	5,000	4
Interest and debt repayment exc. mortgage	8,000	7
Holidays	7,000	6
Other personal, e.g. health club	3,000	2
Insurance	3,000	2
Education – school fees	35,000	28
Total expenditure	**123,000**	**100**
Net cash flow	**+2,000**	

* Please note that the percentages shown in the '% of total expenditure' column have been rounded to the nearest whole number.

Tax: both Ben and Trish are higher-rate taxpayers on their taxable income over £50,270. They are taxed under PAYE.

Discretionary expenditure: £10,000 to £15,000 (8% to 12%) a year.

Analysis

- Ben and Trish are currently spending virtually all their income with very little scope to provide for the future. This might be described as a savings and financial protection gap.
- There could be potential savings to be made in insurance and mortgage by rebroking them.
- Ben and Trish have agreed that some £10,000 to £15,000 a year of their itemised expenditure is discretionary and could be reduced, if necessary, to meet other objectives. So, £10,000 plus £2,000 current surplus plus the savings on insurance and mortgage could be the amount used to meet their objectives.
- The main areas where they could reduce costs are food, leisure and eating out, car and travel, clothing and other personal expenditure.
- There are three times a year when their cash flow is at its worst – when the school fees are payable – and the lowest cash flow point in the year is September to December. This is when all the school fees have been paid for the year and before either Trish or Ben have received their year-end bonuses. The high use of credit cards etc. is most associated with this period.
- If they could save for short-term expenditure instead of borrowing by using consumer credit, they could substantially cut their non-mortgage interest costs.
- They have opted out of receiving Child Benefit due to their high incomes.

D Net assets statement

The ***net assets statement*** (or net worth statement) is like a business's balance sheet. It is a statement of what the client owns and what they owe at a particular moment in time – i.e. now. As with current cash flow, it is helpful to summarise and analyse the component parts separately.

D1 Summary of main assets and liabilities

Net worth is simply assets less liabilities. Assets need to be considered in different ways for this purpose. Investments are at the heart of the summary.

- Generally, the client's home is not really an investment and should be considered separately from other assets that can be used to generate an income. Of course, in extreme circumstances, the home could be sold and it will be taken into account for inheritance tax (IHT), so it needs to be included within overall assets but shown separately.

Refer to

See *Retirement review* on page 4/24 for retirement reviews.

- When summarising a client's assets, pensions should be considered as investments. DC schemes are a major aspect of asset allocation and are capable of generating both income and lump sums.
- Private company shares or interests in business partnerships should be shown separately because they are usually very illiquid.

Where the client has a relatively complex situation, it may make sense to provide a separate schedule for each of the main parts of their net worth statement and then summarise it. If the position is straightforward, a single summary might be easier for the client to understand. In the following sections, each component of the net worth summary is considered separately.

D2 Main home and other used assets

It makes sense to list used assets, like the client's main residence and personal possessions, separately from their investments.

There may be particular issues that need to be clarified about certain assets, such as:

- mortgages or other borrowings – although generally with more detail for borrowings;
- the level of equity in the property;
- any peculiarities about the property;
- whether the client is likely to move in the foreseeable future; and
- the cost of an acceptable replacement property if the client is thinking of trading down at some point to release capital.

Example 4.4

Mark and Liz

Summary of main home, other property and used assets
Mark and Liz have the following property that they use themselves:

Asset	Mark £	Liz £	Joint £	Total £	Income Mark £	Income Liz £
1. Main residence			900,000	900,000		
2. Holiday home in Spain	300,000			300,000	2,000	
3. Furniture etc.			100,000	100,000		
Total used assets	**300,000**		**1,000,000**	**1,300,000**	**2,000**	

1. There is a mortgage of £230,000 on the main residence – details are in the example shown in *Total net assets summary* on page 4/18.
2. Mark does not feel he needs to share the ownership of the holiday home with Liz.
3. The insured value of the furniture etc. on a new-for-old basis is £250,000.

Analysis of the main home, other property and used assets:

- The equity in the home is £900,000 less £230,000 = £670,000.
- Mark and Liz are considering the possibility of moving. Based on their incomes, they could borrow about £400,000 and afford a home worth about £1 million, although this would have a considerable impact on their expenditure.
- The home in Spain is worth less than was paid for it. There is a potential allowable capital loss if Mark disposed of the property. There is currently no intention to sell the property.
- The total holding in property is almost 72% of their total gross assets of £1.67m (shown in the example that follows in *Total net assets summary* on page 4/18) excluding borrowing (but including investments shown in the next example).

D3 Investments

The presentation of the investment information should reflect what is important about the client's situation. This could lead to a variety of possible layouts for this information, depending on the circumstances.

- The objectives that the client has for their investments will depend on the age and circumstances of the client, and might be:
  - Investment growth to meet a future target. For most people of working age, this will be their retirement fund, but there may be other targets, such as school fees provision or the building up of a capital sum for a house purchase or to start a business.
  - The provision of a current income. This would be most applicable for someone who has reached retirement and is now using their pensions and other investments to provide an income.
- Generally, the key variables for investments are:
  - asset class;
  - ownership;
  - income yield;
  - tax wrapper (e.g. individual savings account (ISA), pension, life assurance bond, collective investment); and
  - base value and date of purchase.
- Some investments, such as insured managed funds, fall into more than one asset class. The usual approach is to apportion the fund between the asset classes, depending on the most recent distribution of the fund.

- Some assets – such as venture capital trust (VCT) shares, enterprise investment scheme (EIS) shares and seed enterprise investment scheme (SEIS) shares – could be categorised under equities or in the alternative asset class as private equity.
- The summary should also highlight any funds that conform to ethical or socially responsible investment (SRI) criteria or that have other special characteristics.
- The financial planner should review the past performance of funds and the specialist assessments by organisations that provide analyses of investment funds and other financial products.

Example 4.5

Mark and Liz (continued)

Mark and Liz have a relatively straightforward set of investments, although it is easier to show the overseas investments on a separate schedule in this case.

Asset	Mark £	Liz £	Joint £	Total £	%	Income Mark £	Income Liz £
Total UK equity collectives	36,800	88,200		125,000	34	45	2,170
Overseas equities direct holdings	85,000			85,000	23	2,737	
Gilts	60,000			60,000	16	1,000	
Cash deposits			100,000	100,000	27	1,000	1,000
Total	**181,800**	**88,200**	**100,000**	**370,000**	**100**	**4,782**	**3,170**

The summary could also include the base values to show the level of profit or loss on each investment, or this information could be included in the notes.

D3A Asset allocation and tax wrappers

An important way to summarise investments is often by asset class and tax wrapper. The client may think of their assets more in terms of the wrapper (e.g. the pension or ISA), but it is actually the asset allocation that is likely to be the main determinant of investment growth.

It is possible to summarise investments in one single schedule, especially where the investments are held on a platform, but it is sometimes clearer to provide separate schedules.

Asset allocation is an investment strategy that aims to balance risk and reward by adjusting the percentage holdings of each asset type in a portfolio based on a client's attitude to investment risk, investment objectives and timescales. The theory is based on the principle that different assets react differently to various market and economic conditions. Different asset types that are not perfectly correlated will offer different returns, and therefore diversification reduces the overall risk in terms of the variability of returns.

Academic research has produced a variety of different models based on statistical relationships that existed over a previous period to forecast the likely returns for a specific mix of assets in the future. The major weakness of this approach is that there is no guarantee that past relationships will continue or repeat in the future.

However, asset allocation has become a stalwart in investment planning and most firms have a range of asset allocation models for different risk profiles. A firm may either compile their own models or adopt third-party models.

Where asset allocation models are in use, it is important to compare the asset allocation of the current portfolio to the target asset allocation model for the client's agreed level of risk.

Any major difference in the asset allocation could indicate that the current portfolio is no longer suitable for the client's needs and requirements and should therefore be rebalanced to ensure that future returns are consistent with the level of risk agreed.

Example 4.6

Tom

Tom, a higher-rate taxpayer, has the following investments listed by asset class and tax wrapper:

Asset class	Pension £	ISAs £	UK bonds £	UK direct/ collectives £	Total £	Total %
UK equities	200,000	20,000	70,000	10,000	300,000	**45**
North American equities	30,000	0	10,000	20,000	60,000	**9**
Emerging markets equities	0	20,000	10,000	0	30,000	**5**
Total equities	**230,000**	**40,000**	**90,000**	**30,000**	**390,000**	**59**
UK property	150,000	50,000	0	0	200,000	**30**
Sterling fixed interest	20,000		10,000	20,000	50,000	**8**
Sterling cash	0	0	0	20,000	20,000	**3**
Total	**400,000**	**90,000**	**100,000**	**70,000**	**660,000**	**100**

D3B Analysis of investments

The financial planner should comment on a range of issues, including:

- any mismatch between the client's risk profile and the overall portfolio;
- an excess of investments in any one asset class or market;
- a large proportion of investments with a single provider;
- the level of charges being incurred and whether they represent value for money;
- any mismatch between income and/or growth orientation and the client's needs;
- with-profit issues where they arise;
- investment risk issues, including:
  - volatility over the last three to five years of each investment;
  - volatility for the portfolio as a whole compared to the client's preferred risk profile;
  - drawdown, i.e. maximum percentage loss of value over the period of ownership for each investment;
  - drawdown for the portfolio as a whole compared to the client's preferred risk profile;
  - asset class, economic sector and market percentage breakdown; and
  - an assessment of the probability of the client meeting their investment targets, e.g. desired level of income in retirement.

The analysis might also include the fund ratings from a specialist ratings agency, which should be able to provide most of the information about funds.

Example 4.7

Mark and Liz (continued)

The risk assessment of the past performance of Mark and Liz's investments is as follows. For this purpose, the summary includes details of the two funds they own.

Asset	Value £	%	Annual growth over three years %	Historic yield %	Volatility %	Drawdown %
ABC UK smaller companies unit trust	36,800	10	1.4	0.12	24	52
XYZ UK equity income open-ended investment company (OEIC) shares	88,200	24	14.0	2.46	15	42
Overseas equities direct holdings	85,000	23	9.0	3.22	22	56
ABC gilt fund	60,000	16	6.0	1.67	4	0
Cash deposits	100,000	27	2.0	2.00	1	0
Total	**370,000**	**100**				

Asset type	Actual asset allocation %	Target asset allocation %	Difference +/−
Cash	27	0	+27
Fixed-interest securities	16	16	0
UK equities	34	39	−5
Overseas equities	23	37	−14
Property	0	8	−8
Total	**100**	**100**	

General investment issues

- Certain assumptions have been made regarding the details in their fact-find and the research that may have been completed by the adviser.
- Mark and Liz have a cash reserve of about a year's expenditure. This is probably more than they need in their circumstances and could be reduced to between three- and six-months' expenditure.
- Mark and Liz are aiming for capital growth over at least a 20-year time horizon to provide for their capital and income needs in retirement.
- The net returns after tax they are making on cash and fixed interest are less than the interest they are paying on the mortgage. It may be preferable to reduce the mortgage from the cash and fixed-interest investments, subject to retaining a minimum cash reserve.
- They do not need income now. The XYZ UK equity income OEIC is income-oriented as indicated by the historic yield figures, and the directly held global equities are paying dividends.
- The ABC UK smaller companies unit trust has performed poorly, with low returns, and high volatility and drawdown compared to other similar funds. The rating by Morningstar, the fund analysis and rating organisation, is the bottom category.
- The XYZ UK equity income OEIC has high charges, although it has performed better than the sector average.
- The ABC gilt fund is primarily invested in low-risk short-dated gilts, which may provide relatively low returns compared to a fund that has the freedom to invest in riskier longer-dated stock.
- There is currently no tax liability on switching to achieve higher returns with the same level of expected risk or less.

- Currently 77% of their investments are held in UK assets. This might be an excessive proportion, especially as they are planning to retire overseas eventually.

Investment risk assessment

- Mark and Liz have 43% of their investments in cash and gilts.
- This does not match their risk profiles and suggests that they should have a higher proportion of their assets in equities.
- Cash deposits are yielding very little, although they are secure in principle.
- They should consider holding no more than £85,000 each in any one banking group in order to have the full protection of the Financial Services Compensation Scheme (FSCS). However, this may have the effect of reducing the yield as higher interest rates are generally offered for larger deposits.
- The current allocation to cash and gilts has performed well in recent markets and has balanced the recent poor performance of the other investments. However, Mark and Liz may need to consider increasing their exposure to equities and corporate bonds to meet their long-term objectives, which will require higher growth than either of these two asset classes are likely to generate.
- They could consider whether to repay the mortgage in full by selling some of the equity-based investments. Retaining the equities would be worthwhile in the long term if the growth is higher than the interest on the mortgage, but it does increase investment risk.
- Alternatively, they could use their cash and gilt holdings to repay the mortgage in part.

D4 Liabilities

The liability position of some clients is very simple; it will be nil for many retired people, apart from a possible tax liability. It may be complicated for others, involving mortgages on multiple properties with different purposes, business debts, loan guarantees, short-term loans, hire purchase and car loans, and outstanding credit card balances.

D4A Summary of liabilities

The summary should show:

- the main categories of borrowings by type, security, term, capital outstanding, monthly repayments and annual percentage rate (APR) of interest;
- any special features (e.g. interest-only, fixed rate);
- net wealth (i.e. assets less debts);
- the percentage or ratio of debt to total wealth;
- the amount of equity in the client's property (i.e. value less outstanding mortgage);
- the percentage of mortgage repayments to net income; and
- the percentage of short-term and credit card debt repayments to net income.

D4B The analysis of liabilities

The analysis should comment on such issues as:

- the cost of borrowings in terms of interest rates and level of repayment as a percentage of income;
- the amount of consumer debt and its costs; and
- the likelihood of debt repayment targets being met (e.g. by the client's expected retirement date).

It makes good sense to keep expensive short-term borrowing to a minimum and to repay those debts with the highest interest rates as soon as possible.

Along with personal debts and liabilities, it is important to also establish any third-party arrangements that may be in place. With the difficulty of obtaining credit, it has become much more commonplace for parents to act as guarantors for their children's mortgages; this may also extend to other family members and even close friends. Where a default occurs, the guarantor will become fully liable for the monthly repayments and the outstanding balance of the loan.

It is also important to understand the nature and potential impact of any business liabilities:

- **Sole traders** have unlimited personal liability for the debts of their business, including claims against the business and any default on credit facilities. The sole trader's personal assets are at risk and they could face personal bankruptcy if they cannot meet their liabilities.
- **Partnerships** – partners in an ordinary partnership have joint and several liability. They are not only liable for their own share of the business liabilities but are also responsible for those of the other partners where they are unable to meet their liabilities. Again, the personal liability is unlimited and a partner could face personal bankruptcy and lose all their personal assets in the event of a claim or default against the business.
- **Limited liability partnerships (LLPs) and limited companies** provide some protection from creditors, as they have a separate legal identity to their members. Any liability in respect of a claim or credit default is limited to the assets of the LLP or limited company. The individual members' personal assets are protected and their liability extends only to the amount that they have invested into the business. However, where they have provided any personal guarantees and the business assets are not sufficient, they can be pursued personally to the extent of the guarantee they have provided. Therefore, they could still face personal bankruptcy where their personal assets are not sufficient.

Example 4.8

Maureen

Summary of liabilities

Maureen has the following liabilities:

Type	Term until	Security	Capital	Amount per month	APR %
Mortgage – repayment	2029	Home	£130,000	£800	5
Credit card			£10,000	Min. £500	29
Total			**£140,000**		

Maureen's gross income is £61,000 a year and her net income is about £43,500. Her home is worth £200,000 and she has other assets worth £40,000.

- Maureen's total debt is 58% of her assets.
- The equity in her property is £70,000 or 35% of the value.
- Her mortgage has a remaining term of seven years.
- Her mortgage repayments are 22% of her net income.
- At 29% APR, the credit card interest costs nearly £3,000 a year if the outstanding balance is not reduced.
- Her minimum monthly payments of £500 are nearly 14% of her net monthly earnings.

Analysis of liabilities

- The current level of payments on credit cards is not enough to reduce the capital. She should aim to reduce her expenditure and pay off her credit card debt at the rate of an extra £500 a month, which she agrees is possible.
- On the credit cards being repaid, the saved £3,000 interest a year would allow her to save for her retirement.
- Any investments need to achieve an annual net return of more than 5% for it to be better to save than to repay the mortgage more rapidly. While this is probably achievable, her attitude to, capacity for and tolerance of risk in relation to both investments and her existing mortgage would need to be taken into account before proceeding with such a recommendation.

D5 Total net assets summary

The total gross assets represent the value of the client's assets before taking into account their liabilities, such as any mortgage. The net worth is the assets less the liabilities.

Example 4.9

Mark and Liz (continued)

Mark and Liz have a relatively complex set of assets. Separate schedules have been produced (see Example 4.4 on page 4/12 and Example 4.5 on page 4/13) to show specific aspects of their affairs, such as the income from their various assets. The following summary schedule brings together all their assets and emphasises the division of ownership between them, the main types of investment, the asset allocation and the main liability, which is the mortgage. The percentages are of gross worth (i.e. before any deduction for borrowings).

This is a clear and simple way to set out this couple's total net worth, but other methods of scheduling assets may be more appropriate in other situations. For example, where the number of individual investments is greater, all the investments might be summarised by asset class, although it is usually a good idea to show pensions separately because of the special rules that apply to accessing them.

Asset	**Mark £**	**Liz £**	**Joint £**	**Total £**	**Total %**
Main residence			900,000	900,000	54
Holiday home in Spain	300,000			300,000	18
Furniture etc.			100,000	100,000	6
Total used assets	**300,000**		**1,000,000**	**1,300,000**	**78**
Total UK equity collectives	36,800	88,200		125,000	7
Overseas direct equities	85,000			85,000	5
Gilts	60,000			60,000	4
Cash deposits			100,000	100,000	6
Total investments	**181,800**	**88,200**	**100,000**	**370,000**	**22**
Total gross worth	**481,800**	**88,200**	**1,100,000**	**1,670,000**	**100**
Less mortgage on home			(230,000)	(230,000)	14
Net worth	**481,800**	**88,200**	**870,000**	**1,440,000**	**86**

Analysis of Mark and Liz's total net worth

- Mark and Liz's property is a very substantial part of their total wealth. They are not as well diversified as they should be.
- There is a considerable imbalance between Mark and Liz's assets. This could lead to higher income tax liabilities than necessary in the future.
- They are not heavily geared, with the mortgage amounting to only 14% of their gross wealth.
- They could consider repaying the mortgage, at least to the extent that they hold cash and gilts, and should probably use equity assets to repay it altogether. They could then use the money previously used to repay the mortgage each month to fund regular savings in a bid to diversify their portfolio in fund(s) that match their stated attitudes to risk.

E Risk assessment and protection

Everyone faces various risks throughout their lives. If the financial planner can identify most of the key risks via a ***risk assessment***, it should help the clients decide what action to take.

E1 The main financial risks

The main risks with potentially major financial implications are:

- death of a family member;
- unemployment/redundancy/business failure;
- illness or accident;
- relationship breakdown;
- destruction or devaluation of property or business;
- investment risk; and
- longevity risk (i.e. outliving one's resources).

Consider this…
Consider your own personal circumstances and how the risks identified above would affect you and your family.

E2 Dealing with risk

The main ways of dealing with risk are to manage it or insure it:

- Managing these kinds of risk can be achieved by building up adequate liquid investment reserves and diversifying investments over a range of different asset classes and institutions. Management is the right approach for risks that are relatively probable, such as investment fluctuation or the inability to sell a business.
- Insurance is typically the more appropriate approach for dealing with high impact risks that are not very likely to happen, such as premature death or serious disability.

E3 Actual and potential relationships of dependence

The purpose of life and health insurance is to protect people who are financially dependent on the insured person. An important starting point is to summarise these ***dependent relationships***.

Summary of relationships of dependence

- The client's immediate dependants (e.g. minor children) with estimated age of financial independence.
- Individuals who could potentially be dependent (e.g. adult children and grandchildren) as a result of death, incapacity through sickness or accident, unemployment or the breakdown of a relationship.
- The possible need to provide financial help to an ageing relative for long-term care.

Example 4.10

Andrew and Claire

Name	Andrew	Claire	Simon	Alison
Age	47	40	20	10
Family position	Client/husband	Client/wife	Son	Daughter
Dependant	By Claire for life By Simon for 1 year By Alison for 11 years	By Andrew for life By Simon for 1 year By Alison for 11 years		
Insurability	Smoker	Healthy non-smoker	Racing driver	

E4 Summary of financial protection provision

The summary of financial ***protection*** provision should include:

- a list of the financial dependants of each person covered by the financial plan (e.g. spouse or partner, ex-spouse or ex-partner where there are ongoing commitments, minor children, ageing parents);
- potential dependants (e.g. adult children with their own offspring might not be adequately insured and may become dependent on their parents or other family members);
- the amount of financial loss they would suffer on the person's death or incapacity;
- the length of time they would need support;
- types of school the children or other dependants may attend and plans for any higher education;
- plans to help children or other dependants with home purchase, starting or expanding a business or other possible needs;
- liabilities (e.g. mortgages and other borrowings) that should be covered by life and health insurance; and
- the insurability of the client or other relevant people.

E4A Summary of insurances

The statement of the client's net assets and how they are deployed provides a good summary of the way in which risks are being managed. It is also important to have a summary schedule and analysis of the insurance protection.

The following schedule lists life and health protection, but financial planners should also make clients aware of the importance of adequately insuring their material belongings.

Life assurance	Premium £	Cover 0–5 years £	Cover 5–10 years £	Cover 10–20 years £	20 years + and whole life £	Special features, e.g. renewable, increasing
Client						
Lump sum benefit						
Income benefit						
Assigned in trust or life of another						
Beneficiaries						
Partner/spouse						
Lump sum benefit						
Income benefit						
Assigned in trust or life of another						
Beneficiaries						

E4B Analysis of life cover

The level and term of life assurance cover has to be compared to the dependency schedule showing the need for cover. The adequacy of existing life cover should also be assessed in relation to debts owed. The amount of cover might not match the need, and the term may be too long or too short.

Death in a family can have an impact on expenditure:

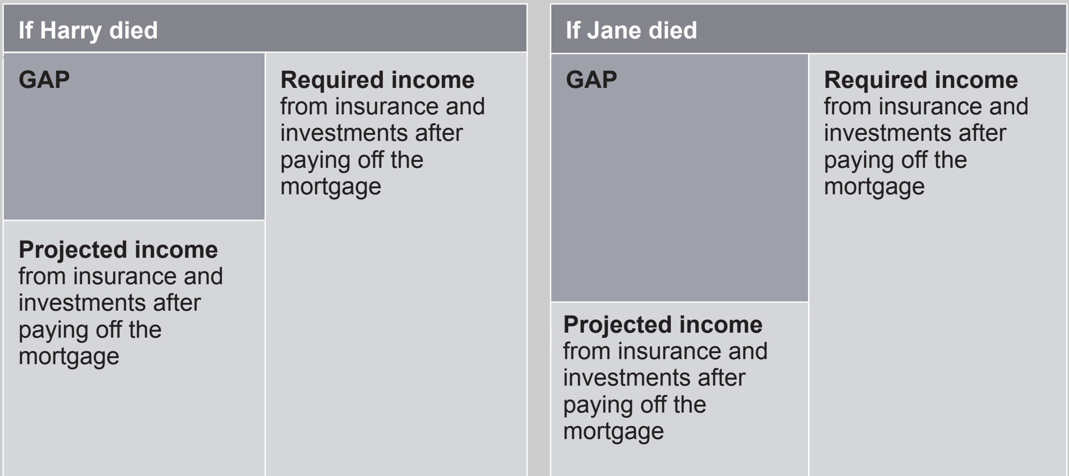
- Where there is a young family, the death of a parent could lead to extra costs, such as childminding or possibly even sending a child to boarding school.
- However, there could be reductions in costs if a partner died and nobody was financially dependent on them.

Example 4.11

Harry and Jane

Harry and Jane believe that they would each need £30,000 a year net in real terms if either of them died and left the other to look after the family for the next 20 years. Looking at the current provision:

- There is family income benefit (FIB) life assurance of £20,000 a year arranged on Harry's life for the next 25 years. If he were to die, the shortfall would be £10,000 a year for the 20-year period of need and then excessive provision in the last five years.
- Jane has £300,000 of life cover for a ten-year term. The shortfall for her life assurance is both the amount and the period of cover. Using a temporary annuity table for an interest factor of 3% annual investment returns, £300,000 would only generate £20,000 a year for a 20-year period. In addition, the insurance would run out halfway through the period of need.



E4C Summary of health cover

Health insurance	Premium £	Cover £	Term years	Inflation protection %	Features, e.g. deferral period and provider
Income protection Client Partner/spouse					
Critical illness Client Partner/spouse					
Long-term care Client Partner/spouse					
Private medical Client Partner/spouse					

The IPI might be arranged either personally or through their employer. The summary should show the:

- length of time the employer would keep paying the salary in full or in part;
- deferral period for the IPI policy;
- level of income from the policy and the extent to which it is inflation-linked;
- termination date (this should identify whether this is before the date that the pension will start to be paid); and
- impact of early termination of pension contributions on pension benefits (if any).

E4D Analysis of health cover

Serious illness can be a major financial disaster for almost anyone, whether they have dependants or not.

There are several types of insurance that can cover the risk in different ways, but they are much less widely used than life assurance.

Based on the current level of expenditure, it should be possible to calculate the approximate expenditure needs of the client in the event of a serious illness. The chances are that they would not reduce greatly; for example, mortgage and other household costs would remain unchanged. There could be a reduction in travel, leisure and entertainment, as well as other discretionary expenditure.

As a rule of thumb, expenditure needs might be about 70–80% of those pre-illness. In some situations, there is also the possibility of additional expenditure:

- The home may have to be adapted to meet special needs.
- There may have to be extra expenditure on holidays for convalescence.
- There may be additional nursing or other care.

Benefits payable from personal IPI policies are tax free but generally limited to 60% of earned income. Employer-sponsored policies are taxable under PAYE but may be up to 100% of income (but would not usually include any allowance for bonus or overtime). In either case, the income from IPI may be less than required, even with State benefits.

The need for IPI could be related to the level of savings on which the client could draw. Where there are very substantial investment resources, it might be worth having a long deferral period to save on insurance premium costs.

The analysis should take into account any early retirement pension the client might receive from their pension scheme if they were forced to retire early. It should also take into account the level of State benefits to which they might be entitled.

The comparison of the client's current provision with their projected needs will generally identify gaps for income and capital with respect to the consequences of a serious illness.

The costs of meeting the shortfall by a combination of building up liquid capital and the provision of health insurance can be assessed to see how realistic the objective is and how it might need to be amended.

Consider this…
What cover do you have in place to deal with the financial risks that you have identified previously? Do you have any gaps that you should be addressing?

F The tax position

Tax is an integral part of various other areas for summary and analysis, notably current cash flow and investments. However, it is of such importance that it deserves its own dedicated section.

F1 Summary of tax position

Calculating net income after tax is an important part of the cash flow statement. The analysis can be included in the presentation to the client at that point or separately in the overall tax analysis. Where an investment or other asset may be sold at some point, it is worth providing an estimate of the capital gains tax (CGT) that might be payable.

If the client's circumstances are likely to change in the foreseeable future, this could have an impact on their ***tax position*** and should be included in the summary. For example, the summary should mention if a client is intending to work overseas in the next three years or will retire soon and will almost certainly become a basic-rate taxpayer.

Example 4.12

Joan

Joan bought 4,000 shares in ABC plc in March 2009 for £5,000. She bought a further 6,000 shares in September 2010 for £26,000. In October 2022, she sold 4,000 shares and received proceeds of £30,600. In matching shares disposed of on or after 6 April 2008 with acquisitions, all shares of the same class in the same company acquired before the date of disposal are pooled to form a single asset (s.104 holding).

Assuming she has no other gains – and that when the gain is added to her income, she remains a basic-rate taxpayer – the amount of CGT she will pay is as follows:

	£	£
Sales proceeds		30,600
Less base cost (£5,000 + £26,000) × 4,000 ÷ 10,000	12,400	
Gain		18,200
Less annual exempt amount	12,300	
Taxable gain		5,900
Tax due at 10%		**590**

A similar calculation would also be required if the client owned a life assurance bond that might need to be encashed. In this instance, it would be an income tax calculation and might allow for top-slicing relief. There is no CGT liability on encashment of a life assurance bond by the original policyholder.

F2 Analysis of tax position

The aim of the analysis should be to highlight the key issues in income tax and CGT planning for the client. These might include:

- how much income is subject to tax at higher rates, to highlight the opportunities for higher-rate tax relief on pension contributions and other payments;
- the use of the marriage allowance (10% of the non-taxpaying partner's personal allowance, i.e. £1,260 (rounded) in 2022/23) for spouses/civil partners, which is available where there is no entitlement to the married couple's allowance, one partner has income below the personal allowance and the other partner is a basic-rate taxpayer;
- tax planning opportunities in terms of spreading the ownership of assets between spouses/partners;
- the use of inappropriate tax wrappers in relation to the underlying investments held in a tax wrapper;
- the potential CGT or income tax liability on switching investments;
- the scope for saving some CGT by spreading disposals over more than one year to maximise use of the client's CGT annual exempt amount;
- the likelihood that the client will become a basic-rate taxpayer at some point in the future, when it might be worth encashing investments that would be subject to the lower rate of CGT or to income tax, such as life assurance bonds or roll-up funds; and
- the Child Benefit tax rules and how these will impact parents – i.e. whether they choose to opt out or receive the benefit and therefore incur additional tax liabilities.

Refer to

See *Pension details – accumulation phase* on page 3/13 for tax relief on pension contributions.

Example 4.13

Tom (continued)
Taken from earlier example on Tom (Example 4.6 on page 4/14):

- Tom holds life assurance bonds containing growth-oriented equities, as well as some fixed-interest securities in collectives. These could be changed to reflect the more advantageous tax treatment of gains made on fixed-interest securities held in bonds and growth-orientated equities held in collectives. The CGT rate on realised gains on the growth-orientated equities held in collectives would be 20% at most. In addition, the fixed-interest securities within bonds would be taxed at 20% at most and would not have to be 'grossed up' to calculate the potential higher rate tax that Tom would have to pay on encashment of the bonds. Tom may be able to avoid this higher rate tax altogether if his income tax rate drops to basic rate (including the 'top-sliced' gains on the bonds at the time of encashment).
- Tom has not often used his CGT annual exempt amount.
- Tom would be liable to a higher rate income tax charge on any gain because he is a higher-rate taxpayer. He would, however, receive a tax credit for the 20% deemed to have been taken at source, meaning he only has to pay an additional 20%, rather than 40%. CGT is not payable on bond encashments.
- It may be more appropriate to switch asset classes by changing the funds within the range of those available within the existing bond contract, rather than to switch out of the bond altogether.
- The collectives could be switched without a CGT charge if disposals were spread over two tax years.
- Tom has not invested in ISAs in the last two years, although he has built up £90,000 of ISA funds in the past. As a higher-rate taxpayer who might have to pay CGT on his investments, an ISA is a highly appropriate tax vehicle and he should consider using his annual entitlement (£20,000 in 2022/23).

In some situations, clients will have to weigh the tax considerations against their other needs, such as the need to reduce investment risk.

Example 4.14

Aamir
Aamir owns 2,000 shares in a small company that increased in value rapidly over three years. They comprise a very substantial part of his portfolio, representing very high risk. He was reluctant to sell the shares to lock-in the gain because of the CGT liability and the fact that he felt they might grow further. Their reduction in value by over 75% in the last year has been a shock to him and meant that he has now lost far more than the CGT that would have been payable had he sold them when they were at their highest point.

G Retirement review

Providing for a comfortable retirement is such an important objective that it often deserves a separate analysis of target and provision – in other words, a ***retirement review***.

The pension freedoms legislation, which came into effect on 6 April 2015, gave members of DC schemes the option to withdraw all of the capital from their pension fund from the age of 55 (increasing to 57 from 2028). Generally, up to 25% can be taken as a tax-free pension commencement lump sum (PCLS). Further withdrawals are taxable as pension income under PAYE.

While this freedom may appeal to some clients, the tax implications need to be considered carefully.

Example 4.15

James

James, aged 67, retired in November 2022. He lives in England, receives a State Pension of around £8,000 a year and has a personal pension pot of £90,000. If he takes the maximum tax-free PCLS of £22,500, he will have £67,500 in his pot. If he then decides to withdraw all of this, his income tax liability for the year will be:

Income source	£	£
State Pension	8,000	
DC pension withdrawal (£90,000 − £22,500)	67,500	
Total gross income		**75,500**
Personal allowance of £12,570	0	
Tax at 20% on the first £37,700	7,540	
Tax at 40% on the balance of £25,230	10,092	
Total income tax		**17,632**
Net income		**57,868**

If James decides to withdraw his entire pot in one go, he will pay tax at the higher rate on £25,230 of his fund. To avoid this, he could withdraw funds over three or more years, keeping him within the basic-rate tax band each year, thus avoiding the 40% tax rate.

Projecting retirement income and comparing it to income that clients believe they need is one of the most valuable outcomes of the lifetime income and expenditure statements. This gap analysis can then be turned into a target with projected pension and investment funds at retirement, in order to simplify the objectives and allow for such issues as the need for survivor pensions/income provision.

Figure 4.1: Gap analysis of projecting retirement income

Target pension and investment funds at retirement		
Projected pension fund	Projected investments	**Total shortfall**

Source: *GBST.* Used with permission and thanks.

The costs of making good this shortfall in retirement planning can then be projected to see whether the target income is realistic or needs to be adjusted.

A refinement of the shortfall approach is to use stochastic modelling to predict the chances of achieving the retirement goals.

For example, the client may have a 30% chance of achieving their retirement income goals based on a given level of funding and the current asset allocation of their investments. This approach can help the client assess their choices more clearly than using gap analysis.

The main choices when faced with a shortfall in the target fund for any purpose are to:

- Increase the level of saving.
- Change the asset allocation in the hope that higher risks will lead to higher returns. However, the shorter the time span, the less feasible this option becomes. With a short period, if there is a downturn, the fund has little or no time to recover. This is why many planners suggest switching to increasingly low-risk investments as the target retirement date becomes closer – often starting ten years from retirement.
- Change assumptions about the need. In the case of retirement planning, this could mean some or all of the following:
  – reducing the target retirement fund;
  – finding another source of income in retirement (e.g. part-time earnings);
  – postponing retirement for a few years; and
  – borrowing in retirement through some form of equity release.

Chapter 4

Example 4.16

Peter

Peter needs an extra £100,000 in his pension fund at age 67 in today's money. At present, there is a less than 10% chance that he will achieve his target income based on his current level of accumulated pension, his other investments, his current rate of saving and reasonable assumptions about investment growth.

On the same assumptions, he would need to save at the rate of £1,000 a month to accumulate £100,000 in five years. He could make tax relievable pension contributions or save in some other way. Otherwise, there will need to be some other adjustment to the planning, such as reducing the target.

In many respects, pension plans are simply investment wrappers with their own particular tax rules and restrictions.

Pensions have particular characteristics that make them different from other investment vehicles in some respects; for example, employers can make contributions to them. There are certain types, such as State Pensions or entitlements under DB schemes, that can be considered part of a person's net wealth in a sense, but not in the same way as other assets.

The review should compare projected retirement income with target retirement income. Double counting investments for retirement and for other purposes can lead to an overly optimistic view of the client's financial position.

Consider this…

Would you realistically be able to carry out any of these identified actions? What other steps could you take to address any retirement shortfall?

Reviewing existing pension provision

For DC schemes, charges should be assessed in terms of value for money. Personal pensions tend to have higher charges than stakeholder pensions. Self-invested personal pensions (SIPPs) may have higher charges still. Where a client has either product, the adviser should check to see if the client needs the add-on services offered and, if not, should consider whether switching to a cheaper stakeholder product would be more beneficial in the long term. Additionally, the fund's current investment strategy should be reviewed to ensure it is in line with the client's retirement objectives and their attitude to risk.

Where a client is in a DB scheme, the adviser should not assume that their retirement needs are taken care of. They should confirm the pensionable remuneration, qualifying years' service and accrual rate. In addition, the adviser should establish the security of the client's future pension by finding out if there are any underfunding issues with the scheme or solvency issues with the sponsoring employer. The annual escalation rate of the pension in payment should also be established to find out if it is likely to be sufficient to meet the client's future income needs.

H Lifetime cash flow projections

Lifetime cash flow projections are being used increasingly by financial planners to forecast clients' income and expenditure profiles over the long term. These cash flow projections provide year-by-year summaries of cash paid to and paid out by the client, showing those years in which there will be a surplus or a deficit, demonstrating the potential accumulated surplus or (more usually) deficit.

The lifetime cash flow is a powerful tool because it allows the client to see their whole life in financial terms in a single illustration. The output of the cash flow is usually a combination of figures and graphics.

The projections provide a form of year-by-year gap analysis. The aim is to see whether the client can maintain their lifestyle and meet their financial goals. If the client cannot achieve these aims, the lifetime cash flow will identify the point at which they are likely to run out of money.

If the projection shows that the client can achieve their aims, it should also show how robust the forecast is by demonstrating the amount of surplus balance throughout the period.

There are several software packages that reduce the amount of time and effort in compiling the data and making the analysis. The principles are essentially the same and the process can be done on a plain spreadsheet or even by hand, although it can be very complicated. Software varies in its sophistication and the degree to which it makes very broad assumptions about future income, expenditure and aspects such as tax. It is important to understand the principles and to be sceptical of the outcomes; otherwise, the ‘garbage in, garbage out’ principle may apply.

The main variables year by year are the:

- level of income and capital inputs;
- level of expenditure; and
- assumptions made about future increases in income, capital values (including year-by-year savings), expenditure and inflation.

As the phrase ‘lifetime cash flow’ suggests, the tool can be used at any time in the client’s life for projecting school fees costs or the scope for saving during the client’s working life and for modelling short-term savings. However, its main use is to project forward to the client’s income and expenditure position in retirement. Indeed, cash flow projections are very important when advising clients on pension transfers from DB schemes as the adviser needs to ensure that the client has sufficient income to maintain their lifestyle throughout their life.

H1 The amount and timing of cash inputs

This data should be derived from the fact-find and subsequent summary and analysis. Each source of income and capital should be itemised separately in order to build up the lifetime cash flow according to amount, timing and growth assumption between now and payment time.

The cash flow can be run with different assumptions about amounts and timing to see how robust it is to changed variables.

Cash inputs into the cash flow will consist of net income and other cash inputs from such sources as inheritances, possibly the sale of an asset such as a business, or the disposal of a valuable home where trading down is feasible. Estimating the timing or amount of such items as an inheritance or the sale of a business is very difficult:

- In the case of a hoped-for business sale, it is safest to agree a realistic timescale and assign it a relatively low probable value. Businesses are notoriously hard to value and sell.
- In the case of a possible inheritance, the timescale could be linked to the current owner’s average life expectancy from the appropriate mortality tables. The client should carefully consider the possibility of not inheriting the full amount – or, indeed, any – of the estate. The younger the potential benefactor, the less value should be placed on the inheritance for financial planning. The probable value should take into account the possibility that the current owner will need some or all of their assets to pay for long-term care.
  A conservative way to do this is to calculate the amount that might reasonably be spent on long-term care and deduct it from the expected inheritance.

H2 Sensitivity to assumptions

The financial planner and client need to understand that the projections can be very sensitive to ***assumptions*** proven to be unrealistic. It is certain that some assumptions will prove inaccurate; the question is how inaccurate will they be? The outcome may be broadly as predicted or it may turn out to be very different from the projection.

As such, it is essential to periodically revise cash flow projections and test them against reality.

Example 4.17

Ian and Linda

Ian is 50 and his wife Linda is 48. They want to retire when Ian reaches age 60, at the same time as their children leave university and their mortgage will be paid off. He earns £75,000 a year and Linda earns £22,000 a year. Ian is paying gross pension contributions of £17,000 a year into a personal pension and he increases these in line with his salary. They have both obtained State Pension forecasts, which indicate that Ian will receive £7,500 and Linda £7,000 a year.

They have accumulated Ian's personal pension fund, some investments and savings, as well as a home and mortgage as detailed below.

Assets and liabilities (current position 2022)

	Ian £	Linda £	Joint £	Total £
Main residence	0	0	500,000	500,000
Household possessions	0	12,000	70,000	82,000
Investments	52,000	25,000	46,000	123,000
Savings	0	25,000	10,000	35,000
Total	**52,000**	**62,000**	**626,000**	**740,000**
Liabilities	0	0	−80,000	−80,000
Net assets	52,000	62,000	546,000	660,000
Pension funds	110,000	0	0	110,000
Total net assets	**162,000**	**62,000**	**546,000**	**770,000**

The clients have provided a detailed budget of their current expenditure and an estimate of what they think they'll need to spend in retirement, as shown below.

Expenditure now and from Ian's age 60

	Ian age 50 £	Ian age 60 £ (today's terms)
Housekeeping expenses	13,735	19,000
Professional expenses	300	210
Personal expenses	16,490	25,061
Children	8,800	0
Cost of servicing debts	4,800	0
Motoring expenses	2,460	6,207
Life assurance	2,160	0
Net pension contributions	13,600	0
Total expenditure	**62,345**	**50,478**

Inflows

For the cash flow, the net inflows will need to be calculated. The clients are both earning salaries and it will be necessary to deduct income tax and NICs. Once they retire at Ian's age 60, he plans to draw a tax-free lump sum from his pension fund and then use the remainder to provide taxable income. Furthermore, Ian's State Pension will commence at 67 and Linda's will start two years later, again at 67.

There are, therefore, a number of calculations needed to determine their net inflows at these different points in time. Some assumptions are required to do this and the cash flow is based on the following:

- Inflation will average 3% a year. Salaries, expenditure and tax thresholds will all increase in line with inflation (i.e. they will maintain their real value each year).
- Ian's pension fund will obtain real growth of 3% each year (i.e. above inflation). He will draw the maximum tax-free lump sum of 25% of the fund value at age 60 and will use

the remainder to purchase an annuity, which increases in line with inflation and has a 50% spouse's pension. The annuity rate is assumed to be 3.5%.

Based upon the assumptions, the net inflows at various times are shown below (all figures are expressed in today's terms):

	£	Ongoing/ one-off	From Ian's age	To Ian's age
Ian's net earnings	55,169	Ongoing	50	60
Linda's net earnings	18,865	Ongoing	50	60
Ian's tax-free lump sum	85,679	One-off	60	–
Ian's net annuity	8,996	Ongoing	60	67
Ian's State Pension & net annuity	16,496	Ongoing	67	95
Linda's State Pension	7,000	Ongoing	69	95

Annual tabular cash flow projection

The annual cash flow is projected in the next example. It shows the aggregate build-up of the clients' liquid assets (non-pension investments and savings) over time. Underneath the tabular presentation is the graphical presentation.

The projections depend on certain assumptions in addition to those made above. These are:

- Investments will obtain real growth at 3% a year after charges and tax. Dividends are included in the growth rate (i.e. the total net return is 3% a year).
- Savings will maintain their real value after tax (i.e. the net interest rate will match inflation and interest is accumulated).
- Surpluses are invested and saved in the same proportions as the current holdings. Equally, deficits are assumed to be drawn from liquid assets in the same proportions. In other words, it is assumed that the clients will wish to retain the current balance between investments and savings throughout the projection. This means that a composite net return of 2.34% across their investments and savings has been applied.

Remember that a change in assumptions can have a substantial impact on the calculations.

The key column to look at is the 'Balance at start', which shows the balance of their liquid assets at the beginning of each year. By age 74, it is a negative amount. This shows that the clients will have used up all their liquid savings by the time Ian is 74 and Linda is 72. Their life expectancies are to around age 84 and 87, respectively, so they potentially face a serious problem. Of course, they may survive many years beyond their average life expectancies, so the cash flow projects their position to Ian's age 95 to illustrate the effect of this.

The 'Balance at end' column shows the value of their liquid assets at the end of each year, having applied the composite growth rate to the starting value and then adding any annual surplus or subtracting any annual deficit. The value at the end of any year becomes the value at the start of the following year. The figures are expressed in today's terms.

Example 4.18

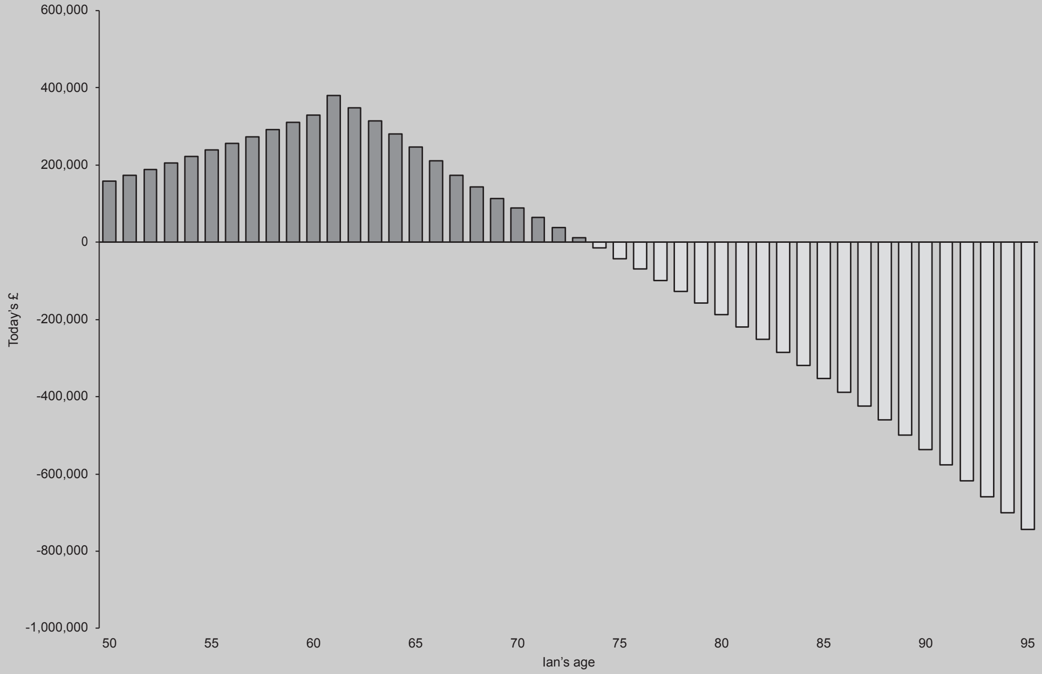
Ian and Linda (continued)

Tabular cash flow presentation

Ian's age	Balance at start £	Inflow £	Outflow £	Surplus/deficit £	Balance at end (inc. growth) £
50	158,000	74,034	−62,345	11,689	173,379
51	173,379	74,034	−62,345	11,689	189,116
52	189,116	74,034	−62,345	11,689	205,222
53	205,222	74,034	−62,345	11,689	221,703
54	221,703	74,034	−62,345	11,689	238,569
55	238,569	74,034	−62,345	11,689	255,829
56	255,829	74,034	−62,345	11,689	273,493
57	273,493	74,034	−62,345	11,689	291,569
58	291,569	74,034	−62,345	11,689	310,067
59	310,067	74,034	−62,345	11,689	328,997
60	328,997	94,676	−50,478	44,198	380,878
61	380,878	8,996	−50,478	−41,482	348,291
62	348,291	8,996	−50,478	−41,482	314,944
63	314,944	8,996	−50,478	−41,482	280,817
64	280,817	8,996	−50,478	−41,482	245,894
65	245,894	8,996	−50,478	−41,482	210,155
66	210,155	8,996	−50,478	−41,482	173,581
67	173,581	16,496	−50,478	−33,982	143,653
68	143,653	16,496	−50,478	−33,982	113,027
69	113,027	23,496	−50,478	−26,982	88,685
70	88,685	23,496	−50,478	−26,982	63,774
71	63,774	23,496	−50,478	−26,982	38,282
72	38,282	23,496	−50,478	−26,982	12,194
73	12,194	23,496	−50,478	−26,982	−14,503
74	−14,503	23,496	−50,478	−26,982	−41,823
75	−41,823	23,496	−50,478	−26,982	−69,781
76	−69,781	23,496	−50,478	−26,982	−98,393
77	−98,393	23,496	−50,478	−26,982	−127,672
78	−127,672	23,496	−50,478	−26,982	−157,636
79	−157,636	23,496	−50,478	−26,982	−188,299
80	−188,299	23,496	−50,478	−26,982	−219,678
81	−219,678	23,496	−50,478	−26,982	−251,791
82	−251,791	23,496	−50,478	−26,982	−284,653
83	−284,653	23,496	−50,478	−26,982	−318,282
84	−318,282	23,496	−50,478	−26,982	−352,697
85	−352,697	23,496	−50,478	−26,982	−387,916
86	−387,916	23,496	−50,478	−26,982	−423,957
87	−423,957	23,496	−50,478	−26,982	−460,840
88	−460,840	23,496	−50,478	−26,982	−498,584
89	−498,584	23,496	−50,478	−26,982	−537,210
90	−537,210	23,496	−50,478	−26,982	−572,699

91	−576,738	23,496	−50,478	−26,982	−617,189
92	−617,189	23,496	−50,478	−26,982	−658,585
93	−658,585	23,496	−50,478	−26,982	−700,948
94	−700,948	23,496	−50,478	−26,982	−744,300
95	−744,300	23,496	−50,478	−26,982	−788,664

Value of liquid assets over time



H3 Contingent lifetime cash flows

Lifetime cash flow projections can also be used to forecast the income and expenditure position of clients in various other circumstances in order to determine whether they need additional provision to meet such events as:

- the premature death of one or both parents;
- the illness and inability of a client to work; and
- in the case of a homemaker, their illness and inability to look after the children.

Example 4.19

Jacob and Faith

Jacob is 27 and Faith, his wife, is 28. They have two children: Bex, aged three, and Luke, aged one.

Jacob earns £35,000 net a year while Faith stays at home with the children.

Before having the children, Faith was a beauty therapist earning £18,000 net a year, and she intends to return to this job part-time in three years' time once both children start school. She expects her earnings then to be around £13,000 net a year. The family intend to use around half of this additional income to save towards their retirement, with the remainder being spent on supporting their children's needs.

Summary of current cash flow	**Annual £**	**% of total expenditure**
Jacob's net income	35,000	101
Faith's Child Benefit	1,885	5
Total income	**36,885**	**106**
Mortgage repayments	9,600	28
Other household	5,500	16
Food	7,200	21
Leisure and eating out	3,000	9
Car and travel	6,000	17
Clothing etc.	1,000	3
Holidays	1,500	4
Insurance	1,000	3
Total expenditure	**34,800**	**100**
Net cash flow	**2,085**	

Analysis

Jacob and Faith have already reduced their expenditure since having their two children. They are eager to get their protection needs covered and feel that they could probably cut back on at least £2,000 a year more if necessary. In terms of life protection, they wish to arrange for a sum assured that would enable the survivor to provide the same standard of living that the children are currently used to without needing to work. They estimate that their children will be financially independent at the age of 18. They would also like their repayment mortgage, which is currently £175,000 and has a remaining term of 17 years, to be paid off in the event of either of them dying or being diagnosed with a specified critical illness.

In terms of income protection, they would both like to receive the maximum benefit possible after a deferred period of 13 weeks (in Faith's case, houseperson's cover for the first two years, followed by full cover from year 3).

Annual tabular cash flow projection

The annual cash flow for the next 17 years is projected below. It starts in the current year and shows the family's anticipated income and expenditure at years 3, 10 and 17. The projection assumes that inflation will average 3% a year and that salaries and expenditure will both increase in line with inflation.

	Year 1	**Year 3**	**Year 10**	**Year 17**
Jacob's net income	35,000.00	37,131.50	45,667.06	56,164.73
Faith's net income	1,885.00	14,999.80	18,447.86	22,688.54
Total net income	36,885.00	52,131.30	64,114.92	78,853.26
Expenditure	34,800.00	36,919.32	45,406.11	55,843.78
Net cash flow	2,085.00	15,211.98	18,708.81	23,009.48

Solution
To enable the surviving family to maintain the same standard of living, the initial sum assured would need to be sufficient to replace their annual net income of just over £52,000 a year (there would be an element of over-insurance until Faith returns to work in year 3), rising to just under £79,000 in year 17. This could be achieved through an index-linked term assurance plan or index-linked FIB plan. A standalone term/critical illness plan would be required to cover the outstanding mortgage. All protection plans should be written for a 17-year term.

To cover their income protection needs, they require two separate IPI policies with deferred periods of 13 weeks and cover of 65% gross earnings for both Jacob and Faith (although Faith will only be eligible for houseperson's cover until year 3). Plans should be written until their intended retirement ages.

I The estate

I1 Summary of the estate

A summary of the client's estate planning should include the following:

- current position of wills, trusts, pension death benefits and lifetime transfers;
- domicile of the parties;
- planned lifetime transfers;
- expected IHT position of client and partner; and
- lasting power of attorney (LPA) or enduring power of attorney (EPA) arrangements.

I2 Analysis of the estate

The analysis of ***the estate*** should include:

- comparison of objectives and current position; and
- scope for changes to planning.

Example 4.20

Jerry and Marta

Summary of the estate
Jerry (aged 52) and Marta (aged 54) are married and have made the following arrangements:

- Their wills leave everything to each other.
- Then, at the second death, the survivor's assets are split equally between their three children.
- The couple would like to make IHT savings where possible, with the proviso that this does not jeopardise the survivor's living standards.
- They have made no lifetime transfers.
- Jerry's pension life cover is written under a discretionary trust, so the proceeds can be held outside his and Marta's estates but can be used to help Marta after Jerry's death if necessary.
- They are not currently planning any substantial lifetime transfers for the foreseeable future.
- The IHT positions are set out in a schedule assuming Jerry dies first.
- Neither of them has an LPA or EPA.

Example 4.21

Jerry and Marta (continued)

Schedule of potential estates at death

Jerry aims to leave £150,000 to his children by his first marriage. This will use up part of his nil rate band. He also intends to leave his business, which is worth £1m, to his daughter, who he shares with Marta.

Marta intends to leave £20,000 to her favourite charity; this bequest will be tax free.

The couple's main residence is valued at £400,000 and it is held on a joint tenancy basis.

The following assumes 2022/23 values, IHT rate and nil rate bands.

The position if Jerry dies first:

On Jerry's death	**£**
Jerry's gross estate	2,350,000
Less 100% relieved business assets left to daughter	−1,000,000
Potentially taxable estate	1,350,000
Bequest to children by first marriage	150,000
Lifetime gifts in the last seven years	Nil
Remaining unused nil rate band (based on the nil rate band of £325,000 less £150,000 bequest)	175,000
Jerry's residence nil rate band ((£2,350,000 – £2,000,000) ÷ 2 = £175,000, so Jerry has no residence nil rate band)	Nil
Balance of estate to Marta	1,200,000
IHT on Jerry's death	Nil
On Marta's subsequent death	
Marta's gross estate before Jerry's death	1,500,000
Add Jerry's estate	1,200,000
Total gross estate	**2,700,000**
Lifetime gifts in the last seven years	Nil
Less exempt bequest to charity	−20,000
Taxable estate	2,680,000
Nil rate bands of £325,000 + £175,000	500,000
Marta's residence nil rate band*	Nil
Estate subject to IHT at 40%	2,180,000
IHT at 40%	872,000
Net estate after charitable bequest and IHT at 40%	**1,808,000**

* However, if Marta were to die first, her personal representatives will have a full £175,000 residence band because her estate is under £2,000,000.

Example 4.22

Jerry and Marta (continued)

Analysis of the estate

- The current arrangements meet the clients' objective of saving IHT as long as it does not jeopardise the survivor's living standards.
- However, the clients may be able to afford to make more lifetime gifts and still retain their standard of living and future security. They may wish to consider this in the future. This could lead to Jerry's residence nil rate band being reinstated.
- They could probably afford to make regular gifts using the annual exemption to fund a life policy to cover the potential IHT liability.
- The business assets that they currently own qualify for IHT business relief.
- If they sell the business, their potential IHT liability will be much higher. They do not wish to plan for this at present.
- They should set up an LPA and register it in case either of them becomes incapacitated through accident or illness.

Example 4.23

Larry and Samantha

Summary of the estate

Larry (aged 68) and Samantha (aged 66) are married. They were both previously widowed and each has two children from their previous marriages. Their assets are as follows:

Asset	Larry	Samantha	Joint	Total
Main residence	£250,000	£250,000		£500,000
Cash	£100,000	£50,000	£150,000	£300,000
Investments	£200,000	£200,000	£100,000	£500,000
Total	**£550,000**	**£500,000**	**£250,000**	**£1,300,000**

- They have not updated their wills since getting married five years ago.
- Their intention is to leave everything to each other and, on second death, share the estate equally between their four children.
- They have made no lifetime transfers.
- On her death, Larry's previous spouse left her entire estate to him in her will.
- When Samantha's first husband died in August 2002, he left £100,000 of his estate in cash to his children and the remainder of the estate to Samantha absolutely.
- They own the main residence as tenants in common.
- They both have secure incomes from private and State Pensions, and will not require any significant income from their investments should either one of them die.
- In the event that either of them should die, they intend to sell the house and downsize to save on expenditure.
- Neither of them has an LPA or EPA.

Example 4.24

Larry and Samantha (continued)

Analysis of the estate

- When Larry and Samantha married, this automatically invalidated their existing wills.
- Therefore, in the event of either death, if they do not rectify this position, they will die intestate.
- Under the rules of intestacy for England and Wales, if Larry dies first, then Samantha would only be entitled to the first £270,000 of his estate, plus 50% of the balance, with the remainder going to Larry's children.
- Samantha would receive the jointly held cash and investments of £250,000 by right of survivorship, plus £270,000 as the statutory legacy, as well as all of Larry's personal possessions, whatever their value.
- The remainder of Larry's estate would be divided 50:50, with Samantha receiving £140,000 absolutely and Larry's children also inheriting £140,000 absolutely.
- On Samantha's subsequent death, her estate including the money she inherited from Larry will pass to Samantha's children absolutely.
- This means that Samantha's children would inherit the bulk of the estate at £1.16m (i.e. the combined total estate of £1.3m less the £140,000 left to Larry's children on his death under the intestacy rules).
- A similar situation would arise should Samantha die first but, on this occasion, Larry's children would inherit the bulk of the estate instead.
- There is unlikely to be any IHT due on Larry's death as he has a nil rate band in 2022/23 of £650,000 – i.e. £325,000 in his own right and £325,000 inherited from his previous spouse. His estate could also benefit from his own £175,000 residence nil rate band, plus a deemed £175,000 residence nil rate band inherited from his previous spouse. Although this is dependent on Larry leaving his share of the main residence to a direct descendant on his death and subject to a maximum of £250,000, as this is the value of his share.
- On Samantha's subsequent death, it is likely that an IHT liability would arise; however, her estate may be able to claim some of any unused nil rate band and residence nil rate band from her first husband and/or Larry. However, Samantha's legal personal representatives can only claim a maximum of 100%, meaning that Samantha's nil rate and residence nil rate bands are increased to a maximum of £1,000,000 (based on the 2022/23 bands).
- This would give rise to an IHT bill of £64,000 (£1,160,000 − £1,000,000 at 40%).

Example 4.25

Larry and Samantha (continued)

Planning opportunities for Larry and Samantha

- They should both write new wills immediately.
- They could include provisions to use the inherited portion of their nil rate band and residence nil rate bands on first death so that these are not wasted.
- Larry could leave 100% of the nil rate band inherited from his previous spouse to the four children equally, should he die first.
- Samantha could leave the 60% of the nil rate band that she inherited from her first husband to the children equally should she die first (this was £250,000 in 2002/03 so, as her first husband used up £100,000 of it when he died in August 2002, 40% of his nil rate band was used, leaving Samantha with 60%).
- On first death, the value of either Larry or Samantha's share of the main residence could be left to the children by using their own and their former spouse's residence nil rate bands, up to a maximum of £250,000.
- As they have confirmed that they have sufficient income should either of them die, leaving these assets on first death should not have an impact on the lifestyle of the remaining spouse, although they should consider carefully the implications of half of the main residence being owned by the four children while the surviving spouse still lives.
- On second death, the estate could then be left equally between the four children.
- Where only the inherited nil rate bands are used on first death, the surviving spouse would receive 100% of the unused nil rate band and residence nil rate band. Based on current rates, this would provide up to £1m that could potentially be set against the estate subsequently passed to the children.
- As they have excess capital, they could also consider gifting assets during their lifetime using their annual allowances. Where gifts of money or assets are made to their children, these would be treated as potentially exempt transfers (PETs) and would drop off their cumulative total should they survive seven years after making the transfer.
- If they are both in good health, they could consider taking out a whole life policy on a second death basis written under trust for the benefit of the children. Alternatively, the children could take life of another whole life plans on their parents if they wish to fund this themselves.

Example 4.26

Michael and Anne

Michael (aged 52) and Anne (aged 46) are married and resident in the UK. Anne is non-UK-domiciled and has assets outside of the UK valued at about £550,000.

- Michael would be able to pass up to £650,000 of his assets to Anne on his death without any liability to IHT (assuming that he has not made any lifetime gifts in the seven years before his death).
- This is made up of his own nil rate band of £325,000 (for 2022/23) and the allowance of a non-UK-domiciled spouse of £325,000.
- Anne could choose to be deemed UK-domiciled and benefit from an unlimited spousal exemption. However, her assets held outside of the UK would then be included in her estate on her subsequent death.
- Anne could consider gifting her non-UK assets to an excluded property trust before opting to become UK-domiciled, therefore protecting these assets from UK IHT.
- Anne will automatically be deemed UK-domiciled when she has been resident in the UK in 15 out of the last 20 tax years.

I3 IHT planning and defined contribution pension funds

A major change brought about by the pension freedoms legislation in April 2015 is the treatment of death benefits from DC schemes. The rules are as follows:

On death before the age of 75	Both lump sum and income benefits are tax free as long as they are paid within the two-year window.*
On death after the age of 75	Both lump sum and income benefits are taxed at the beneficiary's marginal rate.

*The 'two-year window' is the timeframe within which the death benefits must be 'designated' to an income-producing contract or paid out as a lump sum in the case of a lump sum death benefit. It starts from the date the scheme administrator is notified of the death or, if earlier, the date the scheme administrator could reasonably be expected to know of the death. Payments made outside of this timeframe are taxed at the beneficiary's marginal rate of income tax.

The legislation introducing pension freedoms permits death benefits under DC schemes to be left to any beneficiary whereas, prior to the rule changes, only a dependant could receive a pension on the member's death (no such restriction existed with regard to lump sum death benefits). These beneficiaries are known as 'nominees'.

A further class of beneficiaries created under the rule changes are 'successors', who are individuals nominated by a dependant, a nominee or even a previous successor to continue to receive the previous beneficiary's flexi-access drawdown.

These rule changes, combined with the flexible access rules and the fact that pension death benefits are typically deemed to be outside the client's estate, open up IHT planning opportunities for those who can afford to make additional pension contributions.

Example 4.27

Adam

Adam, aged 59, earns £65,000 a year and has significant assets in cash, property and collective investment vehicles. On his death, his estate will pass directly to his son Joe, a basic-rate taxpayer. Despite knowing that there will be a large IHT liability on his death, Adam is reluctant to start gifting, as he is concerned that, if he lives for a very long time, his funds will run out.

Adam could consider moving some of his assets into pensions by increasing his pension contributions. Providing he stays within the annual allowance he has available to him, he will, given the level of his income, receive up to 40% tax relief on his contributions.

If Adam dies before the age of 75, his entire pension pot could go to Joe tax free. Ordinarily, it would also be outside of Adam's estate and not liable to IHT.

The tax advantages here are substantial:

- Adam receives tax relief at up to 40% on his contributions, boosting the value of his fund;
- Joe receives the funds/an income tax free after Adam's death; and
- Adam's estate potentially saves up to 40% IHT.

If Adam does live to a very old age, then he will be able to withdraw from his pension fund at any time to meet his needs. While withdrawals in excess of the 25% tax-free PCLS will be charged as pension income under PAYE, it is likely that he will be a basic rather than a higher-rate taxpayer in retirement, so he will not be losing out in any way. If he dies after the age of 75, any withdrawals made by Joe will be taxed at Joe's marginal rate.

J Identifying the priority areas

Having aims and objectives alone is not enough; it is also necessary to establish their relative importance, so that the financial planner and the client know what order of priority they should be set out in the financial plan.

J1 What prioritisation means

Prioritisation essentially means establishing what aims are most important to the clients. Those views may change over the course of the planning process. After the client has seen the analysis, their priorities may well evolve; for example, the need for additional life cover may become more important.

Prioritisation may mean dealing with some priorities now and leaving some until a later date. It may also involve recognising that, in some areas, it is better to have some provision than none at all.

For example, it is very common that a client cannot afford to buy the home they want, arrange more life assurance and make the recommended level of contributions for their retirement. They could focus on just two of these and exclude the one they think is the least important. For example, it might be more rational to aim to provide less than the optimum amount of, say, life cover or pension contributions, or possibly both.

J2 Benchmark priority list

Some clients have difficulty in deciding on their priorities, especially at the fact-finding stage.

The following is a standard priority list that can be used as a benchmark for younger clients with families but, in many cases, clients will have very different priorities in line with their circumstances:

Covering day-to-day living expenses	• Compiling a budget. • Cutting the costs of borrowing (e.g. credit cards and other forms of borrowing). • Building short-term savings to spend on holidays and other consumer needs, rather than borrowing for these.
Protection against the unexpected	• Building an emergency fund. • Covering financial liabilities against the consequences of death or serious illness. • Protecting income if the client becomes too ill to work. • Protecting dependants against the consequences of a death. • Making sure that the client has enough to live on in the event of redundancy.
Buying a home and raising a mortgage	• Buying to occupy. • Capital raising (e.g. to boost income). • Cutting the cost of borrowing. • Buying to let (not usually a high priority).
Paying for the children's education	• Private schools. • Higher education.
Saving for retirement	• Pension provision. • Other forms of providing for retirement.
Saving and investment	• Short-term savings and investment. • Saving for the longer term. • Lump sum investment for income and/or growth.
Estate planning	• Wills and trust provision. • IHT planning. • Long-term care.

J3 Bringing the priorities together

For a couple in their 30s or 40s, the priorities might be as follows (from the bottom up):

Estate planning

Longer-term saving and investment

Short-term saving

Saving for retirement

Providing for education

Borrowing for house purchase

Financial protection against the unexpected

Providing for day-to-day living expenditure

For a couple in their 60s, the priorities might be rather different (from the bottom up):

IHT mitigation

Paying grandchildren's school fees

Maintaining value of long-term care fund

Providing for future living expenditure

Providing for day-to-day living expenditure

Consider this…
How do your own financial priorities look in comparison with the ones illustrated in these diagrams?

J4 Changing priorities

Clients will start the planning process with some idea of the priorities for each of these areas. As they understand their financial positions better, there is a strong chance that their priorities will change.

Planning is an iterative process: issues need to be revisited as clients consider their financial positions more deeply, and change their views and priorities. This can be especially true once they start to understand the relative costs of providing solutions to identified problems.

In many cases, clients can only decide on their final priorities when they see the report with recommendations setting out the relative costs of different actions.

Example 4.28

Peter and Jill

Summary

Peter and Jill have agreed the following financial objectives and have assigned a priority rating to each, on a scale from 1 to 10, with 10 being the highest priority.

Buy a holiday home in Cornwall	8
Provide a good standard of living in retirement for both partners	8
Provide for children's education	8
Have adequate income and capital if either partner falls ill	6
Repay the mortgage before retirement	6
Retire when Peter is 55	4
Mitigate IHT	2

Analysis of achievability and compatibility

- The aims for future expenditure may not be easily achievable without some additional saving in the immediate future.
- The mortgage may need to be increased to buy the property in Cornwall.
- The savings objectives may clash with the need to finance the house purchase and pay for the additional protection.
- Achievement of some of the objectives may have to be postponed, or it might be worth providing less than the optimum amounts and aiming to fulfil them all to some extent.
- The IHT objective may need to be achieved without making significant lifetime gifts at this stage.

Case study: John and Margaret Williams – completed fact-find

The completed fact-find was constructed by the financial planner for John and Margaret Williams after the first main interview. It reveals further soft facts that the financial planner uncovered during the interview itself and subsequently recorded.

This fact-find is more detailed and has more financial situations to be analysed than the case study scenarios provided in the exam. The purpose of this detailed fact-find exercise is to give the opportunity to practise and become familiar with the range of situations to be taken into account when formulating recommendations for a client.

Introduction

John and Margaret Williams have completed the fact-find and have attended a meeting with their financial planner in April 2022. At this meeting, they clarified a number of important points, discussed their risk profile and disclosed some important news that would change the planning context and objectives.

The news is that John's company made him redundant effective from 31 March 2022.

The financial planner made changes to the fact-find as a result of the interview.

Final fact-find

Part 1 Personal details

Name:	John Williams Margaret Williams
Private address:	1 The Wide Road Broad Town Fairmount BX3 6RT
Home telephone:	01234 567890
Work telephone:	09876 543210
Mobile telephone:	07123 456789
Email address	jmwilliams@jmwilliams.co.uk
Age:	John 59, Margaret 35. (John will celebrate his 60th birthday later this month.)
Tax status:	Both UK resident and domiciled, and born in the UK.
Relationships:	Married to each other – just over five years ago. John was married previously. He divorced and there were no children.
Health:	Both in good health and both non-smokers. No hazardous hobbies.

Part 2 Family details

Two children:	Victoria, daughter, aged three, in good health. Sean, son, aged two, in good health.

Education plans:	They would like both children to go to the following day schools:	
	Annual cost 2022/23	
	Nursery	£5,500 from age 4–7
	Junior	£8,000 from age 7–13
	Senior	£9,500 from age 13–18
	Victoria is due to start nursery in September 2023, with Sean starting the following year. John and Margaret suspect that they will probably go to university, but that won't be clear for over 10 years.	

Part 3 Employment details

John:	In John's previous job, he was a senior marketing manager of Morgan Reeves Ltd and had worked in the company for over 20 years. His salary was £60,000 a year, with £20,000 bonus paid in March. John had a company car – registered before 6 April 2020 – worth about £10,000, bought for about £25,000. It is a large petrol saloon with CO_2 emissions of 147g/km, so was taxable at 34% of the original list price of £25,000 in 2021/22. When John left the company in March, the details of the settlement were: • £30,000 was contributed into his pension scheme. • He was given his company car worth about £10,000, tax paid by the company. • His four times death in service (DIS) benefit would last for six months from 1 April 2022. • His shareholding in the company (which is listed) was valued at £50,000. John is currently self-employed as a freelance consultant – with his previous employer as one of his clients. He intends to take some time out with the family over the summer, but expects to earn £15,000 in the current tax year. He is pretty sure that this will increase to £25,000 next tax year and that this figure will be sustainable for at least five years. He thinks that might continue for about five years, but he is not sure and certainly will have stopped work by the time he is 70.
Margaret:	Currently a full-time mother. However, she is a qualified secondary school teacher with eight years' experience. Her last salary was £32,000 a year.

Part 4 Professional advisers

None listed.

Part 5 Income and expenditure

Total earnings from employment were £80,000 plus benefits.

Net income before tax from property:

- **John:** £18,000.
- **Margaret:** £15,000.

The mortgage is not associated with the rented properties, and they believe that they are claiming all the expenses that they can with respect to the properties.

The expenditure schedule comes to a total of a little over £51,000, excluding pension contributions and tax. See the separate schedule that follows.

In general, they were running a theoretical surplus of about £7,000 each year.

They believe they could reduce their outgoings by £15,000 before taking into account the possibility of repaying the mortgage.

If they moved to another part of the country, they could free up some of the capital in the home, releasing about £100,000, and possibly live more cheaply, but there might be a reduction in John's potential freelance earnings.

Current expenditure schedule

Expenses – current schedule	**£**	**%**
Mortgage	2,115	
Council tax and water rates	3,200	
Property expenses including insurance	7,000	
Gas and electricity	2,320	
Home help	1,920	
Total home-related expenses	**16,555**	**32**
Food and household	9,400	
Satellite TV, phone and broadband	710	
Clothing	4,500	
Other household	500	
Total household	**15,110**	**30**
Car running	1,500	
Fares	650	
Total travel	**2,150**	**4**
Dentist, optician	1,300	
Alternative medicines	750	
Total medical	**2,050**	**4**
Children – clothing and equipment	2,400	
Childcare	350	
Total childcare	**2,750**	**5**
Eating out	2,400	
Other sport and entertainment	1,200	
Holidays	5,000	
Total leisure and entertainment	**8,600**	**17**
Life and health insurance	**3,940**	**8**
Total expenses	**51,155**	**100**

Part 6 Assets

- Their main home is worth £625,000 and is owned under a joint tenancy.
- Estimated value of their possessions, including some family antiques: £50,000.
- John has an investment property currently worth £300,000. It consists of two small offices in the nearby town of Fairmount. The rent is currently £18,000 a year after expenses but before tax.
- The acquisition costs of the property, including minor improvements, were £120,000. He bought the property nearly 15 years ago.
- Margaret owns a flat that she lets for about £15,000 a year after expenses but before tax. It is conveniently located very near their home. She paid £140,000 for it about nine years ago and it is now worth about £200,000.
- John has about £1,000 in his current account, and Margaret usually has about £5,000 in her current account.
- John has a cash ISA worth £11,000 and Margaret has a cash ISA worth £4,500.
- Expected cash from the sale of company shares: £48,100. The acquisition cost of the shares was £28,200. The most CGT due would be £1,900 after the annual exempt amount (£50,000 − £28,200 − £12,300 at 20%). However, if John becomes a basic-rate taxpayer after retirement, the CGT bill could be half this.
- The company car is worth £10,000. Margaret's own car is worth £12,000.

Part 7 Liabilities

Mortgage with the Wessex Building Society for £53,000:

- Interest-only mortgage repayable from the proceeds of a pension.
- Taken out for a 25-year term, 20 years ago.
- Monthly payment is approximately £176 based on an interest rate of 3.99%.
- There would be no early redemption penalties.

Part 8 Life assurance

Policies on John's life:

1. Sum assured £53,000, premium £200 a year to age 65. Term policy assigned to the mortgage lender.
2. Sum assured £100,000, premium £200 a month guaranteed to age 65. Flexible whole life not written in trust. Started five years ago when they married.
3. £320,000 death in service (DIS) benefit, which will cease in October 2022.

Part 9 Health insurance

- Income protection on John's life paid by John: provides an income of £500 a month to age 65. The deferral period is six months. The cost is £20 a month. The benefit does not escalate.
- Private medical insurance for all the family, premium of £1,100 a year paid by John: provides band 2 hospital cover.

Part 10 Regular savings

About £7,000 in savings was accumulated last year in addition to the pension contributions.

Part 11 Pensions

John's pension plans (before employer £30,000 contribution):

Provider	Type	Plan details
Ideal Insurance Co	Retirement annuity plan	• Current value £100,000. • Managed fund. • Retirement date age 75 with option to draw earlier without penalty. • Not currently contributing. • The current managed fund asset allocation: – UK equities 60%; – overseas equities 10%; – property 5%; – UK fixed interest 23%; and – cash 2%.
Acme Life	Personal pension plan	• Current value £110,000. • Managed fund. • Retirement date age 75 with option to draw earlier without penalty. • Personally contributing £27,000 a year gross (monthly contributions £1,800 net of basic rate tax). • The current managed fund asset allocation: – UK equities 65%; – overseas equities 15%; – property 0%; – UK fixed interest 15%; and – cash 5%.
Acme Life	Retirement annuity plan	• Current value £50,000. • UK equity fund. • Retirement date age 65 with option to draw earlier without penalty. • Not currently contributing. • The current asset allocation: 100% UK equities.

Provider	Type	Plan details
ABC Funds	Personal pension plan	• Current value £140,000. • Fixed interest fund. • Retirement date age 75 with option to draw earlier without penalty. • Not currently contributing. • The current asset allocation: – UK fixed interest 85%; and – overseas fixed interest 15%.
Acme Life	Personal pension plan	• Current value £110,000. • Managed fund. • Retirement date age 65 with option to draw earlier without penalty. • Not currently contributing. • The current managed fund asset allocation: – UK equities 65%; – overseas equities 15%; – property 0%; – UK fixed interest 15%; and – cash 5%.

Acme Life is said to have good annuity rates on its pension policies.

The funds in all the pension schemes have more or less closely followed their index benchmarks, less the annual management charges, which are average for DC pension schemes, apart from the Ideal retirement annuity plan, which has relatively high charges.

The company paid £30,000 into John’s pension scheme as part of his leaving settlement.

State Pension entitlement: John has a full contribution history and expects to receive the new State Pension.

He was contracted out of State Earnings Related Pension Scheme (SERPS) and State Second Pension (S2P), now referred to as the Additional State Pensions, until legislation changed. His new State Pension will therefore be reduced to reflect the time he spent contracted out.

John has completed expression of wishes forms confirming that on his death he would like the funds to be paid into a discretionary trust that names Margaret and the children as beneficiaries.

Margaret has eight years’ NIC history but no private pension benefits.

Part 12 Inheritance

- Both John and Margaret have made wills in the last three years, leaving everything to each other on the first death and then in trust for the children to age 25 in equal shares.
- They have not settled any trusts and do not expect any inheritances.
- They have appointed some close friends with children to be potential guardians.
- They have agreed to set up LPAs.
- They do not think they can afford to make lifetime gifts to the children to mitigate IHT in the light of their current circumstances, although they will keep the issue under review.

Part 13 Risk profile and capacity for loss

- The risk profiling exercise has produced a suggested portfolio of:
  - 50% fixed interest;
  - 40% equities; and
  - 10% property.
- They agree that they need to discuss this further in the light of the emerging plans, their existing property exposure and current market conditions.
- John is happy to invest in equities and is used to taking business and investment risks, but he is more cautious than he was before he was made redundant. He is well aware that without the security of full-time salaried employment, his capacity for capital loss has reduced significantly.
- Margaret is more cautious and needs reassurance before considering equity-based investments.

Part 14 Ethical investments

- John is ‘not interested’.
- Margaret might be interested in investing in ‘good causes’ but would like to learn more.

Notes on concerns, aims and objectives

- To provide enough income and capital for the family to meet its needs in the next 20 years.
- To provide for the family if either spouse were to become seriously ill or die.
- To keep their affairs simple.
- They are not very concerned about IHT.

Case study: John and Margaret Williams – summary and analysis

1: Income and expenditure

Based on the revised fact-find, provide John and Margaret with a summary and analysis of their financial situation setting out their circumstances and needs and the main issues that face them.

1.1: Summary of income for the last year of employment (2021/22)
The household's earned income for the year, based on 2021/22 tax rates and allowances, was as follows:

John's taxable income	**£**	**£**
Salary plus bonus	80,000.00	
Company car benefit (£25,000 at 34%)	8,500.00	
Rental income less allowable expenses	18,000.00	
		106,500.00
Less personal allowance*		(12,570.00)
Total taxable income		93,930.00
Income tax		
Basic rate: £64,700† at 20%	12,940.00	
Higher rate: £29,230 (£93,930 – £64,700) at 40%	11,692.00	
		24,632.00
NICs		
£50,270 − £9,568 at 12%	4,884.24	
£80,000‡ − £50,270 at 2%	594.60	
		5,478.84
Total income tax and NICs		**30,110.84**

* Even though John's taxable earnings are in excess of £100,000, he still maintains his full personal allowance, as the adjusted net income figure used by HMRC to test for entitlement to personal allowance is less than £100,000. The adjusted net income is calculated by taking John's taxable income and deducting certain expenses including pension contributions (i.e. £106,500 – gross pension contributions of £27,000 = adjusted net income of £79,500).

† The basic-rate tax band has been extended by the gross amount of pension contributions paid by John. This increases the amount of his income on which he pays 20% income tax, thereby providing for the additional tax relief due on the pension contributions paid (£37,700 + £27,000 = £64,700).

‡ Only £80,000 has been used to calculate NICs as there are no employee NICs payable on P11D benefits and the rental income is investment income and not liable for NICs.

Margaret's taxable income	**£**	**£**
Rental income after expenses	15,000.00	
		15,000.00
Less personal allowance		(12,570.00)
Total taxable income		2,430.00
Income tax		
Basic rate band £2,430 at 20%	486.00	
Total income tax		**486.00**

1.2: Income and expenditure – cash flow statement for last year of employment (2021/22)

The income and expenditure cash flow for the final year of John's employment was as follows:

Net spendable income	£	£
John's total income	106,500	
Less company car benefit	(8,500)	
		98,000
Margaret's rental income	15,000	
Plus Child Benefit	1,828	
		16,828
		114,828
Less		
Tax and NICs for John (rounded up)	30,111	
Child Benefit tax charge	1,828	
Tax for Margaret	486	
		(32,425)
Less expenditure		
Home-related	16,555	
Household	15,110	
Travel	2,150	
Medical	2,050	
Children	2,750	
Leisure and entertainment	8,600	
Life and health insurance	3,940	
Pension contributions (net)	21,600	
		(72,755)
Net surplus income		**9,648**

1.3: Summary of current cash flow post-employment (2022/23)

Now that John no longer has paid employment, it is necessary to review their income in the light of their new circumstances:

- John and Margaret have a core income from their properties and from Child Benefit (assuming neither of them has income of more than £50,000 a year).
- In seven years' time, they will also have John's State Pension income.
- They have three further potential sources of income:
  - John's self-employed earnings;
  - Margaret's potential earnings; and
  - John's pensions and the income from his tax-free PCLS, if he decides to start drawing on them.

The first task is to identify the income that should be available from their property and Child Benefit, regardless of their other decisions:

Rental income and Child Benefit	£	%
John's net rental income before tax	18,000	
John's personal allowance	12,570	
Subject to tax at 20%	5,430	
Income tax at 20% on £5,430	(1,086)	
John's net rental income	**16,914**	51
Margaret's net rental income before tax	15,000	

Chapter 4

Rental income and Child Benefit	**£**	**%**
Margaret's personal allowance	12,570	
Subject to tax at 20%	2,430	
Income tax at 20% on £2,430	(486)	
Child Benefit for two children	1,885	
Margaret's net rental income and Child Benefit	**16,399**	49
Total joint income	**33,313**	100

- The current level of expenditure, excluding school fees, is just over £51,000, but they believe they could save about £12,000 a year, bringing total expenditure down to about £39,000.
- John has stopped making pension contributions, with the last one having been paid in March 2022.
- In round terms, the shortfall of ordinary expenditure over income is (£51,000 − £12,000) − £33,313 = £5,687.
- So, to cover their ordinary expenditure, including a safety margin, they need to have an additional net income of at least, say, £8,000 a year.
- In addition, there will be the need to cover school fees, on which the annual expenditure will rise to over £19,000 a year (see section 2, 'School fees planning', on page 4/52).

1.4: Analysis of earned income position

John's earnings

- John believes he has been reasonably conservative in his estimate of consultancy income. He may make more than the assumed £15,000, but at some point in the next 10 to 20 years, the income from this source will probably reduce and may disappear, so it will need to be replaced.
- John's consultancy income is expected to be £15,000 a year gross but could be as much as £25,000. However, John's freelance earnings could easily be lower than the amount projected if he has been optimistic or if trading conditions deteriorate.
- John would have to pay income tax and NICs on his self-employed earnings:
  - Income tax would be at the basic rate of 20%, i.e. £3,000 on £15,000. (Note that his personal allowance has already been accounted for in relation to his rental income. Although, in reality, it would be taken from earned income first, it has been ignored here to avoid accounting for it twice.)
  - NICs would be Class 2 at £163.80 flat rate (i.e. £3.15 a week), plus Class 4 at 10.25% of the excess over £11,908 = £316.93.
    Total NICs on self-employed income = £480.73.

So, after tax, John's income from £15,000 self-employed earnings would be £11,519 (rounded down). However, he may be able to claim certain additional expenses, e.g. for running a car.

Margaret's potential earnings

Margaret could decide to return to work at some point:

- She would pay tax at 20% as well as employee NICs (for the 2022/23 tax year, this will be at 13.25% on income between £190 and £967 per week, with 3.25% applying above £967 per week for 13 weeks, followed by 13.25% on income between £242 and £967 per week, with 3.25% applying above £967 per week for 39 weeks).
- Having reduced his hours by becoming solely self-employed, John may be able to undertake a portion of the childcare.
- If Margaret returned to teaching, the holidays would be convenient for childcare. She could take advantage of the tax-free childcare scheme. For every £8 she saves into a childcare account, the Government will add £2 up to a maximum of £2,000.
- Margaret's teaching work would probably be pensionable.

Assuming that Margaret returned to work on a part-time basis and was paid, say, £20,000 a year, her net earnings after 20% income tax (£4,000) and 13.25% employee NICs

(£1,072.22) would be £14,927 (rounded down). The calculation for the employee NICs is as follows:

£20,000 ÷ 52	£384.62
(£384.62 − £190) at 13.25% × 13 weeks	£335.23
(£384.62 − £242) at 13.25% × 39 weeks	£736.99
Total	**£1,072.22**

1.5: Summary of potential pension income

The total value of John's pension plans amounts to £540,000, including the £30,000 that his employer contributed on the basis of the leaving settlement. He could draw on his pension now or defer taking it for a few years.

- Under the pension freedoms rules, assuming that John started to draw on his fund at age 60, he could take £135,000 as a tax-free PCLS and then use the balance to either buy an annuity or go into flexi-access drawdown, and take an income or further lump sum withdrawals as and when required. In either case, the withdrawn funds in excess of his tax-free PCLS will be taxed as pension income under PAYE. Alternatively, he could take an uncrystallised funds pension lump sum (UFPLS), in which case, a quarter of the payment would be tax free, and the remainder taxed as pension income under PAYE.
- Assuming that he could invest the tax-free lump sum to generate a gross income of around 3.75%, he would receive about £5,000 a year. Of course, he might not be able to generate that level of income in a dependable way.
- If John decided to use the whole of his remaining fund (after PCLS) to buy a single life, non-escalating annuity, he could expect to receive an income of around £18,326 (based on rates in February 2022). This is over twice the couple's current income shortfall.
- Assuming he qualifies for the full new State Pension, this would be around £9,627 in 2022/23 terms less a deduction for the time he was contracted out. This would be payable from age 67. John can either access a State Pension statement online, or complete and post a BR19 form for confirmation of what he might get.
- John can defer taking his State Pension if he so wishes. The main benefit of doing so is an increased pension income once he eventually starts taking the Pension. The uplift is 1% for every nine weeks deferred, equivalent to 5.78% for every full year of deferral. John will be increasing his guaranteed level of future income and the income itself benefits from the triple lock guarantee. On the downside, he may need to continue working to make up for the loss of immediate income. There is also mortality risk. Should John die in his early 70s, for example, he will not have been able to recoup the lost payments. As John will reach SPA after 6 April 2016, there is no longer the option to take the deferred income as a lump sum payment and it will not be possible for Margaret to inherit any of John's deferred State Pension, although John's estate may claim up to three months' arrears.

1.6: Analysis of investment income

- Both investment properties are generating substantial yields, which should tend to rise over the long term.
- The yield for John is 6% after expenses; for Margaret, it is 7.5% after expenses – neither are an easy income to achieve from most other asset classes.
- They have very few other sources of investment income and are therefore relatively poorly diversified.
- They can invest the proceeds of the sale of the shares to generate an income:
  - However, with today's low interest rates, investing in an instant account would currently yield very little, if anything.
  - The best low-risk and effective high-yield return would be derived from repaying the mortgage as quickly as possible. That would effectively provide about 4% net. Basic-rate taxpayers would need a gross yield of 5% from any alternative interest-paying investment, which they almost certainly could not achieve on a risk-adjusted basis.

- They could trade down and release equity from their home:
  - Trading down could be worthwhile, but they need to be sure of where they intend to live and bear in mind that, with growing children, this may not be feasible unless they move to a less expensive area. Suitable schools for the children would be an additional consideration.
  - It is typically easier to achieve the optimum results from trading down in a buoyant housing market.

1.7: Analysis of potential pension income
John could start to draw on his pension funds and would begin to receive his State Pension in about seven years' time. The benefits of deferral are not easy to quantify with certainty, but they are worth considering:

- There should be an increase in the value of the fund, although it is not likely that John would add significantly to the fund by further contributions. Assuming, say, 4.5% annual net growth, a delay of seven years in drawing on the fund might increase its value by about £195,000, although this is by no means certain.
- Annuity rates reflecting John's potentially shorter drawing period should be higher. The same annuity on the larger fund at age 67 would be around £30,268 or £21,206 with a widow's pension (based on rates in February 2022).
- If John is to start drawing on his pension this tax year, he can either buy an annuity straight away or go into flexi-access drawdown or take an UFPLS and simply withdraw the funds needed to meet his current income shortfall.
- If he decides to buy an annuity, there is the choice between level, escalating and investment-linked annuities. He would also have to decide what provision in the form of a widow's pension should be made for Margaret, who is much younger than him.
- If he enters flexi-access drawdown, he will need to decide on the asset allocation for the funds, the level of withdrawals etc. and how much of the funds he would wish to draw on, bearing in mind the couple's income shortfall and his own tax position.
- The new State Pension (current value of £9,627 a year less a deduction for the time spent contracted out) that will start to be paid in seven years' time will be a helpful addition to his income just at the time when school fees will be increasing substantially. The cash flow projection for the first year after John has left his employment does not include the school fees, which will have a major impact on expenditure in the following years, as discussed in section 2.

1.8: Tax position
If John only withdraws enough to meet the couple's income shortfall of £8,000 (i.e. including safety margin), then he should remain a basic-rate taxpayer in retirement. This would give the couple a joint net income of £41,313 a year (assuming neither John nor Margaret returns to work) and would mean that no income tax charge would be incurred on the Child Benefit they are receiving. Alternatively, if John were to return to work, the joint net income would be £44,832, enabling the couple to meet the aforementioned income shortfall and avoid the High-Income Child Benefit tax charge. John's pension could remain untouched for now and Margaret could remain at home.

Margaret is a basic-rate taxpayer and seems likely to remain so for the immediate future. It might therefore be worth passing any PCLS (up to £135,000) from the pension scheme to Margaret to reduce the impact of income tax on the resulting investment income.

2: School fees planning

Based on both sets of school fees, the cost of future school fees will first double and then treble the cash flow gap in 2022 prices. School fees starting in September 2023 raise such a major issue for John and Margaret that they need special consideration and planning.

- John and Margaret will have to start paying school fees in the autumn of 2023 for Victoria, aged three, and the following autumn for Sean.
- Junior school fees will start two years later and last for six years.
- Senior school fees will start eight years after that and will probably continue for six years.

John would like to have an analysis of the capital needed now to fund the future school fees requirements. He is considering setting up a fund that is earmarked for school fees payments – or at least for some of them.

The basic assumptions are:

- There will be annual payments of the fees (for the sake of simplicity), and the fees will increase at the rate of 5% a year.
- This will require a return on investment of:
  - 2% net for the first two years;
  - 4% for the next six years; and
  - 6% for the remainder.

So, for example, all investments earmarked for school fees in years 3–8 are assumed to earn 2% in the first two years and then 4% thereafter.

2.1: Summary of the future school fees costs
Prepare a schedule of the school fees payable annually and calculate the capital sum needed now using these assumptions.

Year	Victoria £	Sean £	Total £	Fees factor	Total fees £	Rate of return %	Discount factor	Capital need £
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**
1	5,500	0	5,500	1.05	5,775	2	1.02	5,662
2	5,500	5,500	11,000	1.10250	12,128	2	1.0404	11,657
3	8,000	5,500	13,500	1.15763	15,628	4	1.08201	14,443
4	8,000	8,000	16,000	1.21551	19,448	4	1.12530	17,283
5	8,000	8,000	16,000	1.27628	20,421	4	1.17031	17,449
6	8,000	8,000	16,000	1.34010	21,442	4	1.21712	17,617
7	8,000	8,000	16,000	1.40710	22,514	4	1.26581	17,786
8	8,000	8,000	16,000	1.47746	23,639	4	1.31644	17,957
9	9,500	8,000	17,500	1.55133	27,148	6	1.39542	19,455
10	9,500	9,500	19,000	1.62889	30,949	6	1.47915	20,923
11	9,500	9,500	19,000	1.71034	32,496	6	1.56790	20,726
12	9,500	9,500	19,000	1.79586	34,121	6	1.66197	20,530
13	9,500	9,500	19,000	1.88565	35,827	6	1.76169	20,337
14	9,500	9,500	19,000	1.97993	37,619	6	1.86739	20,145
15	0	9,500	9,500	2.07893	19,750	6	1.97943	9,978
Total	**116,000**	**116,000**	**232,000**		**358,905**			**251,948**

Chapter 4

Reinforce

Calculating school fees payments

The aim of the exercise is to calculate the school fees payments that will be needed for both children and then work out the sum of money that would be needed now to fund those future payments. The results of the calculations are set out in the preceding schedule. The method of calculation is as follows:

1. In column A, set out the number of years for the total payments of the school fees.
2. In columns B and C, set out the school fees for each child over the course of their school careers in today's values.
3. In column D, add together the total cost of the school fees in today's values.
4. The assumption is that school fees will increase at the rate of 5% a year. In column E, insert the compound interest factor, which can be calculated using the formula:

   $[1 + \text{rate of interest} \div 100]^n$

   Where n is the number of years of inflation.

   For example, in year 5, the inflation factor is $[1 + 5 \div 100]^5 = 1.27628$.

   The very simple way to produce that figure with a basic calculator is to multiply 1 by 1.05 and then multiply it again by 1.05 a further four times.
5. For column F, multiply each figure in the total fees column by the fees increase factor to calculate the total revalued fees for the next column.
6. In column G, set out the rate of return expected on investments earmarked for each year's school fees. This is the discount rate that will be used to calculate the present value (PV) of those future school fee payments.

   In the first two years, it is assumed that a relatively low rate of return is achieved, i.e. 2% net a year from fixed-rate term deposits. In the next six years, it is assumed that a higher rate of return should be possible at 4% a year. For the remaining years, the assumption is that it would be possible to achieve a net annual 6% rate of return. These are example returns, and it would be quite possible to use different – probably lower – rates of return. The overall return assumed needs to be consistent with the school fees inflation.
7. Column H sets out the compounding factor for the investment returns. These can be calculated in exactly the same way as the compounding factor in column E. So, for years 1–2, use the 2% factors. Then use the 4% factors for years 3–8 and, for the balance, use the 6% factors for years 9–15.
8. Column I contains the discounting calculation. The aim is to work out the amount needed now to provide the annual school fees in column F using the rate of return assumed for each year. This is achieved by dividing the school fees figure in column F by the factor for the same year in column H. So, for example, in five years' time, it would take a sum of £17,449 invested now (column I) at 4% a year to provide school fees of £20,421 (column F). Add up all the capital figures needed now for each of these years, and this gives you the total capital required: £251,948.

In practice, the calculation is most easily done with spreadsheet software, such as Excel, which allows assumptions to be readily varied.

2.2: Analysis of school fees position

- If the assumptions about the rate of inflation on fees or the return on investment turn out to be wrong, the projections will be wrong. However, it gives an idea of the size of the problem.
- Chances are that Margaret will decide to go back to work at some point and that her earnings will provide the majority of the cash flow for the school fees payments. School fees costs tend to rise in line with salaries generally, so her likely future earnings will provide the best hedge against future school fees rises.
- If Margaret does go back to work and is the main source of future school fees payments, there seems little point in setting up a fund to pay all the school fees. It may be worth setting up a reserve for the first few years when she probably will not be at work and for the especially heavy years when both children are at senior school. The years of the greatest burden – £19,000 in 2022 terms – are years 10–14, when both children will be at senior school at the same time.

Reinforce

The costs of school fees

The private sector educates around 620,000 children in 2,500 schools, according to the Independent Schools Council (ISC). The ISC gives details of average school fees levels, which are the basis for the figures used in this case study. Fees have risen sharply in the past, with increases of 2% or 3% above the consumer prices index (CPI) being common. Salaries make up about two-thirds of schools' costs, so fees tend to rise broadly in line with earnings – hence the recent slowing of fee growth.

3: Summary of the main options for income and expenditure

- John and Margaret have current expenditure of around £51,000 a year.
- They believe they can save about £12,000 a year, bringing their expenditure down to £39,000 a year.
- In addition, they have school fees to pay for the next 14 years, which will reach an estimated £19,000 at their peak.
- Their investment income and Child Benefit combined is £33,313, which they can supplement in several ways if they so wish.
- John and Margaret can make savings on their expenditure in a range of areas. They think that they can save about £12,000 on their expenditure before mortgage and insurance costs. For an employee, it takes about £1.50 to generate £1 of net income after basic rate tax and NICs. So, saving £12,000 of costs is the equivalent of earning £18,000 of taxable income. The gross investment and pension income required to meet these expenses is lower as no NICs are payable. For the self-employed, such as John, the maximum NICs on earnings is 10.25% rather than 13.25%, making £1 net equate to around £1.43 of earnings at basic rate.
- John should be able to earn about £11,519 net a year for a few years.
- Margaret should be able to start work at some point. On a part-time basis, she might earn around a net £14,927 a year.
- John can start to draw on his pension funds to generate around £8,000 to meet their joint income shortfall and will begin to receive the new State Pension in seven years' time.
- By increasing their earnings and/or saving on their expenditure, John and Margaret can build other assets, or at least not draw so much on the pension. They could then accumulate savings for the future, when John may be less able to generate earnings.

4: Net assets

4.1: Total net assets summary

Asset	John £	Margaret £	Joint £	Total £	%	Income John £	Income Margaret £
Main home			625,000	625,000			
Possessions			50,000	50,000			
Cars	10,000	12,000		22,000			
Total used assets	**10,000**	**12,000**	**675,000**	**697,000**	**40**		
Investment property	300,000	200,000		500,000		18,000	15,000
Net cash from sale of company shares	48,100			48,100		1,500	
Cash ISAs	11,000	4,500		15,500			
Current accounts	1,000	5,000		6,000			
Total investments	**360,100**	**209,500**	**0**	**569,600**	**32**	**19,500**	**15,000**
Mortgage			**(53,000)**	**(53,000)**	**(3)**		
Net assets exc. pensions	370,100	221,500	622,000	1,213,600		19,500	15,000
Pension funds	**540,000**			**540,000**	**31**		
Total assets	**910,100**	**221,500**	**622,000**	**1,753,600**	**100**	**19,500**	**15,000**

- Used assets, investments and pension funds are roughly one-third of their wealth each.
- The mortgage only makes up 3% of their wealth.
- John owns substantially more assets than Margaret.
- UK residential (£625,000) and investment properties (£500,000) make up 64% of their total assets.

4.2: Pension fund summary by asset allocation

Provider	Fund £	UK equity £	Overseas equity £	Property £	Fixed interest £	Cash £
1. Ideal	100,000	60,000	10,000	5,000	23,000	2,000
2. Acme	110,000	71,500	16,500		16,500	5,500
3. Acme	50,000	50,000				
4. ABC	140,000				140,000	
5. Acme	110,000	71,500	16,500		16,500	5,500
Contribution	30,000					30,000
Total £	**540,000**	**253,000**	**43,000**	**5,000**	**196,000**	**43,000**
Total %	**100**	**47**	**8**	**1**	**36**	**8**

- John's recent contributions have been made into the first Acme policy, shown in line 2 of Table 4.2.
- The funds in all the pension schemes have more or less closely followed their index benchmarks, after taking account of the annual management charges. They are actively managed funds but seem to behave much like index trackers.
- The pension fund charges for the Acme and ABC policies are average for DC pension schemes.
- The Ideal policy has relatively high charges.
- The ABC fixed interest fund is 85% UK and 15% overseas and is all 'investment grade'.
- John feels having five separate schemes is excessive and is interested in consolidating his existing funds into just one or two schemes.

4.3: Overall investment summary by asset allocation and wrapper

Asset class	Pension £	ISA £	Direct £	Total £	%	'Target'
UK equity	253,000			253,000	23	40
Overseas equity	43,000			43,000	4	
Property	5,000		500,000	505,000	46	10
Fixed interest	196,000			196,000	17	50
Cash	43,000	15,500	54,100	112,600	10	
Total	**540,000**	**15,500**	**554,100**	**1,109,600**	**100**	

- John's investment property yields 6% net of expenses.
- Margaret's investment property yields 7.5% net of expenses.
- The combined £500,000 exposure to both properties is 45% of their investment.
- Both properties have tenants who seem likely to stay.
- The cash figure includes the net proceeds of the company share sale.

4.4: The potential capital gains tax that might arise on the value of the properties

This assumes that the properties are disposed of in 2022/23, that John remains a higher-rate taxpayer but does not sell his company shares until next tax year and that Margaret has not returned to work.

	John £	Margaret £
Disposal proceeds	300,000	200,000
Base cost	(120,000)	(140,000)
Gain	180,000	60,000
Annual exempt amount	12,300	12,300
Taxable	167,700	47,700
Tax at 28%*	46,956	13,356*

* CGT on residential property is chargeable at 18% or 28%. The lower rates do not apply. Note also that in practice, Margaret would pay 18% on at least part of this gain, assuming any earnings do not push her into higher rate tax.

4.5: The analysis of investments

- The ideal asset allocation has a lower proportion of property in the portfolio. The risk profiling exercise has produced a suggested portfolio of 50% fixed interest, 40% equities and 10% property.
- The asset allocation recommendation is very different from the current holdings.
  The overall equities allocation at 27% is nearest to the suggested target percentage.
- There is a very low current allocation to fixed-interest securities.
- The investment portfolio overall has a very high allocation to property, especially taking into account the main residence. This lack of diversification makes them very dependent on the property market for both income and capital.
- John and Margaret have not suggested that they would like to sell either of the investment properties and may be reluctant to pay the potential CGT liability involved.
- If John and Margaret were to sell either or both of the investment properties, they should bear in mind that they will find it hard to replace the income yield, especially after depleting the capital value with transaction costs and CGT.

4.6: Summary of liabilities

Mortgage with the Wessex Building Society for £53,000:

- Interest-only mortgage repayable from the proceeds of a pension.
- Five-year term to redemption.
- Monthly payment is around £176.
- Variable interest rate of 3.99%.
- No early redemption penalties.

There are no other liabilities.

4.7: Analysis of liabilities

- They could use the available cash funds to repay the mortgage: net £48,100 from the sale of the company shares and the balance of £4,900 from current accounts and/or cash ISAs.
- Repaying the mortgage would save £2,115 (the figure given by John and Margaret at the meeting) a year in monthly interest-only mortgage repayments.
- Ignoring the personal savings allowance, to generate 3.99% net, a basic-rate taxpayer would have to generate 4.99% gross and a higher-rate taxpayer would have to generate 6.65% gross.

5: Risk assessment

5.1: Risk dependency summary

In the new situation, there should be a new risk assessment. John and Margaret have considerable potential for flexibility over both their income and their expenditure.

- Their expenditure is currently £51,000 and the school fees are projected to rise to a maximum of £19,000 a year.
- However, they have identified up to about £12,000 of spending cuts they could make, and paying off the mortgage from the pension tax-free cash would free up about another £2,100 a year. So, their expenditure could be reduced to just £39,000 a year or, if they paid off the mortgage, around £36,900 a year.
- Before drawing on the pension or either of them working, their core income from investments and benefits is £33,313 a year. The immediate spending gap of about £8,000 (including margin) a year could be filled from a range of sources: John's expected self-employed earnings, drawing from the pension scheme or even Margaret's earnings.
- They could take the PCLS from John's pension and then draw little or no income until they needed it for school fees.
- If neither John nor Margaret worked, it would be possible to pay all the expenses, but they would need to draw on capital in some years.
- The family would still be financially dependent on John's earnings, but to a much lesser extent. If John died or became seriously ill, there would be a loss of earnings – say, £15,000 a year gross – and there would also be extra childcare costs.
- If Margaret decided to return to work, her death or illness would result in a loss of both earnings and childcare.
- Unemployment or loss of income is a possibility for both, although they seem to be rather less vulnerable than they were.
- They may decide that Margaret's life and health should be covered based on:
  - the loss of her potential long-term earnings;
  - her portion of the childcare and homemaker work, which would need to be replaced; and
  - her ability to look after John as he gets older, which might also need to be replaced.

5.2: Summary of insurances

Insured	Type	Term	Premium	Sum assured	Beneficiary
John	Level term	Five more years	£200 a year	£53,000	Assigned to lender
John	Whole life	Whole life	£2,400 a year	£100,000	Own benefit
John	DIS benefit	To October 2022	Paid by employer	£320,000	In trust for family
John	Income protection	Five years	£20 a month	£500 a month	Own benefit

- The term policy with five more years is linked to the mortgage and would be available for family protection if the mortgage were repaid.
- The whole life policy could be replaced with a ten-year term assurance policy for about £48 a month. It is very unlikely that John will work past age 70.
- The DIS benefit will end in October 2022.
- The pension funds – shortly to be £540,000 – are effectively life cover on John's life, although the value of the death benefit could be reduced if he were to die after the age of 75 as it would be subject to income tax at the recipient's marginal rate. There could also be a tax charge if the fund was not paid out within the two-year window, regardless of his age at the date of death.
- There is no life or health cover on Margaret's life, although there might be some if she returned to work as a teacher.

5.3: Analysis of insurance policies

- The term assurance that will run out in five years is inexpensive and worthwhile.
- The whole life assurance could be replaced and could probably save over £1,800 a year, if it is needed.
- The DIS benefit will shortly run out.
- The income protection policy is so small as to be almost irrelevant, but it is probably worth maintaining in view of its low cost and the relatively high risk of a claim at John's age. The financial planner should check whether the insurance company would be prepared to continue the policy on the same terms in view of the change in employment status and function.
- The pension funds probably provide virtually all the protection that John requires in view of his reduced earnings.
- The higher priority is Margaret, and this will be partly dealt with if/when she returns to work, but both her life and health protection provision may need topping up.
- The private medical insurance is an attractive policy to have, but John and Margaret need to consider if it is a priority in view of the other competing objectives, notably paying the school fees.

6: Inheritance tax position

6.1: Summary and inheritance tax computation

Based on the current position of the estate and the wills, the IHT position would be as follows, assuming no change in the rate of tax, the level of the nil rate band and the value of the estate:

	£
Estate at the second death	1,213,600
Nil rate band £325,000 × 2	650,000
Residence nil rate band £175,000 × 2	350,000
Taxable estate	213,600
IHT at 40%	**85,440**

6.2: Analysis of the inheritance tax position

- The average amount of tax in relation to the estate is 7% because of the availability of the two nil rate bands and the two residence nil rate bands.
- The whole life policy on John’s life should be put in trust on a discretionary basis for Margaret and the children as potential beneficiaries, if they are to continue the policy.
- The pension funds should be free of IHT.
- If at least 10% of net assets are left to a registered charity, the IHT rate above the nil rate bands will reduce from 40% to 36%.
- John and Margaret have made it clear that IHT planning is a low priority.

Key points

The main ideas covered by this chapter can be summarised as follows:

Main aspects of the financial planning process

- The main aspects of the financial planning process are:
  - synthesis or summary;
  - analysis; and
  - prioritisation.
- The financial planner will then carry out a gap analysis to identify and quantify shortfalls.

Summary and analysis areas

- The main areas to be considered in the summary and analysis stage are:
  - current cash flow statement;
  - net assets statement;
  - risk assessment and protection;
  - the tax position;
  - retirement review;
  - lifetime cash flow projections; and
  - the estate.

Current cash flow statement

- The aim of the current cash flow statement is to summarise and analyse income and its relation to expenditure, both in terms of the amounts and the timing.
  - The current cash flow should separate the client's income into earned income and investment income.
  - Analysis of income should consider the following:
    - the security of the income;
    - the taxation of the income;
    - the stability of the income;
    - inflation protection;
    - the degree of dependence on a single source of income; and
    - the contingent income position.

Net assets statement

- The net assets statement is a balance sheet showing what the client owns and owes at a particular moment in time.
  - Net worth is assets less liabilities.
  - The financial planner should separate used assets from investments.
  - When analysing investments, the financial planner should comment on a range of issues, including fund ratings from specialist rating agencies, if applicable.

Risk assessment and protection

- The financial planner should identify the main risks with potentially major financial implications.
- The main ways of dealing with risk are to manage it or insure it.
- It is important for the financial planner to summarise and analyse any relationships of dependence and any existing financial protection provision.

Key points

The tax position

- The client's tax position should be considered separately by the financial planner in order to highlight key issues in income tax and capital gains tax (CGT) planning.
  - In some situations, clients will have to weigh the tax considerations against their other needs, such as the need to reduce investment risk.

Retirement review

- Providing for retirement is such an important objective that it deserves a separate analysis of target and provision.
- When faced with a shortfall in retirement provision, the client can:
  - increase the level of saving;
  - change the asset allocation;
  - postpone retirement;
  - reduce the target income;
  - find another source of income in retirement; and/or
  - enter into an equity release scheme in retirement.

Lifetime cash flow projections

- Lifetime cash flows are increasingly used by financial planners. The cash flow provides a year-by-year summary of cash paid to and out by the client:
  - cash flow projections are very sensitive to the assumptions used; and
  - cash flows can also be used to forecast the impact of death, illness or redundancy on the income and expenditure of the client.

The estate

- The client's estate should be summarised by the financial planner and should include:
  - the current positions of wills, trusts and lifetime allowances;
  - domicile of the parties;
  - planned lifetime transfers;
  - expected inheritance tax (IHT) position of the client and their partner; and
  - lasting power of attorney (LPA) and enduring power of attorney (EPA) arrangements.

Identifying the priority areas

- Having aims and objectives is not enough; it is also necessary to establish their relative importance.
- Priorities will change as clients get older.
- Clients' priorities need to be reviewed on a regular basis.

5

Formulate suitable short-term planning

Contents	Syllabus learning outcomes
A Client outcomes	*4.1*
B Behavioural finance	*4.1*
C Planning and current cash flow issues	*4.1*
D Debt	*4.1*
E Financial protection planning	*4.1*
F Protection against redundancy	*4.1*
Key points	

Learning objectives

After studying this chapter, you should be able to formulate a financial plan, make recommendations and explain them in the following areas:

- current cash flow planning, including liquidity and short-term savings planning;
- debt, including loans, mortgages and equity release solutions;
- life and health insurance protection planning; and
- redundancy and unemployment protection.

Key terms

This chapter features explanations of the following ideas:

Affordability	Behavioural finance	Buy-to-let (BTL)	Critical illness cover (CIC)
Debt repayment	Equity release	Home reversion plans	Income protection insurance (IPI)
Life assurance planning	Lifetime mortgages	Liquidity planning	Mortgage repayment
Protection planning	Redundancy	Term assurance	Whole life cover

A Client outcomes

When making recommendations, it is worth remembering that virtually all clients are looking for broadly the same outcomes, regardless of their aims and circumstances:

Refer to

See *The financial planning process* on page 1/2 for the full financial planning process.

- They want to retain flexibility about access to their funds and only want to give this up if the returns are worthwhile.
- They want to keep the costs down, although they may regard additional costs as worth incurring for extra convenience – especially for high earners who put a premium on their time.
- They want to minimise tax where possible. The solution will involve different strategies and products for people in different circumstances.
- Minimising risk is always rational. Some people are less risk averse than others, but that only means that they are prepared to take on more risk to get higher possible rewards – not to take on risk for its own sake.
- There are almost always drawbacks as well as advantages to any recommendation. Clients need to understand these drawbacks.

B Behavioural finance

Behavioural finance is the study of how psychology can affect the financial decision-making process.

Modern portfolio theory assumes that investors are rational and that emotions do not play a part in the investment decision-making process, but history has shown that this is often not the case. Some of the key concepts in behavioural finance are:

- **Anchoring**. Ideas and opinions should be based on relevant and correct facts in order to be valid. However, there is a tendency for people to attach their thoughts to a reference point that may have no logical relevance to the decision at hand. For example, when an investor is refusing to sell a loss-making investment and is waiting for it to return to the initial value, ignoring fundamentals that suggest this is unlikely, the investor is said to be anchored to the initial price paid for the investment.
- **Mental accounting**. People tend to separate their money into different accounts based on a variety of subjective criteria that depend on the source of the money and each account's purpose.
- **Confirmation bias**. First impressions can be difficult to change or amend, as people tend to selectively filter and pay more attention to information that supports their own opinions while ignoring or rationalising anything that does not.
- **Hindsight bias**. This usually occurs when a person believes that the onset of a past event was predictable and completely obvious, even though the event could not have reasonably been predicted. Examples of hindsight bias include the technology bubble in 1999/2000 and the 2008 global financial crisis.

- **Herd behaviour**. This is the tendency for individuals to mimic the actions of a larger group, regardless of whether they are rational, even though they may not make the same choice as an individual. This can be seen in investors following trends and jumping on the latest bandwagon.

B1 The importance of losses versus the significance of gains

One of the key elements of behavioural finance is prospect theory as presented in 1979 by the psychologists Daniel Kahneman and Amos Tversky (in *Prospect Theory: An Analysis of Decision Under Risk* (1979)). They argued that people value gains and losses differently and, as such, perceive gains rather than losses as the basis for decision-making. By extension, Kahneman and Tversky ascertained that losses have a greater emotional impact than the equivalent amount of gains.

Consider this…
A client is likely to view a single gain of 5% more favourably than a gain of 10% and a loss of 5%, even though the net benefit is the same.

A number of illogical financial behaviours can be explained with prospect theory, such as people who do not want to put their money into a bank to earn interest or work overtime to pay more taxes. Although there is a clear financial benefit, this is not enough to overcome the feeling of loss incurred by paying taxes.

Prospect theory can also be used to explain the tendency for investors to hold on to losing stocks for too long and sell winning stocks too quickly. Previous studies have shown that people are willing to accept a lower guaranteed gain of, say, £500 rather than choose a riskier option that could provide either £1,000 or £0. This explains why investors cash in early to realise the amount of gains that have already been guaranteed. Conversely, investors are willing to assume a higher level of risk in order to avoid the pain of a loss.

C Planning and current cash flow issues

The statement of income and expenditure is the starting point for planning current cash flow. Some clients are reluctant to carry out this sort of budgeting exercise, but it is difficult to help them achieve their goals unless they are prepared to analyse their position fully.

Even high net worth clients who have substantial incomes should undertake this exercise, as expenditure can exceed income at any level of wealth.

C1 Pre-retirement current cash flow issues

The lifetime cash flows and the contingent cash flows already performed at this stage should have helped identify gaps in the client's provision for retirement provision, other targets (e.g. school fees) or insurance cover. These targets should have then been costed in terms of the monthly or annual expenditure needed to meet them.

The current cash flow analysis should have identified whether there is a surplus or deficit of income over expenditure. If there is a surplus, the question is how this surplus would best be used. In many cases, however, there is either a break-even position or a deficit. The financial planner then needs to help the client change the income or expenditure, or both.

- Some clients have scope to increase their earning levels. This might be by changing jobs, increasing their productivity (e.g. by taking on overtime) or deciding that both partners should take on paid work.
- It is worth considering how much of the client's expenditure is discretionary and could be cut back if necessary. The financial planner should find out how much the client is prepared to adjust their current spending habits in order to meet the target levels. It is important to document the change in spending patterns that would be necessary and agree this with the client to establish that a plan is actually affordable.
- In some cases, there may only be a small, or even no, excess of net income over expenditure. If the client is not confident that they can maintain a commitment, they should look at their priorities and decide whether to postpone or scale back the outlay.

This is likely to mean that they will have to revise their aims for protection planning or future expenditure.

Clients who habitually borrow to fund current expenditure should usually be encouraged to follow the strategy of cutting back expenditure.

C1A Liquidity planning and short-term saving

All clients should factor in ***liquidity planning*** (making sure they have the cash they need when they need it) and short-term savings for two main purposes:

- To be able to make consumer purchases, such as holidays, cars and other consumer durables, without having to resort to expensive consumer finance, such as borrowing on credit cards.
- For emergencies, such as incapacity through sickness or accident, or redundancy. Even if they are well insured, there will be shortfalls, especially at the start of the period of incapacity or job loss. The more uncertain their job prospects or business situation, the more they need to keep as a cash balance.

eg

Example 5.1

Marcus
Marcus earns £70,000 a year as a computer programmer and systems analyst. He is concerned that his employer may make him redundant and he might then have to work on a freelance basis. He thinks it would take about six months before his income would reach the level of his core expenditure, so he agrees that he should hold at least six months' worth of personal expenditure in the form of cash. In his case, this amounts to £25,000.

Historically, cash balances have been deemed to be risk free. However, in the current environment of very low interest rates, advisers should regularly review cash balances to ensure that they still meet the client's requirements. Whereas previously, interest added may have been sufficient to cover any additional amount needed year on year, this may no longer be the case and an additional capital injection may be required.

C1B Longer-term savings and insurance provision

In many cases, clients will need to free up income to provide for longer-term savings and protection provision.

eg

Example 5.2

Ken
Ken is an employee earning £50,000 a year. He has about £8,000 in his building society account, which he thinks is enough of a cash reserve for his current circumstances. He feels confident about the security of his employment and believes that he could save a further £3,000 a year from his net earnings if he cut some of his monthly discretionary expenditure. The aims would be to invest more in his pension and pay premiums to meet his life and health insurance needs. The amount that he can afford to save each month should take into account the tax relief that he will receive. The flexibility to stop and restart his pension contributions at any time without penalty is an important feature of the contract for him.

C1C Affordability

The issue of ***affordability*** – whether a client can afford to commit to a programme of saving or premium paying – is an important one. The financial planner should have a reasonably clear idea of whether a client can afford to take on a commitment from the current cash flow statement and their general understanding of the client's position.

Certain sorts of commitment should not be taken on unless the client can afford to continue them under normal circumstances, such as:

- Any pension and/or savings programme where there are early termination penalties. These should generally be avoided in any case.
- Any investment into an equity-based or other volatile investment if the client is likely to need access to the funds in the near future when the value may have fallen.

- Any life or health protection policy where it is unlikely that the client will be able to maintain the premiums for a reasonable proportion of the term.
- A pension scheme if the client is likely to need access to the funds before they retire.

C2 Post-retirement current cash flow issues

After a client has retired, the need to keep income and expenditure in line is usually greater because the scope to boost income from earnings is usually much more limited.

- Nevertheless, the scope to earn might exist and should be explored if it is appropriate. It would require capital of £50,000 to generate an income of £1,000 gross a year, assuming 2% interest.
- Clients could also consider spending their capital, but the danger is that they might outlive the amount of capital that they have, particularly in light of the increased flexibility available to defined contribution (DC) scheme members. One way to insure against this is to buy an annuity.
- Clients should also be encouraged to budget carefully, although retired people usually do this without any need for prompting.
- Clients can also borrow to make ends meet. While the client has capital, this should usually be avoided, because the interest on the borrowing is generally several percentage points more than the client can expect to earn on their investments on a risk-adjusted basis. However, for older clients, equity release is a possibility.

D Debt

There are many different types of loan and methods of ***debt repayment***. Recommendations for strategies should generally be to:

- Clear high-cost debt (usually consumer and credit card) as quickly as possible and set up short-term savings plans to avoid using such debt facilities in future.
- Retain flexibility of repayment as far as possible.
- Consider flexible/offset mortgages for self-employed people and those whose income or expenditure patterns are irregular. Then consider making either large irregular payments to reduce the mortgage or deposits to offset the interest costs.
- Regard fixed-interest loans primarily as a means of being able to budget for future expenditure or insure against increases in interest rates, rather than to speculate on future interest rate movements.
- Choose a loan repayment arrangement that corresponds with the client's attitude to risk and circumstances.
- Protect loans with insurance cover against death, sickness or accident and possibly redundancy.

Activity

There are two main methods of repaying a mortgage – capital repayment and interest only. Ensure that you are aware of the different investment vehicles that could be used to pay off an interest-only mortgage and the potential benefits and drawbacks of each method.

D1 The mortgage repayment decision

A strong candidate for action in many cases is ***mortgage repayment***. Clients instinctively like being free of debt and this may turn out to be an attractive option, depending on the circumstances.

In this scenario, the client pays off the mortgage and has an immediate higher spendable income because of the cost saving.

Alternatively, the extra income can be saved for another purpose, such as provision for retirement, if that seems appropriate.

Investing a lump sum, such as an inheritance, rather than repaying the mortgage, is the higher-risk approach because it effectively amounts to borrowing to invest.

However, this may be a sensible approach if the returns are likely to be significantly more than the costs of borrowing. For example, if the costs of borrowing on the mortgage are expected to be about 5% a year, then an investment that generates a net return of more than 5% a year could be worthwhile in principle.

When comparing the two possibilities, the financial planner should remind the client that repaying the mortgage is risk free; alternative uses that might generate a higher return are not and may therefore be unsuitable for clients with a more cautious attitude to risk. The client's risk profile is thus an additional factor to be taken into account when considering the decision to repay a mortgage.

D1A Why keep the mortgage?

The investment will need to be in equities or property to have a long-term chance of providing a higher return than the interest costs of a mortgage. This involves buying investments that are volatile and, in the end, might not return as much or could even lose money. The differential is the risk premium, and a client might want a relatively high-risk premium given the alternative. There is no point in investing the funds in a deposit account where the interest rate is likely to be less than the rate of borrowing and where the interest may be taxable.

Research, such as the Barclays *Equity Gilt Study*, shows that equities have generally outperformed deposit accounts over the long term. However, mortgage interest is typically 1% or 2% higher than even the highest-paying deposit accounts so, at best, the differential is less.

D1B Why rearrange the mortgage?

If the decision is to keep the mortgage, then the current arrangements should be reviewed to ensure that they provide the most efficient way to repay the loan. It may be possible to obtain a lower interest rate or a more flexible contract that allows for ad hoc or regular overpayments to reduce the balance of the loan more quickly.

For higher-rate taxpayers who hold cash balances, an offset mortgage may have additional tax advantages. The balance of the deposit account, while not earning any interest in its own right, is set against the outstanding balance of the loan, thereby reducing the amount of interest payable.

Example 5.3

Deposit account

A deposit account with a balance of £10,000 and a gross interest rate of 1.8% will pay gross interest of £180 a year. Ignoring the personal savings allowance, the net amount of income to a higher-rate taxpayer is £108, with an income tax liability of £72.

If the same £10,000 were used to offset a mortgage loan with an interest rate of 4.5%, this would provide an interest saving of £450 a year with no income tax charge. The net benefit to a higher-rate taxpayer is therefore £342 a year.

D1C Why repay the mortgage?

The return on paying off the mortgage – and not paying the interest – is tax free; the expected returns from the alternative investment will have to be projected on a post-tax basis.

The shorter the period for investment, the less attractive the prospect of borrowing to invest will be. This is partly because equity and property returns are much more reliable over periods of 15 to 20 years than for 5- or 10-year periods. Even a small difference in investment returns can have a much greater impact over 20-year periods than, say, 10-year periods. Over 10 years, the difference between £100,000 invested at 5% and 6% is £16,195 (9.94%). Over 20 years, the difference is £55,384 (20.87%).

Inflation, and possibly deflation, is an additional factor to take into account. In the past, inflation has cut the real value of debt in relation to incomes and asset values, reducing the incentive to repay mortgages early.

Example 5.4

Max

Max inherits £100,000, which, coincidentally, is the amount of his mortgage that he expects to pay off in ten years. The rate of interest on his mortgage is currently 5%, although it could rise or fall from this level.

If he paid off his mortgage now, Max is effectively making an investment that provides him with a tax-free return of 5%. He also has no investment risk, except that the interest that he might have paid goes below 5%, but then it could also rise higher than 5%.

Max needs to decide on the rate of return he is willing to accept that would be better than this. He might think it is worth keeping the mortgage and investing the inheritance in something that might reasonably provide a net return of 6% to 8%, which is roughly the long-term return from equities.

However, Max might feel that even this (uncertain) prospect would be insufficient to tempt him. Instead, he might just invest the monthly saving on his mortgage into an equity-based savings plan. If Max invests £100,000 at 10% a year, he will generate a profit of just under £160,000 after ten years. At 5% a year, Max's profit would be just under £63,000. But, of course, this is not guaranteed and he could make a loss instead.

See Example 3.15 on page 3/44 for the formula to calculate a compounded phased investment.

If Max paid off the mortgage and invested the £5,000 a year interest saving (assuming, for the sake of simplicity, that it is an interest-only mortgage where he makes no capital repayments each month and that the £5,000 is invested annually in advance), his accumulated fund in ten years' time (assuming 10% interest) would be just over £87,500. He would therefore miss out on a potential extra profit of around £72,500 compared to his possible 10% return on the £100,000 lump sum, proving that borrowing to invest could pay off handsomely. If he made just 5% on his investment, he would match the return on the lump sum.

With a ten-year timescale, not paying off the mortgage looks like a high-risk strategy that relatively few would take. The risks are less over longer periods, and the rewards potentially greater. Indeed, most people are prepared to save for their retirement and have a mortgage at the same time.

An alternative that Max may consider is to pay off, say, half of his mortgage and invest the balance. The advantage would be that he would have some capital available for any other project or expense that he may wish to undertake.

D1D Early repayment charges

An adviser should check to see what, if any, early repayment charges will apply if the mortgage is paid off before the end of its term. Typically, charges are between 1% and 5% of the value of the early repayment and can therefore have a significant impact on the amount of savings that a client could otherwise make by paying the mortgage off early. In some cases, it may be worth delaying repayment until the early repayment charges are no longer payable. These charges are usually tied into a special feature of the mortgage, such as a fixed, capped or discounted rate.

In addition, some lenders will ask to be reimbursed for any rewards or incentives received by the client at the outset, such as cash back or stamp duty land tax or legal fees paid, reducing the potential savings further still.

D1E Buy-to-let

A ***buy-to-let (BTL)*** mortgage enables a client to purchase a rental property with a loan secured on that property for the purposes of generating income and obtaining long-term capital growth which, ultimately, could be used to fund retirement. While the buy-to-let market was once seen as being lucrative to both lenders and borrowers, increases in stamp duty land tax and the less favourable tax treatment of finance costs have diminished its attractiveness. It is also not without risk. There is no certainty that property prices will continue to rise in the future or that there will be a steady demand for rental property.

Although most BTL mortgages are not currently regulated, the majority of mainstream lenders offer them, but they are usually subject to more restrictive criteria than conventional residential mortgages. The lending criteria will normally be underwritten on the basis of projected cash flows from rents to be paid by tenants. Many lenders require prospective rents of 120% to 125% of the mortgage payments to give some surplus during periods of non-occupancy.

Consumer buy-to-let
Consumer BTL covers lending to some consumers and is regulated by the FCA. A consumer BTL mortgage contract is defined as one 'which is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower'. Examples include:

- borrowers travelling overseas who need to let out their home to cover their mortgage;
- borrowers who have inherited a mortgaged property who need to let it out; and
- borrowers moving elsewhere who do not wish to sell their existing property.

The regulator feels that these borrowers are 'accidental landlords' in need of consumer protection.

Business buy-to-let
In contrast, business BTL mortgages are not regulated. The rationale here is that borrowers are entering into the contract as a professional landlord, and as such are engaging in an enterprise. Examples include where a borrower:

- uses a mortgage to buy a property intending to rent it out;
- has previously bought a property intending to rent it out and neither they nor their relatives live there; and
- already owns another property that they have let out on a rental basis.

In the Government's view, these are characteristics of a business rather than a consumer activity and therefore such borrowers do not need to be protected by FCA regulation.

Table 5.1: The benefits and drawbacks of buy-to-let

Benefits	Drawbacks
• Low interest rates currently on offer make borrowing attractive. • The rental income can be used to meet monthly mortgage payments. • Borrowing to fund the buy-to-let property purchase may mean a client's other capital can be used to achieve other financial objectives. • Interest payments on a buy-to-let mortgage benefit from basic-rate tax relief (to an extent). • Gearing may magnify returns. • Adds diversification to investment portfolios that may be heavily weighted in cash and/or equities.	• Interest rates may continue to rise, leading to higher monthly mortgage costs. • The property may experience void periods (where it is unoccupied and no rental income is received). • Fees and costs (e.g. upfront fees, early repayment charges, protection costs and property management fees) can be substantial. • Mortgage and tax-related administration – in addition to the time it takes to apply and be accepted for a mortgage, the borrower will have to find the time to complete the rental income section of the self-assessment form on an ongoing basis. • Borrowing to invest can be a high-risk strategy. • Other investments could provide higher returns once ongoing costs are taken into account. • Property is an illiquid investment, and it may not be possible to sell without making a loss if capital is needed in a hurry.

Be aware

In a bid to help first-time buyers, the taxation of buy-to-let properties is now much less favourable for landlords.

- The majority of buy-to-let and second home purchases in excess of £40,000 attract a surcharge of an additional 3% stamp duty land tax (SDLT). The impact of this on the purchase of a second property valued at, say, £275,000, is to increase the SDLT payable from £3,750 to £12,000.
- Landlords are no longer able to deduct all of their finance costs (e.g. mortgage interest, interest on loans to buy furnishings and fees incurred when taking out or repaying mortgages or loans) from their rental income when working out their profit. Instead, relief is received as a basic-rate reduction from their income tax liability.

D2 Debt consolidation

Debt consolidation means renegotiating a new loan to repay an existing loan or loans, often with a lower interest rate and lower monthly repayments. There are benefits and drawbacks to this method of debt management, as illustrated in the following table.

Table 5.2: The benefits and drawbacks of debt consolidation

Benefits	Drawbacks
• Debt consolidation loans typically benefit from lower interest rates. • Reduced monthly payments mean an increase in the client's disposable income. • A single monthly payment is easier to manage. There is less paperwork for the client to deal with. • The income freed up can be used for other financial objectives.	• If the loan is secured on their home, the client may lose their home if they cannot keep up the repayments. • Because the loan is likely to be paid back over a longer term, the total amount paid back may be higher. • The provider will charge a fee. • The client may be tempted to run up further debts in the future. • If the client's credit history is particularly poor, they may be declined.

D3 Equity release

Equity release is a possible way of obtaining capital from a property. For it to be an option, the individual must have sufficient equity within their own residential property. There are limits to the maximum amount that can be released and, depending upon the scheme used, the homeowner may only receive a proportion of the value. There are potentially very high risks, especially if the capital is subsequently placed in volatile investments.

The financial planner should:

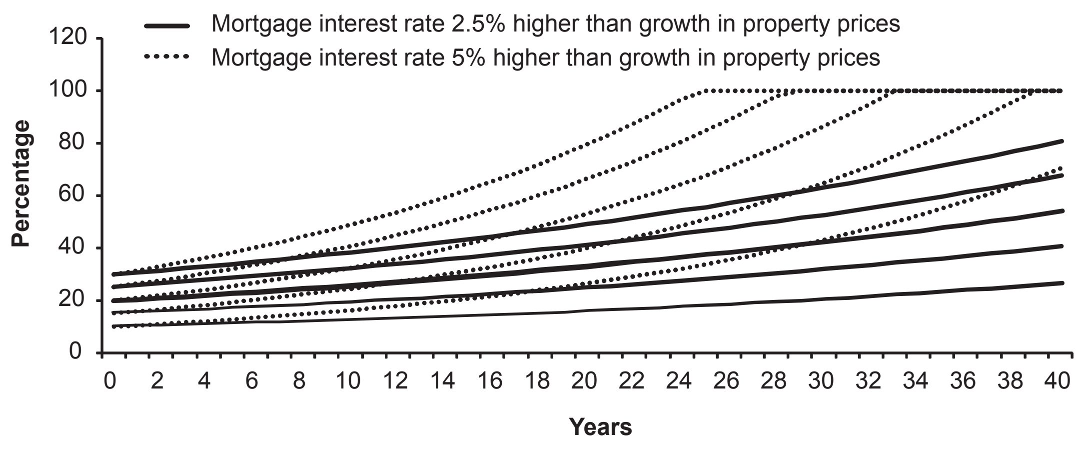
- ensure that all other options for increasing income have been fully explored by:
  – identifying entitlement to State benefits;
  – reviewing existing arrangements and investments to see if additional income can be provided; and
  – reviewing all other current debt arrangements to see if they can be rearranged.
- carry out a full income and expenditure analysis to see if other savings can be made;
- identify any potential adverse effects for the client on their entitlements to means-tested State benefits; and
- ensure that the client has also seriously considered other planning options, such as trading down to a smaller house to release capital to provide income.

A significant downside of equity release is just how quickly the debt owed mounts up. This debt must be repaid on death, usually with the proceeds from the sale of the property. A 'no negative equity guarantee' prevents the equity release customer's estate from having to pay back more than the value of the property.

However, the debt will reduce the amount available to the beneficiaries of the estate on death. This may come as a shock if they were not aware of the equity release provider's prior claim, particularly if their own financial plans were built on the expectation of a larger inheritance. It is for this reason that financial advisers encourage equity release customers to discuss their intentions with their families.

The following graph illustrates just how quickly the debt can grow. The graph shows the growth in a roll-up equity release mortgage as a proportion of property value if the mortgage interest rate is 2.5% (bold line) or 5% (dotted line) higher than the growth in property prices. A no negative equity guarantee is assumed to apply. Initial loans are 10%, 15%, 20%, 25% and 30% of value.

Figure 5.1: Equity release



Equity release is not generally available or suitable for all clients, and the following should be taken into account:

- The minimum age at entry is usually 60, although there are some schemes available from age 55.
- The individual must own the property, and it should have little or no mortgage outstanding.
- There are limits on the amount that can be borrowed.
- The maximum amount that can be borrowed depends on the value of the property, the age of the youngest borrower and, in some cases, the state of health of the applicants.
- There will be costs to set up a contract, such as valuation and arrangement fees, as well as the cost of advice and solicitor's fees.
- The client will remain responsible for the repair and maintenance of the property, and will be expected to keep this to a reasonable standard. They will also be responsible for the cost of insurance.
- If the borrower wishes to move home, the loan can usually be transferred to another property. However, if they are downsizing, they may have to repay some of the loan, and if they are moving into sheltered accommodation, they may have to pay back all of it. This could impact the viability of moving house.
- The loan taken out can considerably reduce the size of any inheritance in the future, and it is therefore important to consult with other family members who may be affected.

There are generally two different types of equity release arrangement:

- lifetime mortgages; and
- home reversion plans.

D4 Lifetime mortgages

Lifetime mortgages are usually in the form of roll-up mortgages where a lump sum is provided at the outset and the interest accrues to the outstanding balance until the loan is repaid – usually on death or if the client moves into a care home. As interest is compounded on a rolled-up mortgage, the amount outstanding can increase very quickly.

Consider this…
A roll-up loan of £20,000 with a fixed-interest rate of 7.5% a year can more than double in just ten years.

The amount that can be borrowed varies, but it is usually based on the value of the property and the borrower's age. Younger clients are able to borrow less because their life expectancy is longer and the amount of debt they will accumulate as a result of interest compounding will be greater. Considering the compounding effect of rolling up interest and the current economic conditions for house prices, it is important to only consider arrangements that include a 'no negative equity' guarantee – i.e. where the loan outstanding can never exceed the value of the property.

Loans generally offer fixed or capped rates to provide some certainty of what the loan will accrue to in the future. Some schemes also offer an inheritance guarantee, which means that a certain percentage of the property will be available to beneficiaries in the future, although this usually decreases the maximum amount that can be borrowed at the outset.

The advantages of lifetime mortgages are that the borrower receives a substantial lump sum to spend as they wish, or is able to draw a regular income without having to pay any interest up front. They also retain full ownership of the property and may benefit from future increases in the value of the property.

The disadvantages are that the loan can accumulate quickly and the interest rate may be comparatively high if it is fixed for the lifetime of the loan. Since this kind of loan is not intended to be repaid until death or on entering a care home, the early redemption penalties are generally high. However, there are now schemes that only apply penalties during, for example, the first ten years.

Other variations of a lifetime mortgage are:

- **Drawdown lifetime mortgage**. The maximum amount of borrowing is underwritten at inception. However, the borrowings are not drawn down in one go, but over a period when required. Interest only accrues on the actual amount drawn down.
- **Interest-only loan**. A lump sum is paid at the outset and is repayable on death or going into care. However, the borrower makes interest payments to the lender so that the amount of the loan does not increase in value.
- **Fixed repayment life mortgages**. A lump sum is paid at the outset and, instead of interest accruing on the loan, there is an agreement to pay the lender back an amount that is higher than that borrowed. This amount is fixed at the outset based on the age and life expectancy of the borrower, and remains the same no matter how long the mortgage lasts.

D5 Home reversion plans

Unlike a lifetime mortgage, where the ownership of the property is retained by the borrower, under a ***home reversion plan***, part or all of the property is sold to a private company called a reversion provider. In return, a lump sum or monthly income is paid and the seller enters into a lease giving them the right to residency for their lifetime rent-free or for a nominal rent. When the property is sold, usually after death, the reversion provider receives the proceeds of the sale according to what proportion of the property was sold.

For example, if 50% of the property was sold to the reversion provider, then it would retain 50% of the eventual sale proceeds.

The amount a reversion provider pays for a proportion of the property is likely to be at a discount to the property's open market value, because the company gives the client the right to live in the property.

The advantages of this type of arrangement are that a client will continue to share in any rise in the property's value, unless they sold 100% to the reversion provider. In addition, there are no ongoing repayments, apart from a nominal rent (if charged), and the share of the property available for beneficiaries is known (if not the value).

The disadvantages of home reversion plans are that when the property is sold, the full market value will not be achieved by the borrower, and where the whole property has been sold to a reversion provider, there will be no participation at all in any increases in value.

If the seller dies soon after taking out the plan, they may have sold their share or the entire value of the property cheaply. The client will lose ownership of at least a proportion of the property and it may be difficult or impossible to move home in the future.

Activity
Visit *www.equityreleasecouncil.com* to find out about the work of the Equity Release Council, and the *Statement of Principles and Rules and Guidance* they promote.

E Financial protection planning

Protection planning is a top priority for many clients.

E1 Planning for life assurance

Life assurance planning recommendations should be based on need rather than rule of thumb calculations like 'ten times annual income'. A simplified methodology might involve:

1. **Identifying the general need for life assurance cover**.

   Is there anyone who would suffer financially if the client died? In many cases, there will be a spouse/civil partner or family, although many people, especially single people (unless they have children), have no dependants or debts and do not require life assurance.
2. **Quantifying the amount of capital and income needed if the client dies**.
   It is usually a good idea to distinguish between:
   - **capital needs that may require inflation-proofing** (e.g. funeral costs, IHT liability, car purchase);
   - **capital needs that may decrease over time** (e.g. outstanding capital repayment mortgages, other liabilities);
   - **capital needs that remain constant** (e.g. interest-only mortgages);
   - **long-term net income needs** (e.g. to provide an annual lifetime income for a surviving spouse or partner).
     – Ideally, we would determine this using a lifetime cash flow projection (see *Lifetime cash flow projections* on page 4/26, ignoring: the costs associated with any children (these are dealt with under short-term income needs); costs that would be saved on the person's death, e.g. mortgage repayments where these are insured; and any cost savings that would be made on their death, e.g. food, travel.
     – Additional costs, such as the need for a housekeeper or replacing a valued benefit in kind previously provided by the employer of the deceased spouse or partner need to be identified. Consideration should be given to whether the surviving spouse or partner is likely to return to work and whether some form of income will continue after retirement. A person with a disability who is a beneficiary may also need to have an income to last for their lifetime if they are unable to earn sufficient income to support themselves. These amounts should be continuing income after tax and pension contributions.
     – The amount of income needed could be reduced by extra income payments that would be received following the policyholder's death, e.g. widow(er)'s pensions, proceeds of a family income benefit (FIB) plan.
     – Amounts should be continuing income after tax and pension contributions.
   - **short-term net income needs** (e.g. to provide for children).
     – This includes the costs of feeding, clothing and educating the children. These expenses will generally stop when they leave school or college. In most cases, this will provide the required period of cover and the income that will need to be replaced.
     – It is a good idea to focus parents' minds on the short-term extra costs that would arise if either of them died. The obvious one is extra childcare.
     – Clearly, if the homemaker died, there would be extra costs, but they might also arise if the breadwinner died.

- In some cases, extra net income may be generated on a person's death, e.g. many pension schemes pay dependants' benefits until children reach the age of 18 or leave full-time education/training. The net after-tax benefit should be included. The annual payment under any FIB plan should also be included.

3. **Determining how long the insurance cover for each identified capital and income need should last**.

   Some needs will be relatively short term – perhaps until the children have left home. Other policies will be needed until retirement. Most people who have reached retirement age do not need life assurance, unless they want to make some provision for inheritance tax (IHT).

4. **Taking into account any of the existing policies, pension schemes and other assets that can be offset against the client's life assurance needs**.

   While care needs to be taken not to over-insure and waste client's money, paring back protection to the bare bones after all other forms of liquid assets are used runs the risk of under-insurance. Affordability, therefore, needs to be balanced with adequacy of cover. Consider:

   - The suitability of using existing policies or assets to meet the identified needs. For example, is the sum assured and term of an existing life assurance policy adequate? Does the type of cover provided, say level or decreasing term, match the type of cover needed? If there is a mis-match, would it be better to arrange a new policy with the appropriate type of cover, sum assured and term and then cancel the existing policy, rather than continue with a policy that is not entirely appropriate?
   - In some circumstances, it may be more appropriate to continue with an existing policy and take out an additional policy to plug any gaps. This might be the case, for example, where the policyholder is in poor health and any new policy may be more expensive than the existing one. A cost–benefit analysis should be conducted to determine the most beneficial option for a given client.

5. **Recommending the appropriate type(s) of policy**.

   Consider:

   - If lump sum policies will be used, it will be necessary to calculate the capital amounts required to generate the target income over the various selected periods of need. It is usually possible to incorporate additional flexibility into policies, such as the ability to extend or increase the insurance cover. Flexibility is always useful, but the financial planner should bear in mind the cost: more expenditure on insurance will mean less to spend on some other priority, such as retirement planning. For income needs, a simple approach to provide for needs of up to about 25–30 years is a FIB plan. The financial planner should simply assess the net income required and the term, and then arrange the policy accordingly. Some inflation protection should ideally be included.
   - Alternatively, choose the appropriate factor from the table in *Income multipliers* on page 5/15 to calculate a lump sum to provide for the income needs. Clearly, the capital required to generate an income for five or ten years is much less than the amount needed to provide for 25 years or more of expenditure.

Example 5.5

Logan and Sophia

Logan and Sophia have two children aged four and seven. The period that income is needed to cover their cost is until they reach age 22, when Logan and Sophia believe the children should be financially independent. The net cost, in today's prices, of providing for each child if Logan dies has been calculated to be £10,000 a year.

Life cover needed on Logan's life is therefore £20,000 a year for 15 years, when the elder child is expected to have left university and found a job. It will then be £10,000 in today's prices for a further three years.

E1A Term assurances and whole life cover

The two main types of life assurance are:

- ***Term assurance***. This pays a fixed sum on death within the specified term on either a level, increasing or decreasing basis, typically used to protect families and liabilities against the financial consequences of death. FIB is a form of decreasing term assurance. Premiums are usually guaranteed, although they can be reviewable. The benefits are paid out free from income tax and CGT, and policies can be written on a single, life of another or joint life basis. Term assurances are usually written under trust to avoid the benefits forming part of the deceased's estate and becoming liable to IHT, unless their objective is to pay off a debt.
- ***Whole life cover***. This pays a fixed sum on death whenever it occurs, typically used to provide for funeral expenses, to leave a legacy and for IHT planning.

A client may have additional life assurance needs that are not taken into account in the broad expenditure-based analysis. These may be met by the various features available on both term and whole life policies:

- **Inflation**. It may be prudent to provide additional amounts to cover future possible inflation. The lump sum figures assume 3% inflation. FIB policies are assumed to have a similar rate of escalation, but many provide level benefits only. Pessimistic clients may want to provide for higher levels of inflation. Alternatively, clients can index-link their policy to keep pace with inflation.
- **Additional benefits for the family**. Some clients may want to leave their spouse/partner and children more than would be strictly justified on the basis of current expenditure. They may feel that their income in the future is likely to rise substantially and, if they were to die prematurely, this expected increase in future living standards should be taken into account. Some policies have guaranteed insurability options, enabling the client to increase their cover in the event of marriage or entering into a civil partnership, the birth of a child, house purchase or a substantial pay increase.
- **Flexibility**. Some clients might feel that they need life assurance cover for other purposes after the immediate needs are over. They might therefore prefer convertible or renewable terms or whole life assurance. For example, Tim wants cover while his daughter is financially dependent on him but, after that, he might want to continue the life assurance policy and place it in trust as part of IHT planning.
- **Waiver of premium**. This option gives peace of mind to the client that their premiums will continue to be paid if they are unable to earn because of incapacity for periods of longer than six months.

Other considerations include:

- **Timescale**. Clients might be unsure about the timescales needed for the cover. They may therefore either want cover for a longer period than is strictly necessary or want a whole of life or renewable policy.
- **Existing cover**. It may sometimes be appropriate not to take some existing life cover into account. For example, if a client were made redundant, the cover under a pension scheme would cease. There may be a case for providing some independent cover if this is likely and no continuation option exists. An existing insurance policy may have a shorter term than needed; an element of duplication may be justifiable in this case as well, or the existing policy may need to be replaced. Where cover is provided under a pension, the client should ensure that they have completed their expression of wish (nomination) form so that the trustees are aware of who the member would like any death benefits to be paid to, albeit without being bound by the member's wishes.
- **Impact on State benefits**. Consideration needs to be given to the various benefits available. Where benefits, such as Universal Credit, are means-tested, a high level of life cover and income are likely to result in ineligibility.

E1B Income multipliers

Once the amount of net income required has been calculated, factors can be used to work out the amount of capital needed to produce the required level. Broadly, the factors are based on temporary annuity rates and may have to be changed from time to time.
The assumptions are:

- The capital will be used up over the period to provide the spendable 'income'. Some advisers suggest that enough capital should be provided so that the interest or dividends alone would provide the replacement income. This leads to the provision of higher sums assured than are strictly necessary and, of course, can greatly increase the cost.
- The annual income will rise by about 3% a year. Additional cover may be required if income needs to increase at a higher rate.
- Tax of 20% is deducted from the taxable income element of the withdrawals. Over the longer term, additional cover may be required if tax is likely to be paid at the higher or additional rate.
- The factors are rounded to the nearest 0.5.
- These figures are intended to illustrate the principles, and different figures may be appropriate depending on rates of interest applying at the time and the tax status of the beneficiaries. A broad alternative indicator is to multiply the income by the number of years needed, although this overstates the amount needed for longer terms.

Table 5.3: Income multipliers

Period	Factor
5 years	5.0
10 years	10.0
15 years	14.5
20 years	18.5
25 years	22.5

Example 5.6

David and Jane
David is married to Jane, and they have two children aged ten and twelve. They have total monthly expenses of £1,400 after the payments on their interest-only mortgage of £80,000 have been met.

They believe that Jane's expenses for herself would be about £780 a month. This is roughly the amount of their monthly expenditure now, less the costs directly associated with David and the children. Jane estimates she will need £650 a month for the next ten years to meet the usual costs of bringing up the children, with an additional £1,600 a year required for extra childcare costs.

Funeral expenses would be £4,500. Jane feels that an emergency fund equivalent to five months' expenditure would be required, i.e. £7,150. As David leaves everything to Jane, there are no IHT liabilities or specific bequests to meet. However, the £80,000 mortgage needs to be repaid. Estimated expenses assuming David died are detailed in the table that follows. On David's death, it is estimated that his employer will provide Jane with a spouse's pension of £8,090. The couple wish to ignore any State benefits that may become payable due to their short-term nature.

	Monthly £	Annual capital £
Capital needs		
Funeral expenses		4,500
Mortgage repayment		80,000
Emergency funds (five months' expenses)		7,150
Capital needs		91,650
Long-term expenses		
Jane's personal expenses	780	9,360
Less long-term pension income		(8,090)
Net long-term income need		1,270
Multiply by long-term factor for over 25 years (see Table 5.3)		
Capitalised long-term income need		28,575
Short-term expenses		
Children's cost (over ten years)	650	7,800
Extra childcare costs		1,600
Less Child Benefit		(1,885)
Total short-term expenses		7,515
Capitalised short-term income need. (This could be provided for the required ten-year period or a lump sum could be generated (multiply by ten))		75,150
Maximum lump sum required		**195,375**

E1C Choosing the term of life cover

The term of a life policy should be directly linked to the needs identified in the fact-finding process. For example, if the need is to cover the financial dependency of children, then the term of the policy should be calculated to match the period of time for which the children are likely to be dependent. This could be when they attain majority at age 18 or when they finish education – or their dependency may never end where the child has a disability or special care needs.

eg

Example 5.7

David and Jane (continued)
David and Jane have a mortgage protection plan in place with a remaining term of 15 years, but their mortgage is due to be repaid in 20 years' time. Clearly, if they do not rectify this situation, they will have no protection for the last five years of the mortgage.

E1D Choosing the level and type of cover

Financial planning is concerned with establishing priorities and the first attempt at assessing the level and type of life cover required may lead to unacceptable levels of cost. The following factors should be considered to see whether the costs could be reduced:

- Can the amount of income needed be less? The basic requirement could be pared back or there might be other potential sources of income, e.g. if the surviving spouse/partner went out to work. However, it should not be assumed that a spouse/partner can or will return to work – there are issues of childcare, employability, etc.
- Can the period of cover be shortened? The build-up of savings could reduce the term over which policies should be arranged. A reduction of five years on the term of a policy can reduce the premium substantially.
- Are the extra features incorporated into the policy really necessary? Renewability, increasability and convertibility are attractive, but they may not be essential if other

priorities are more important. On the other hand, they may allow the initial cover period to be shortened but still provide subsequent insurability, reducing initial costs. The costs of replacement policies, for example, under a 'renewable' option, would likely be high in view of the increased age at the date of renewal.

- Can more life cover be provided by an employer under pension plan rules and therefore effectively qualify for tax relief on contributions? The maximum tax-free death benefit payable from registered pension plans is a lump sum equal to the lifetime allowance. Any excess payable as a lump sum is subject to a 55% tax charge. Pensions payable to dependants or other beneficiaries from uncrystallised DC funds following the death of the member before age 75, and where the entitlement meets the two-year rule, are tested against the lifetime allowance under benefit crystallisation event BCE 5C (entering into flexi-access drawdown) or BCE 5D (purchasing a lifetime annuity). In both cases, any excess over the lifetime allowance will be taxed at 25%. The drawback with this type of cover is that this is usually dependent on remaining with the same employer.
- Can cover be provided as part of a package, e.g. critical illness insurance and life cover together? Some cover and flexibility are lost, but the cost savings might release funds for other priorities.

Relevant life policies are standalone death in service plans that can be set up by an employer providing benefits for an employee on an individual basis. The premiums paid by the employer are not treated as a benefit in kind on the employee and may also be tax deductible for the employer, as long as they qualify under the 'wholly and exclusively' rules for business expenses.

In order to benefit from these tax advantages, certain conditions apply:

- The policy must:
  - only provide a lump sum death benefit payable before the age of 75; and
  - only be payable to an individual (including a trust) or a charity.
- The policy must not:
  - provide any other benefit;
  - be capable of acquiring a surrender value; and
  - be mainly used for the purpose of tax avoidance.

The advantages for a client are as follows:

- The benefit does not form part of their pension rights for testing against their lifetime allowance.
- The payments do not form part of their pension input amount for testing against their annual allowance.
- The cost of premiums is not classed as a taxable employee benefit.
- In most cases, the benefits are paid free from IHT provided they are paid through a discretionary trust.

Activity

Do some research on the internet and see if you can find more information about the features and benefits of relevant life plans.

E1E Prioritising life cover needs

The analysis so far has shown the required level of cover based on pure need, but without taking into account the cost of funding. In practice, the cost of this insurance will have to compete with other needs and its elements therefore must be prioritised:

- The capital needs are generally a high priority. Of these, the largest by far is usually the mortgage. If the property is occupied by the client alone, protection of this liability by life assurance might not be high on their list of priorities, although some lenders insist on the cover. If there is a potential surviving spouse or partner, the provision of debt-free accommodation is usually a very high priority.
- The long-term income needs are certainly important, but if other competing priorities are high, they should be examined in detail. Is it a high priority that the surviving spouse

continues to live at more or less the same standard of living after the main income earner dies? For the purpose of prioritising, these needs could be considered as follows:

- The highest priority needs are to provide a reasonable standard of living for the spouse/partner and family, but not necessarily the same standard of living as they previously enjoyed.
- A reasonable level of income that the spouse/partner could earn should be deducted from the agreed after-tax income, unless there really is no prospect of them working.
- State benefits, if available, should also be deducted.
- Multiplying the result by the appropriate factor gives the high priority need.
- The remainder is a provision that it would be desirable to have, but that is not a high priority.

- The same approach should be taken for the prioritisation of short-term income needs. The relative importance to the client and their family of keeping children at a private school needs to be considered. For some families, this will fall into the category of desirable but not essential when compared to some other form of savings or protection. For others, it will be seen as a top priority.
- If there is a need for more capital, it might be possible to release some funds by trading down to a cheaper home.
- For many clients, life assurance (except perhaps enough to repay the mortgage) is not a high priority, simply because they already have substantial capital. If there is enough to meet the basic requirements set out above, the rest of the possible cover becomes a need to be judged among other needs.

Example 5.8

Peter

Peter earns a salary of £30,000 and has building society savings of £5,000. His wife, Jenny, earns £10,000 a year. They have calculated that the net income loss to the household if Peter died would be £20,000 a year.

To provide this amount, increasing by indexation over the next 20 years, would require a lump sum of approximately 18 times this amount – say, £360,000. The couple might consider that providing a tranche of this, perhaps the first £100,000 on a reducing basis, is a worthwhile priority. The remainder could be a relatively low priority compared to other needs, such as ensuring that he and Jenny have adequate income in retirement. Even this requirement has to be weighed against other possibilities in constructing a holistic financial plan.

Prioritisation is at the heart of financial planning. However, the cost of providing life assurance is usually so little – especially for younger clients – that reducing it may be of hardly any benefit.

Example 5.9

Shah

Shah is aged 35 and is choosing between an extra £100,000 of 15-year term assurance or investing the premium in his pension scheme.

The premium for the life cover is £9 a month for 15 years. If this were invested into his pension, it would increase his contributions by a total of only £108 × 15 = £1,620 before tax relief and £2,700 grossed up at 40%. The resulting additional income at retirement could be negligible in relation to his overall provision, but the difference in the amount of insurance provided might be very significant.

E2 Incapacity through sickness or accident

The approach to incapacity needs is similar to the analysis for life assurance cover:

- The first question to ask is how long the family could satisfactorily cope with a lack of income. With clients who have significant assets, the answer may be more than six months and quite likely twelve months, although some clients might need to claim immediate benefits, especially if they have high borrowings.
- The next question is how long an employer would continue to pay either full or reduced salary.
- The next stage is to identify the necessary level of income, always remembering that the benefits from individual income protection insurance (IPI) policies are not taxable and that over-insurance could lead to the full insured level of benefit not being paid. The high priority should be to provide a level of income on which the family can live comfortably, with the excess to keep them at their current standard of living being a lower priority.
- Finally, the income that could be generated from savings and from the work of the spouse or partner would have to be deducted. However, there is also the possible need for care in the home to look after the disabled breadwinner.

The need to insure the homemaker in case of incapacity should also be considered. There are two possible solutions to this problem that can be combined to achieve the optimum result – ***income protection insurance (IPI)*** and ***critical illness cover (CIC)***.

E2A Income protection insurance and critical illness cover

IPI and CIC are complementary and pay out in different ways and possibly in different circumstances:

- IPI provides cover for long-term illnesses, whereas CIC is designed to pay out on the diagnosis of a serious illness.
- IPI provides an income for as long as the policyholder is unable to work (within the policy definition). A young person with a long-term illness lasting to retirement could receive substantial total payments; for example, £15,000 a year index-linked at 5% between ages 25 and 65 could pay out over £1.8 million. IPI meets a real need for replacement income.
- IPI pays out for many illnesses not covered by CIC (e.g. a mental illness, back pain).
- One limitation of IPI is that a person may be technically judged to be able to work, but not fully able or inclined to work as hard after a serious illness. IPI generally does not reflect this or may pay out a reduced level of benefit; in contrast, CIC pays out on diagnosis.
- Incapacity criteria for IPI have become increasingly strict.
- Another limitation is that IPI benefits are generally very low if the individual did not have significant earnings before the illness. CIC benefits are not related to earnings.
- Some needs in illness are for capital sums. It may help the client’s recovery to relieve them of debt or mortgage costs, or to provide finance for their otherwise ailing business. The lump sum from a CIC policy could also finance short-term needs, such as house improvements to accommodate a wheelchair or buying a specially adapted car.
- CIC can be used to provide a fund for retirement income, taking over when IPI ceases to pay out at retirement age.

E2B Health insurance – budgeting and priorities

There is a case for having both IPI and CIC. To fit within the budget (see the income protection needs and critical illness calculators that follow), this may involve:

- having less than the maximum cover for income protection;
- looking for the cheapest way to arrange IPI, e.g. through a group scheme if possible;
- considering the cheapest way to arrange CIC, e.g. by attaching it to a life policy or arranging it within a group scheme.

Figure 5.2: Income protection needs calculator

	Client £	Partner £
The level of current expenditure		
Plus additional expenditure incurred as a result of the illness, e.g. nursing		
Less the savings, e.g. travel to work	( )	( )
Net expenditure		
Gross up net expenditure for tax after allowances		
Less any State benefit	( )	( )
Less any other income protection	( )	( )
Less income from other sources	( )	( )
Total need for income protection cover per year		

Figure 5.3: Critical illness calculator

		Client	Partner
General needs in the event of serious illness – nursing, holiday etc.	£		
Repayment of loans and mortgages	£		
Additions and substitutes for income protection	£		
Pension protection	£		
Total CIC need	£		

In many cases, however, some degree of trade-off may have to be accepted. For example, if the employer already provides a good IPI scheme, it may be more difficult to assign a high priority to substantial amounts of CIC when there are competing claims on the available funds.

Conversely, if the major element in planning for contingencies is the mortgage, the most that can be afforded might be achieved by incorporating CIC into the mortgage life assurance policy. Even a small amount of CIC can be very helpful if a claim arises.

E2C Pension issues and health insurance

IPI should be considered in the context of pension provision. If a client is unable to work through sickness or accident, and therefore has no pensionable earnings, there is only scope for making small pension contributions (maximum contributions £3,600 a year gross). They could receive income protection benefit to age 60 or 65 and then find that they only qualify for a very minimal pension. It is therefore important to consider protecting the pension as well as income with either extra IPI to cover ongoing future pension contributions or enough CIC to provide an alternative retirement fund.

Another issue that should be considered is whether an ill-health retirement pension would be paid from an employer's scheme. This will usually only be available if there is no possibility of returning to work before normal retirement age, but it may negate some of the benefits of IPI or replace the need for it altogether.

E3 Private medical insurance

Access to PMI is a high priority for many clients:

- Many clients want to be able to arrange cover so that they can receive medical treatment at the time of their choosing, rather than wait for when the National Health Service (NHS) can schedule treatment. This can be especially important for people who run their own businesses.
- Clients often appreciate the additional facilities that are available from private hospitals and medical centres.
- Some clients travel overseas regularly and need cover for that purpose.

E3A Private medical insurance choices

There are several issues when considering the need for PMI:

- The client's employer may provide PMI. There are few tax advantages: the premium is treated as a benefit in kind and therefore fully taxable and is also subject to employer Class 1A National Insurance contributions (NICs), but the economies of scale of bulk purchase can provide significant savings.
- The client may choose to insure privately, either alone or by adding their partner or spouse and children at an additional cost.
- The level of cover can vary considerably, with limits on the amounts of cover, types of treatment provided and quality of accommodation in hospital.

The costs can also vary considerably, and savings can be made to the extent or type of coverage in order to reduce the cost to meet other objectives. PMI is a specialist area and many financial planners pass the detailed planning and implementation to specialists.

Activity
Do some research on PMI on the internet and look at the key options available and typical exclusions applied.

F Protection against redundancy

Clients should aim to have enough to live on if they lose their job. Mostly, this will be provided by State benefits, savings and possibly ***redundancy*** insurance.

The most important planning will be to reduce spending.

Clients should be aware that it is not wise to depend on the State if they become unemployed. Even if they are eligible to claim, Universal Credit or 'new style' Jobseeker's Allowance is usually much less than they would have been earning.

- State benefits do not usually meet an unemployed person's mortgage payments during the first 39 weeks in which they claim State benefits.
- After 39 weeks, Support for Mortgage Interest (SMI) may be available on up to £200,000 of a mortgage, although this is subject to a capital means test and is restricted to interest payments only (not capital repayments).
- SMI is now payable as a loan rather than a benefit. The money needs to be paid back with interest once the claimant sells their home.

On the Web
Visit the website *www.gov.uk/support-for-mortgage-interest/what-youll-get* for further information on SMI.

F1 Planning and redundancy

There are several possible strategies including:

- Creating an emergency reserve. This is probably the most helpful resource if a client becomes unemployed.
- Taking out insurance to pay mortgage interest on redundancy, although this is not available to everyone. Loans and other credit can also be covered by some redundancy insurance.
- Switching to a flexible mortgage that allows the borrower to suspend or reduce monthly payments for a period of time. This could ease the burden temporarily during a period of unemployment.
- The client being prepared to reduce expenses drastically as soon as they appear to be in danger of redundancy.
- Keeping a redundancy lump sum amount safe and accessible, and drawing on it as sparingly as possible.

Advantage of redundancy cover
The client has the reassurance of knowing that the mortgage interest will be paid for a certain period in the event of redundancy.

Disadvantages of redundancy cover

- The policy may never pay out, or the client's circumstances may change, which would make the policy itself redundant (i.e. the client may become self-employed).
- Redundancy policies may also be relatively expensive in relation to the level of benefits, with people most at risk unlikely to be insurable.
- Redundancy insurance typically only pays out for a short set period, e.g. two years.

Key points

The main ideas covered by this chapter can be summarised as follows:

Client outcomes

- Virtually all clients are looking for broadly the same outcomes, regardless of their aims and circumstances.

Behavioural finance

- Behavioural finance is the study of how psychology can affect the financial decision-making process.
- History has shown that investors do not always make rational decisions; emotions come into play.

Planning and current cash flow issues

- The statement of income and expenditure is the starting point for planning current cash flow. This budgeting exercise is instrumental in helping clients achieve their goals.
- Establishing affordability is essential before a client can commit to a recommendation.
- Proper budgeting is even more important for a client once they have retired because they have limited opportunities to boost earnings.
- All clients should aim to have some easily accessible cash resources for two main purposes:
  - to be able to make consumer purchases, such as holidays, cars and other consumer durables, without having to resort to expensive consumer finance; and
  - for emergencies, such as incapacity through sickness or accident, or redundancy.

Debt

- High-cost debt should be cleared by the client wherever possible.
- The financial planner should discuss with the client the pros and cons of paying off their mortgage.
- Clients taking out a mortgage to fund buy-to-let purchases should be aware of the increasing political and regulatory pressure surrounding these mortgages.
- When a financial planner is advising a client regarding equity release schemes, the risk involved should be fully discussed as well as any potential adverse impact on means-tested State benefits.

Financial protection planning

- Life assurance recommendations should be based on need rather than rule of thumb calculations.
- A simplified methodology can be used that distinguishes between:
  - capital needs;
  - long-term income needs; and
  - short-term income needs.
- Other factors for a financial planner to consider when calculating life cover needs are whether the client:
  - should build in inflation-proofing;
  - has specific requirements for additional benefits;
  - wants a level of flexibility in their arrangements;
  - should have a waiver of premium option;

Key points

- – has considered the timescales needed for cover;
- – takes some existing cover into account; and
- – needs to consider the impact on State benefits.
- Having calculated the amount of net income required, factors based on temporary annuity rates can be used to work out the amount of capital needed.
- The financial planner needs to help the client prioritise which type and level of cover is most important to them. The client has to prioritise among:
  - life cover;
  - critical illness cover;
  - income protection insurance;
  - private medical insurance; and
  - redundancy cover.
- The financial planner will have to explain to the client the features of these types of cover and how they complement each other.

Protection against redundancy

- Clients should be aware that it is not wise to depend on the State if they become unemployed.
- There are several strategies that clients can use to minimise the impact of redundancy.

6

Formulate suitable long-term planning

Contents	Syllabus learning outcomes
A Longer-term saving and investment	*4.2*, *4.3*
B Providing for the costs of education	*4.2*, *4.3*
C Retirement planning	*4.2*, *4.3*
D The ‘two pools’ approach to asset allocation for retirement income	*4.2*, *4.3*
E Post-retirement planning – long-term care	*4.2*, *4.3*
F Post-retirement planning – estate planning	*4.2*, *4.3*
G Product evaluation, research and selection	*4.2*, *4.3*
H Planning for particular events and circumstances	*4.2*, *4.3*
I Explaining and justifying the recommendations	*4.2*
Case study: John and Margaret Williams – recommendations	
Key points	

Learning objectives

After studying this chapter, you should be able to formulate a financial plan, make recommendations and explain them in the following areas:

- savings and investment planning, including formulating the investment policy statement, asset allocation and taking account of clients’ ethical concerns, fund selection and wrapper choice;
- providing for school fees and other education costs;
- building funds for retirement;
- the use of pension and other funds to generate cash flow in retirement;
- long-term care planning; and
- inheritance tax (IHT) mitigation and other estate planning.

Key terms

This chapter features explanations of the following ideas:

Asset allocation	Defined benefit (DB) schemes	Defined contribution (DC) schemes	Education costs
Flexi-access drawdown	Individual savings accounts (ISAs)	Investment policy statement	Life events
Long-term care	Peer-to-peer (P2P) lending	Self-invested personal pensions (SIPPs)	Short-term annuities
Tax wrappers	The two pools approach	Uncrystallised funds pension lump sum (UFPLS)	Wills

A Longer-term saving and investment

Clients may want to build up a lump sum over the longer term by setting aside money on a regular basis or as and when money becomes available for investment. The longer the timescale, the more chance there is that the return from an equity-based investment will be positive. If the money is likely to be required at a fixed point in, say, less than ten years, an equity-based investment is relatively risky.

- The client should agree a short-term reserve in cash. The remaining investments are for longer-term needs.
- While the client is still working, the priority for saving and investment is probably to accumulate a lump sum, and generate growth in the value of the capital.
- After retirement, the probability is that income generation will be the much higher priority. The financial planner should calculate the client's income needs in retirement and try to plan accordingly.

Refer to

See *Liquidity planning and short-term saving* on page 5/4 for more on liquidity planning.

The investment policy statement

The investment strategy should be broadly summed up in the ***investment policy statement***, which is based on the client's risk profile and investment goals.

The policy statement should set out:

- the purpose of the investments;
- the income or growth objectives;
- the timescale;
- a statement about the client's risk profile (in detail or outline);
- a statement about asset allocation (in detail or outline); and
- other issues, such as ethical or socially responsible investment (SRI).

The policy statement – as with other aspects of the financial planning process – may evolve as issues become clearer. It will certainly change over subsequent years, as the client's circumstances develop and the investment and financial environments change.

If two clients are involved and both have different views about investment and risk, there may need to be two policy statements for their respective investments. They will have to compromise for joint investments, and it is the financial planner's job to facilitate that discussion.

By the stage of making recommendations, the client should generally have agreed on the outline investment policy statement. At this stage, there should be a more comprehensive agenda on:

- detailed asset allocation;
- approaches to ethical issues;
- fund selection strategy and criteria; and
- choices of tax wrapper.

Consider this…
Do you use investor policy statements in your business? If so, how do you think they could be improved? If not, what advantages do you see in starting to do so?

A1 Asset allocation

The foundation of investment strategy is ***asset allocation***. Research demonstrates that most of the difference in investment returns comes from asset allocation rather than fund or stock selection.

The asset allocation strategy should set out the recommended asset classes in which the client should invest, depending on their risk profile and aims.

The following table is a range of broad asset allocation models to provide an indication of the spread of possibilities (although it is only provided as an illustration of what one adviser thought was appropriate at a particular time).

Table 6.1: Asset allocation

	More cautious			More adventurous			
	1	2	3	4	5	6	7
% Equities	20	30	40	45	55	70	90
% Property	10	10	15	15	15	10	5
% Fixed interest	70	60	45	40	30	20	5

- This is a relatively simple asset allocation structure, leaving the investment manager a considerable degree of latitude regarding the more detailed asset allocation between different geographical markets, industrial and commercial sectors, or other themes.
- Other asset allocation models are much more prescriptive about such areas and provide more detailed allocations to markets and sectors, specifying how the portfolio should be broken down between, say, the UK, Europe, North America and emerging markets.
- Some asset allocation models also use a wider range of asset classes, such as hedge funds, private equity and commodities.
- If the client needs income, this will generally skew the asset allocation towards the more cautious end of the scale and will result in a higher exposure to fixed-interest investments.

Financial planners may undertake their own asset allocation decisions or may outsource them to a range of outside organisations.

A2 Ethical issues

In very few cases, ethical issues might be the overriding criteria for fund selection and financial planning generally, although, for many clients, they will be just one of the general selection criteria and only for part of the portfolio.

Refer to
See *Socially responsible investing* on page 3/21 for more on religious and ethical issues.

Financial planners need to consider two main aspects of ethical investments or SRI and the criteria that will be used in fund selection:

- themes – whether the client is concerned with environmental, animal rights or other issues; and
- approaches taken by the fund managers – e.g. some funds have a policy of avoiding certain activities, while others aim to take an interventionist stance.

A3 Fund selection

There are thousands of different funds from which investment managers can choose within the different asset classes or across them. This can provide financial planners with a problem. Even if they carry out the main asset allocation process, they need to consider whether they can also competently choose appropriate funds. Much depends on the resources and expertise that they have in-house.

An alternative to in-house investment management is to outsource this function to a specialist discretionary investment management (DIM) firm.

Organisations that specialise in fund selection generally pick funds on the basis of a range of criteria, including:

- strength of investment process and length of time it has been in place;
- continuity of investment managers;
- an investment style that has been proven over time;
- clearly defined investment objectives; and
- strong and consistent past performance record.

Many financial planners take the view that they need the assistance of specialist outside organisations to carry out the fund selection process effectively.

Some of the main issues in fund selection are detailed in the following sections.

A3A Income or growth orientation

Whether a client is looking for income or capital growth is an important determinant of portfolio design. In general, a client who is looking for income should invest in income-oriented and especially fixed-interest funds, while a client who wants capital growth should usually buy funds that are aimed at generating capital growth.

There can be circumstances where an investment manager will not necessarily follow this basic pattern. 'Income' can be generated by making regular capital disposals from a fund; this might be tax-efficient for investors who pay 40% or more tax on income and a maximum of 20% on gains. Income-oriented funds can generate capital growth through their stock selection and by the investor reinvesting dividends. In any event, the label 'income fund' may not signify a very high level of actual yield.

A3B Active versus passive orientation

Financial planners are increasingly using passive investment strategies.

This is based on the grounds that they deliver asset allocation at relatively low cost. In addition, it is difficult to predict which active fund managers will add value for their fees by outperforming their benchmarks or providing absolute returns.

However, there is a range of strategies:

- Some are wholly based on index-tracking passive funds.
- Some are wholly based on active management.
- Some provide a mix of active and passive – possibly with passive funds providing the core, while actively managed funds provide the hoped-for extra performance.

A3C Fund of funds or individual funds choice

Some funds provide asset allocation and stock selection within a single fund or a fund of funds. It is important to know about the asset allocation model that the managers use and the extent to which it might change in the future.

Managed or balanced funds holding a range of asset classes have been traditionally used for life assurance and pension products. They have generally been less popular among collective investments for a range of reasons, some of which are technical and tax-related. However, collective mixed funds and funds of funds with mixed assets are now available.

Mixed funds and funds of funds can provide a simple solution, especially where the amounts involved do not justify the use of an individually designed portfolio.

A3D Past performance

'Past performance is not a reliable indicator of future results' runs the current risk warning. It is clearly preferable to the old warning, that past performance is not a guide to the future, which effectively wrote off all experience as worthless. However, the warning about the unreliability of past performance has to be taken very seriously.

A considerable amount of research into past performance by the regulator and by academics in several markets has made it clear that very few fund managers are consistently strong performers.

In many cases, where a manager has achieved higher than average returns, it has been on the basis of taking greater than average investment risk. So, it is always important to look at investment returns that are adjusted for risk – for example, by using Sharpe ratios.

A3E Fund management styles

Active fund management styles vary widely and tend to differ with regard to income and growth orientation or sector specialisation. Some of the main styles, which may not be mutually exclusive, include the following:

- **Absolute return**. The fund aims to provide positive returns in all markets rather than outperform a particular benchmark. The fund manager typically uses hedge fund strategies, such as derivatives and leverage (borrowing), to help achieve these objectives.
- **Bottom-up**. The manager picks stocks based on fundamental analysis of the company, such as a low price–earnings ratio and high balance sheet value. This is sometimes known as value investing.
- **Top-down**. The manager chooses sectors in the economy that are doing well (or are expected to grow) and then picks stocks within those sectors.
- **Sector rotation**. The top-down manager switches the investments to different sectors of the economy or industry based on analysis of economic and technical indicators.

A3F Fund charging issues

Fund charging issues may be a high or low priority issue, depending on the financial planner's approach to investment, but they cannot be ignored altogether. The key question must always be whether the client is getting good value for money for the charges that are being levied.

A3G Fund recommendations and risk

The aim of asset allocation and fund selection is to design a portfolio of investments that corresponds with the client's risk profile and other investment objectives. This is an imprecise art.

The basis for selection of both asset classes and funds is past performance. Past performance is a relatively accurate guide to future performance in some periods, but it can be disappointing in others.

Be aware

The warning about past performance, in *Past performance* on page 6/5, must always be borne in mind.

Conventional investment theory broadly predicts that if a fund varies up or down in value no more than 5%, on average, a month for two-thirds of the time, it will fluctuate no more than about double that (10% in a month) for nearly 98% of the time and virtually no more than three times that (15% in a month) for the remainder. However, in 2008 and 2009, for example, the degree of volatility was greater and more frequent than conventional theory predicts. As several commentators have remarked, there have been several such events that theoretically should happen only once every 10,000 years.

A large part of investment asset class and fund selection depends on choosing investments that are not correlated, as diversification reduces risk.

However, in 2008 and 2009, diversification did not provide the required results. All international markets moved more or less together, as did most asset classes, although UK and US government securities generally rose as equities fell almost everywhere.

Financial planners can draw two main conclusions from this experience:

- A portfolio of funds should be judged by its overall performance in terms of risk and return, rather than on the way in which its components behave individually. A medium risk portfolio taken as a whole could consist of investments with varying levels of risk.
- Portfolios may be designed to perform in a particular way and within the bounds of defined risk profiles, but they may not always achieve these aims, especially over the short-term. Investment planning is still more of an art than a science.

A4 Tax wrapper selection

Tax wrappers are structures for holding investments that are taxed in different ways and may be subject to other restrictions. Some of the tax rules are beneficial to investors; some are not. Much depends on the type of investment being held and the tax position of the investor. The main tax wrappers are:

- collectives;
- individual savings accounts (ISAs);
- UK life assurance policies;
- offshore life assurance policies; and
- UK-registered pensions.

There are other wrappers that might also need to be considered, including offshore funds, offshore closed-ended funds, venture capital trusts (VCTs), enterprise investment schemes (EISs) and seed enterprise investment schemes (SEISs). New schemes are introduced from time to time, and the rules governing the old ones change occasionally as well – sometimes with retrospective effect.

A4A Tax position summarised

Each of these wrappers is taxed in different ways and is also subject to different kinds of restrictions. Wrappers also involve costs and charges, although it is difficult to generalise as a wide range of approaches can be taken. The tax position for each tax wrapper varies according to the position on:

- the original investment – whether it qualifies for some level of tax relief;
- the accumulating income and growth – how they are taxed; and
- the encashment – the extent to which the proceeds are taxable or tax-free.

The summary of the tax position is briefly set out below and in the table that follows.

- The **initial input** benefits from no tax relief, partial tax relief or full tax relief.
- The **growth**, or build-up, of income and gains within the fund itself: income could be tax free, taxable at the equivalent of basic rate or fully taxable. Gains could be taxable or tax free.
- **Encashment** could mean that the gains are fully taxable, partly taxable or tax free. In the case of pensions, the whole of the proceeds (not just the gains) are taxable apart from the 25% (generally) tax-free pension commencement lump sum (PCLS).

Table 6.2: Tax wrappers compared

Wrapper	Initial input	Growth	Encashment
ISAs	No relief	Tax free	Tax free
Collectives	No relief	Income generally taxable but gains tax free	Gains chargeable to capital gains tax (CGT)
UK life assurance policies	No relief	Income basic rate equivalent and gains taxable	No CGT. Higher rates of income tax on gains, or tax free if 'qualifying' policy, subject to the beneficial owner investing no more than £3,600 a year in premium payments from 21 March 2012
Offshore life assurance policies	No relief	Free from UK tax, may be subject to overseas withholding tax	No CGT. Full income tax on gains
UK-registered pensions	Full relief, subject to limits	Tax free	25% tax free and 75% taxed as earned income
Enterprise investment scheme	Tax reducer, with 30% income tax relief (reclaimed if held for less than three years). CGT deferral relief	Dividends fully taxable	CGT-free on disposal after three years
Seed enterprise investment scheme	Tax reducer, with 50% income tax relief (reclaimed if held for less than three years). CGT reinvestment relief	Dividends fully taxable	CGT-free on disposal after three years
Venture capital trust	Tax reducer – 30% income tax relief (reclaimed if held for less than five years)	Tax free	CGT-free on disposal from the outset

A4B The purpose of tax wrappers

Tax wrappers are simply containers for investments, not investments themselves.

Wrappers can contain virtually all the asset classes and different types of fund. A client who takes the view that ISAs or pensions are poor investments misunderstands the nature of the tax wrapper. It is reasonable to comment on the cost or tax structure of a wrapper, but any investment problems are likely to be associated with the underlying investments, not the container or wrapper in which they are held.

In using tax wrappers, the financial planner should aim to make the most of any tax advantages and avoid the drawbacks as far as possible. The key variables are:

- the type of underlying investment to be held in the wrapper; and
- the tax position of the investor both while holding the investment and at disposal.

It is possible to make some generalisations about the use of tax wrappers.

ISAs

The funds inside an ***ISA*** have the equivalent tax status of a UK-registered pension or an offshore life policy, but they are tax free on disposal. In addition, funds held within an ISA can be withdrawn at any time (subject to any fixed term early withdrawal penalties for cash ISAs) either in whole or part. Equally, the income generated by the funds within an ISA can be paid tax free to the client on a regular basis. It usually makes sense to use ISAs as much as possible.

For most investors, ISAs provide the biggest tax advantages for cash and fixed interest in terms of the increased net returns from these asset classes. For example, the tax differential between holding a fixed-interest security fund yielding 5% inside an ISA and outside an ISA is £45 for every £100 of interest for an additional-rate taxpayer. However, for basic-rate taxpayers in particular, the tax advantages of interest producing ISAs have been reduced by the introduction of the personal savings allowance.

On death, an ISA becomes a 'continuing account of a deceased investor' (a continuing ISA). While no further funds can be added, income and gains remain tax free up until the earlier of the estate being administered, the ISA being closed or three years and one day from the date of death.

If an ISA saver in a marriage or civil partnership dies, their spouse or civil partner inherits a one-off additional ISA allowance (the additional permitted subscription) set at the higher of the value of the deceased's continuing ISA on the date of death or on the date the continuing ISA is closed. Once probate has been granted, the surviving spouse/civil partner can either encash the investment they have inherited (that was formerly in the deceased's ISA wrapper) or re-invest the proceeds using the inherited ISA allowance. Alternatively, they can invest money from another source to use the inherited ISA allowance.

Help to buy ISA
The Help to buy ISA scheme closed to new savers on 30 November 2019. Existing account holders can continue saving until 30 November 2029, at which point no further contributions can be made. They then have until 1 December 2030 to claim the bonus.

The Help to buy ISA is a type of cash ISA for first-time buyers, which offers a Government bonus when investors use their savings to purchase their first home.

- For every £200 that a first-time buyer saves, there is a £50 bonus payment up to a maximum of £3,000 on £12,000 of savings. The maximum monthly saving is £200.
- The bonus is available for purchases of homes of up to £450,000 in London and up to £250,000 elsewhere. The bonus only applies for home purchases.
- Savers have access to their own money and can withdraw funds from their account if they need them for any purpose but, if they do so, they will lose the bonus associated with those funds.
- Money paid into the Help to buy ISA counts towards the individual's overall £20,000 annual limit for ISA savings.

Innovative finance ISA
The innovative finance ISA allows peer-to-peer (P2P) lenders to receive their interest tax free. It is a separate type of ISA to a cash or stocks and shares ISA.

Refer to
See *Peer-to-peer lending* on page 6/9 for more on peer-to-peer lending.

Lifetime ISA
The Lifetime ISA, which became available on 6 April 2017 for adults under the age of 40, is a way of saving for a first home and/or retirement. There is an annual contribution limit of £4,000. This is part of the overall £20,000 annual limit for ISA savings; if £4,000 is invested into a Lifetime ISA, only £16,000 can be invested into the other types.

Savers receive a 25% government bonus, with a maximum bonus of £1,000 on an annual contribution of £4,000. The bonus is payable until age 50.

The savings and the bonus can be used towards a deposit on a first home worth up to £450,000 anywhere in the UK. Savers with a Help to buy ISA can transfer their savings into their Lifetime ISA or continue to save in both, although they can only use the bonus from one to buy a house.

If the saver chooses to save for retirement, then they can take out all of their savings (including the bonus) from age 60 tax and penalty free. Unless they are terminally ill, if the saver withdraws any of the money before age 60 for any purpose other than buying their first home, a penalty will be charged equivalent to 25% of the Lifetime ISA savings.

Be aware
A client's ISA allowance (£20,000 in 2022/23) can be spread across the four types of ISA: cash (either a cash ISA or an existing Help to buy ISA), stocks and shares, the innovative finance ISA, and the Lifetime ISA (subject to the £4,000 limit and eligibility criteria).

Junior ISAs
Junior ISAs are available for children who were not eligible for child trust funds (CTFs). Once the child reaches 16, they become the registered contact for their Junior ISA and can take control of the account. Once the child is 18, the Junior ISA will become an adult ISA, at which point, the child can encash the ISA and use it however they wish. If the parents had planned for it to be used for a specific purpose, such as a tax-efficient way to save for education costs, this may lead to a shortfall in the parents' financial plans. Neither the parental settlement rules nor the ISA flexibility rules apply to Junior ISAs.

Collectives
Collectives are generally subject to tax on the income they generate but are free of tax on gains until encashment. At that point, most people pay no CGT because of the annual exempt amount or the tax-free uplift on death. The rate of CGT is 10% or 20%, depending on whether the gain falls under or over the investor's basic-rate tax band. Collectives are usually most appropriate for growth-oriented investments.

UK life policies – onshore bonds
UK life policies are broadly subject to the equivalent of basic rate tax on their accumulating income and gains. Non-qualifying policies – investment bonds – may also be subject to higher rates of tax on encashment, while qualifying policies that meet the conditions are usually tax free on encashment. CGT is not payable on encashment. Gains on investment bonds qualify for the personal savings allowance.

For those investors who are unlikely to pay CGT, UK life policies can result in policyholders paying tax on their investment gains inside the fund and then possibly again on encashment. Therefore, UK life policies are generally less suitable wrappers than collectives for investments that generate gains. For higher-rate taxpayers, UK life policies may be advantageous where the underlying funds generate income that is either accumulated or paid out through the 5% withdrawal facility.

Non-UK life policies – offshore bonds
Offshore bonds are popular with non-UK-domiciled residents who are temporarily resident in the UK and want a tax shelter for their investment income and gains until they return home. There might be no tax on the encashment if the policyholder moves overseas at the time of encashment and escapes local tax on the gain.

Pensions
The tax position of UK-registered pension funds is discussed further in *Retirement planning* on page 6/15.

A4C Tax wrappers and platforms
It is important to be able to see how the client's asset allocation is distributed across their tax wrappers to understand their overall risk position. Platforms can be very helpful in providing this perspective in their reporting.

Refer to
See *Platforms* on page 7/4 for more on platforms.

A5 Peer-to-peer lending
Peer-to-peer (P2P) lending enables savers to lend directly to borrowers. It is regulated by the FCA and is becoming increasingly mainstream. Borrowers benefit from lower rates than they would usually get from banks or building societies, and savers get a better return than they would from a normal deposit account. Terms range from one month to five years.

Usually, a saver's money is split among a number of borrowers, thereby reducing the risk. However, P2P lenders are not covered by the Financial Services Compensation Scheme (FSCS), so additional care should be taken when choosing the lender. In order to provide some degree of protection, the P2P lender will typically have some form of fund in place to cover any bad loans, which is funded by a contribution from the fee that each borrower pays when their loan is approved.

A6 Longer-term saving and investment – priorities

As with shorter-term investments, the first question is to consider whether it is better to repay any outstanding debt, starting with the most expensive, e.g. credit cards.

The next question is to determine the purpose of the investment – does the client need access to the capital at a particular point in the future for a specific purpose?

- For clients whose priority is a comfortable retirement, investing in a pension scheme may provide enough tax and other benefits to offset the restrictions on access and benefits.
- For younger people, it might be more appropriate to put money in accessible investments like ISAs and collectives, and then switch the accumulated amounts to pensions later in life. However, given the current restrictions to the annual allowance, this is not quite as appealing as it has been previously.
- For people near or at retirement, the tax privileges of pensions become significantly more attractive.

Over a longer timescale, clients can afford to invest in more volatile investments, especially if the aim is capital growth.

With some plans, the charging structure means that they will receive much lower returns than expected if they need early access. Flexibility is usually desirable and, where it is not provided, the financial planner should make sure the client understands the implications.

Tax wrappers could be used as an umbrella for holding the investments in order to give the client a more cost-effective structure that is easier to understand.

B Providing for the costs of education

The need to plan for the costs of education has heightened in recent years with the rise in school and university fees as well as many other related costs. It is important for advisers to understand the wide range of needs and the structure of the costs involved in attending private schools and institutions of higher education.

There are three main educational needs that many families need to consider:

1. The initial issue is whether to provide for the costs of private education. Parents and other family members generally pay these fees, and around 7% of school age children in the UK attend private schools. This probably remains the most common type of ***education costs*** planning.
2. The costs of higher or university education have also risen dramatically, as successive governments have increased the level of tuition fees in England and scrapped maintenance grants for all students regardless of financial background. Parents (and sometimes other family members) often feel the need to help their children (or grandchildren, nieces and nephews) through this part of their education. In many families, however, the children take on most of the responsibility themselves for financing this part of their education.
3. Postgraduate and professional education is mostly seen as the responsibility of the students themselves. Support from the government and other organisations is significantly less than for undergraduates, although postgraduate master’s and doctoral loans are now available. Many parents would like to be able to support their children through these periods and, without such help, it can be hard for young people to gain valuable qualifications.

A difficulty for advance planning is that it is hard to predict exactly what will be needed, especially in the longer term. Some families are very clear that they want their children to attend a private school and then university, with the possibility of further professional training after that. Others are sure that they will keep their children in the State sector for schooling and that if they go to university or beyond, the children will mostly need to fund it themselves.

Many families are far less certain about their plans, and so their planning needs to remain flexible. Planning for education costs can also vary considerably according to the student’s age and situation, as well as the attitudes and circumstances of their family.

The financial planning aim may be to fund in advance for the full costs, but most families expect to save for more limited objectives, such as:

- Covering expected gaps between projected net income and expenditure in those years of especially heavy expenditure on school fees. These might occur when several children are expected to attend expensive schools at the same time. These periods should be identified in the lifetime cash flow projection.
- Building up a reserve of two or three years of school fees in case there are any unexpected financial difficulties that would otherwise mean withdrawing a child from their chosen school.

The possible strategies for school fees funding are broadly the same as for any other spending target, although there are some special tax and other considerations:

- All of the income on funds that originate from a parent of a child is usually taxed on the parent if the income exceeds £100 a year, even if they put the funds in trust for the child.
- The income on funds from grandparents and others is generally taxed on the child. This means that the income can be set against the child's tax allowances and bands.
- When making provision for a minor, it is important to consider the use of an appropriate type of trust as a means of controlling when and how the child should become entitled to the income and/or capital set aside for their education. Trusts have a variety of advantages, especially in terms of control of the money and flexibility as to who receives it and when, as well as for reducing the potential for inheritance tax (IHT), but inevitably they also come with additional complexity and the associated costs of administering them.
- A child is entitled to a full CGT annual exempt amount.

B1 School fees

Advisers should understand the costs of education at different types of institution, ranging from nursery schools through to university. Very often, parents do not know the costs of the programme of education they are considering. There are considerable regional variations, with Greater London about 25% more expensive than, say, Wales or parts of northern England. The two tables that follow demonstrate the range of fees seen around the country and in different age groups.

Table 6.3: Average termly school fees by age group

Age group	Boarding fee £	Day fee (boarding schools) £	Day fee (day schools) £
Sixth form	13,049	7,693	5,638
Senior	12,146	7,239	5,514
Junior	8,957	5,542	4,832
Nursery		3,334	3,835

Source: *Independent School Council (ISC) Annual Census 2022 (Appendix Two)*.

Table 6.4: Average termly school fees by area

Area	Boarding fee £	Day fee (boarding schools) £	Day fee (day schools) £
London	14,227	7,331	6,246
Scotland	12,065	7,048	4,381
Wales	12,340	5,067	4,395
All areas	12,401	6,845	5,143

Source: *ISC Annual Census 2022 (Appendix Two)*.

On the Web

To see the ISC's full report on fees, student demographics, and school locations and sizes visit: *www.isc.co.uk/media/8421/isc_census_2022_final-v2.pdf*.

Chapter 6

Example 6.1

Ben and Rob

Ben (aged 3) and Rob (aged 5) are due to attend a prep school from age 8 to 13 where the fees are currently £4,500 a term. They will then attend a private secondary school from age 13 to 18 where the school fees are currently £5,200 a term. The average rate of increases to school fees is expected to be 6% a year.

These amounts are factored into the overall cash flow projection for their parents to see whether there is a gap between income and expenditure. In addition, they can be separately identified to quantify the costs in isolation. The cash flow projection might show that there is a funding gap of, say, £11,000, £12,000 and £13,000 in the three years when both Ben and Rob are at the more expensive private secondary school.

B2 Higher education

Higher education costs also vary considerably by subject, institution and geography. In most respects, English students receive the least support from the State, while those in other parts of the UK have access to more generous State support.

In England, students currently have to pay tuition fees of up to £9,250 a year for undergraduate degrees. The fees can be financed by student loans.

The terms applying to the latest loans taken out in England are:

- The loans are subject to a rolled-up interest rate of up to the retail prices index (RPI) plus 3%.
- The loan has to be repaid at the annual rate of 9% of the former student's income once that is over £27,295 a year.
- The 9% is only calculated on the excess income over £27,295, not on the whole amount.
- The loan may be written off if there is still an outstanding amount after 30 years from the end of the course, after death or after permanent disability. A condition for writing off is that the former student has kept up the repayments.

On the Web

Students who took out loans in previous years may be subject to different terms. Full details are available at: *www.ucas.com/repaying-your-student-loan*.

B2A Undergraduate education

Parents and other family members should consider whether it makes sense to pay the student's fees and not expect the student to take out a government-sponsored student loan. In reality, it may be more appropriate to provide the student with enough money to pay a deposit on a property or cover other costs.

One of the main impacts of a graduate having a student loan is the limit it imposes on the amount of mortgage they can raise for a house purchase. However, student loans are currently relatively good value, are only repayable once the student has reached a certain level of income and could be cancelled in some circumstances.

When projecting the costs of undergraduate education, it is worth remembering that many courses extend beyond the conventional three-year period.

A strategy adopted by some affluent families has been to buy a flat or other property for the student to live in during their course. This can help to control the cost and quality of the student's living accommodation and can also help to subsidise the costs. The other tenants in the property would help pay the costs of the mortgage, and the student would have a property that could be resold at the end of the course. If the property is purchased in the name of the student, then any rental income will be taxed on them and they can set this against their personal allowance. The approach does involve an element of risk: property values could decline or the student might turn out to be an incompetent landlord.

Another course of action could be for the parents/grandparents to build up a flexible lump sum for when the child reaches age 18 to 22, with the exact use of the money to be decided once the child's circumstances and requirements become clearer at a later date.

This approach allows the parents to direct the capital towards helping with the costs of the child's higher education, helping with repaying their student loan or putting down a deposit on their first home, or could even be spread across all three.

B2B University postgraduate fees, mature students and professional training

The costs of education and training tend not to end with graduation with a first degree, such as a BA or BSc. Many professions require higher qualifications and the process could continue for several years.

Sometimes, the student can finance this education and training through their employer, and the work itself may even count as part of the training. Increasingly, there is a parallel tendency for new graduates to take unpaid or very low-paid internships. Parents and families generally should be aware that the period of financial dependency because of education can extend far longer than was the norm in the past.

Another trend is for people who graduated in one subject to want to retrain or re-educate themselves in another area. This often occurs in their late twenties or even their thirties or forties, when they may be fully independent of their parents.

While students may need to build up savings to be able to pay for their education, financial assistance from the State for postgraduate students is improving:

- Government-backed postgraduate master's loans of up to £11,836 a year for taught and research master's degrees are now available.
- Postgraduate doctoral loans of up to £27,892 for PhD programmes are also available.

In many cases, the biggest cost is the loss of earnings while taking a course. A good many adult students have found themselves dependent on the earnings of their partner or spouse for the duration of their course, in which case, the latter's life and health cover is a very important aspect of financial planning.

B3 Planning considerations

As with any advance planning to meet a commitment, there are several possible approaches. The first step is to quantify the expenditure with the help of a cash flow projection.

This involves:

- Asking when the child or children will be attending their respective schools. A child might attend nursery school from age 3 to 5, pre-prep school from 5 to 8, prep school from 8 to 13 and a private secondary school from 13 to 18. The plan might be for them to attend as day pupils until the age of, say, 10 and then to board, or they might board from an earlier age or not at all. Boarding costs are typically 80% to 100% higher than day school costs. It is important to remember that school fees can vary considerably from one school to another.
- Finding out the current total level of fees for each stage of schooling at the institutions that the children will attend. The cost of school fees is usually higher for each further stage. The core school fees themselves are not the only costs that should be taken into account. Extra costs may add 5% to 10% to the total expenditure.
- Deciding what would be an appropriate assumption for the future rate of school fee increases. Historically, it has far exceeded the consumer prices index (CPI) and has even been higher than average earnings increases. Due to the current economic conditions, there might be a moderation in the increases, but it would be prudent to expect that they will keep rising at roughly the current rate or more.

Some considerations to take into account are as follows:

- Many parents and grandparents like to save in advance or perhaps earmark capital for education.
- As with any pre-funding, the longer the timescale for investment, the more risk the investors can afford to take and the higher the returns it should be possible to consider. For example:
  - Funding for a child's school fees or university costs in, say, 15 to 20 years' time could be achieved with a high proportion of equity-based investments, especially in the early years of the programme.
  - If a parent has a very low tolerance of investment volatility and, therefore, is not willing to commit to equity-based investments, they will have to accept the consequences of the potentially lower returns and the need to save more or adjust their approach to investment.
  - Funding for fees with a five-year timescale will have to involve fewer potentially volatile investments. It is often sensible to switch from more volatile investment classes to those that generally fluctuate less as the timescale shortens.
- The current cash flow projection should help the financial planner and the client identify how much they can afford to save for future education costs. However, this amount is likely to reduce as soon as they start to incur the education costs themselves. For example, the parents might be able to afford to save at the rate of £15,000 a year while the children are at home, but the nursery school fees of, say, £6,000 a year from age three will reduce that savings level.

B3A Financial options

As with all investments, it makes sense to try and keep the arrangements flexible.

Investment vehicles for education costs
For example:

- The appropriate investment vehicles are likely to be ISAs, collectives and cash deposits. ISAs are particularly useful as:
  - their tax-free status can accelerate investment growth when compared to less tax-efficient investments;
  - they can provide a tax-free savings vehicle for up to £20,000 a year per parent/grandparent;
  - there is a wide choice of providers who offer a wide range of funds to match varying risk profiles;
  - they are generally very flexible investments so can accommodate changing needs, for example;
    - savers can switch between funds;
    - transfers can be made between providers and between the different types of ISA;
    - both lump sum and regular contributions can be made and regular contributions can be stopped, re-started and varied at any time;
    - funds are generally accessible without penalty at any time; and
  - due to the additional permitted subscription, the value of a deceased spouse's ISA investments can pass to the surviving spouse and remain within an ISA wrapper.

  There are, of course, some downsides to ISAs in the context of funding for education costs:

  - the £20,000 annual subscription limit may be insufficient, meaning an additional investment vehicle could be required;
  - a cash ISA may not be able to achieve the growth required to meet the costs involved;
  - a P2P ISA is not protected under the FSCS – if the provider defaults, the investment could well be lost;
  - a Lifetime ISA is not an appropriate vehicle as the proceeds are locked away until the investor buys their first home or reaches age 60. If the money is withdrawn before this, the investor generally loses the Government bonus and any interest or growth on this, and has to pay a charge equivalent to 25% of the Lifetime ISA savings.

- Some schools offer discounts for advance payments. These can provide attractive returns and should be considered investments. However, there is likely to be no investment protection if the school gets into financial difficulties, and there may not be any flexibility if the child changes schools. In any case, it is probably sensible not to tie up too much cash in such a plan.
- Grandparents may wish to create trusts for holding investments for their grandchildren's school fees planning. Such trusts might also include offshore bonds where the chargeable event gains could be assessed on the beneficiary with careful planning. The income and gains on investments in trusts are generally highly taxed.

Education costs – protection needs
A very important aspect of planning for education costs is having enough life and health cover on the lives of the parents or other relevant people to make sure that the school fees can be covered regardless of their death or incapacity. The estimated post-inflation costs should form the basis for the overall levels of insurance and the periods over which it will be needed. It is usually possible to set up enough life cover for this purpose, but income protection insurance (IPI) will almost always have to be topped up with critical illness cover (CIC). Unemployment insurance is desirable but will seldom be adequate.

Borrowing to meet education costs
Borrowing, or even remortgaging, is another approach taken by parents who have not been able to make provision in advance. The interest may add substantially to the costs of the school fees, especially if the borrowing is over a long period.

It may not be possible to borrow enough in some circumstances, for example, if the parent is experiencing cash flow problems because of redundancy or ill health.

Changing plans and targets
An alternative to saving in advance and borrowing is to change the education plans. This could involve moving to an area where the maintained schools are of a very high quality, although this might involve higher mortgage and other costs. It might mean opting for less expensive schools or perhaps a day (rather than a boarding) school.

C Retirement planning

A key aim for most clients who are still working is to provide enough income in retirement to support a comfortable lifestyle for themselves and their dependants. The lifetime cash flow analysis is the foundation for retirement planning.

The level of income needed in retirement should have been established in broad terms when putting together the lifetime cash flow projection. As a very rough rule of thumb, most people seem to need an income of between 60% and 80% of their pre-retirement income in the years immediately after retirement, but patterns can vary greatly. There may also be capital requirements, such as buying a car or a second home.

Even where the client has every intention of continuing to work on a full-time or part-time basis into their late 60s or even 70s, the aim should usually be to provide them with the option to be able to stop working if they wish or, indeed, if they must. This may involve the need to provide flexibility and the scope to draw on retirement income and capital when required, rather than at set times.

For many clients, it is very important to have a core of completely dependable and safe income that they know will last them for the rest of their lives. Once they have secured that, they can possibly afford to see more fluctuations in their other income.

C1 Financial planning for retirement

Funding in advance to provide for retirement income can be done in a range of ways:

- If the client is a member of a defined benefit (DB) pension scheme, they may not find a better way to provide for retirement, although they may have to top up the provision. This can be due to:
  - **Security**. In some cases, there might be a suspicion that the scheme is not financially sound. If so, it would be necessary to obtain specialist actuarial advice. This concern is mitigated to some extent by the existence of the Pension Protection Fund (PPF).

  - **Choice**. Clients may choose to buy extra benefits through an in-house additional voluntary contributions (AVC) scheme, but there are other options. How clients top up their pension provision will depend on their attitude to risk, timescale, tax position, product costs and the investment options available.
- If the employer is offering to make payments into a pension scheme, the client should almost certainly join the scheme unless this would affect any lifetime allowance protections. Again, topping up will probably be necessary to meet retirement targets.
- Where clients are wholly responsible for making their own pension provision, the challenge is likely to be greater. In most cases, the chosen vehicle will be a personal pension. The financial planner's approach should be to make clients aware of how much they need to invest to meet their goals and to balance their retirement aims with their other priorities.
- If the financial planner recommends a personal pension rather than a stakeholder pension, they need to explain to the client why the personal pension is at least as suitable as the stakeholder pension.
- The lifetime allowance limit decreased to £1m in 2016/17.
  - Fixed protection 2016 was introduced, which fixes an individual's lifetime allowance limit at £1.25m as long as no further pension contributions or pension accrual takes place after 5 April 2016. Fixed protection 2016 can be applied for at any point prior to the member crystallising their pension rights.
  - Individual protection 2016 is also available for those with total pension funds of between £1m and £1.25m. This fixes an individual's lifetime allowance at the pension funds' value on 5 April 2016 and, unlike fixed protection, further contributions can be made. Individual protection 2016 can be applied for at any point prior to the member crystallising their pension rights.
  - Other lifetime allowance protections may be in place for years prior to 2016/17.
  - For 2022/23, the lifetime allowance is £1,073,100.
- Clients whose pension funds are around the lifetime allowance should take specialist advice on the best way to preserve their entitlement, if they have not already done so. Steps a client could take include:
  - stopping their own contributions and redirecting them to their spouse's/civil partner's scheme if that is both suitable and agreeable to both parties;
  - using alternative methods of savings, such as ISAs and collectives;
  - reworking their employee's benefits package to stop employer contributions and increase salary or other benefits by way of compensation; and
  - switching existing pension funds to lower growth investments, such as cash or fixed interest, to ensure that the fund remains below the lifetime allowance until after crystallisation.

Drawdown funds, in all their forms, are exposed to sequencing risk and reverse pound cost averaging. Sequencing risk refers to the greater impact an early loss has on a client's capacity to take withdrawals over the longer term. This is illustrated in the example that follows.

Example 6.2

Bettina and Anna

Bettina has a pension portfolio of £200,000 and draws £20,000 a year from it. Very early in the first year, the portfolio doubles to £400,000 and stays unchanged in value for the next five years, during which she draws a total of £100,000, leaving £300,000. The portfolio then halves to £150,000. She still has 7.5 years of withdrawals left.

Anna is in exactly the same position, but the sequence of her losses is reversed. In the first year, her portfolio halved in value, leaving her with £100,000. Five years later, after drawing a total of £100,000 at the same £20,000 a year rate as Bettina, she is left with nothing. She has no investment left to double in value.

Running down a fund amounts to pound cost averaging in reverse. When the price of units is low, more of them are sold and when it is high, fewer are sold. So, the effect of taking regular withdrawals of capital is to exaggerate the impact of the fluctuations rather than to smooth them out or average them.

C1A Automatic enrolment

Employers must enrol 'eligible jobholders', i.e. those between the age of 22 and State pension age (SPA), and earning in excess of £10,000 a year, in a qualifying workplace pension scheme. Both employer and employee have to pay a minimum level of contribution, although the employee can opt out. Non-eligible jobholders are allowed to opt in.

Existing pension schemes can be used provided they meet the requirements to be a qualifying workplace pension scheme in relation to minimum contributions (for defined contribution (DC) schemes) and minimum benefits (for DB schemes). The total minimum contribution is 8%, with at least 3% coming from the employer.

On the Web
Visit the Pensions Regulator website, *www.thepensionsregulator.gov.uk/en/employers*, for an overview of automatic enrolment.

The Government set up the National Employment Savings Trust (NEST), a qualifying trust-based occupational pension scheme, to support automatic enrolment. NEST must accept as members each of the three categories of employee under automatic enrolment rules: eligible jobholders, non-eligible jobholders and entitled workers.

There is no cap on annual contributions into NEST. Transfers in from previous workplace pension schemes are generally allowed and transfers out are permitted. Basic-rate tax relief is given at source with any higher- or additional-rate relief having to be claimed back via self-assessment. There is currently a contribution charge of 1.8% and a maximum annual management charge of 0.3%.

C2 Product choice for retirement planning

Pension plans are not the only way of providing for retirement or necessarily the most appropriate. For many clients, accumulated ISA investments, collectives, and UK and offshore life policies may be a suitable, more flexible means of building retirement funds, even though they do not qualify for tax relief on the contributions.

The relative advantages and disadvantages of investing in pension plans and other vehicles need to be discussed with clients.

Table 6.5: Relative advantages and disadvantages of saving through a pension plan or stocks and shares ISA

Saving into a pension	Saving into a stocks and shares ISA
• Tax relief on contributions. • Employer may also contribute. • Maximum tax-relievable contributions are limited to the lower of 100% of earnings or £40,000 per year, which may be less if the money purchase annual allowance (MPAA) or tapered annual allowance applies. • Contributions invested in a fund that benefits from tax advantages. • Generally, 25% of pension pot tax free at retirement. • No access to pension pot until 55 (57 from 2028).	• No tax relief on contributions. • Employer not likely to contribute. • Contributions limited to £20,000 per year. • Contributions invested in a fund that benefits from tax advantages. • 100% of ISA tax free at any time. • Access to ISA at any time.

Some people prefer to use property as a means of either saving for retirement or providing a retirement income. There are three main ways in which property can be used – buy-to-let, trading down or equity release.

C2A Saving through a pension plan

Advantages

- The client receives the benefit of tax relief on the contributions. The funds grow free of UK tax on investment income and capital gains, and 25% of the fund on retirement is available as a tax-free PCLS.
- The premiums paid are earmarked for retirement and cannot usually be accessed prior to the normal minimum retirement age (currently age 55, increasing to age 57 in 2028). This inflexibility has the advantage that the funds are protected and invested exclusively for long-term retirement needs and cannot be drawn on in the interim for other purposes.
- The funds are broadly protected from the effects of bankruptcy.
- The pension funds on the client’s death are usually outside their estate for IHT purposes.
- Death benefits from a DC scheme, whether paid out as a lump sum or an income, can generally be paid to any recipient tax free if death occurs before age 75. Benefits from a DB scheme where the deceased is under 75 will be tax free if paid out as a lump sum, but chargeable to tax under pay as you earn (PAYE) if paid out as an income.
- Employer contributions of at least 3% of earnings are made to workplace schemes.
- DB schemes are protected by the PPF in the event of the employer’s insolvency.

Disadvantages

- Only 25% of the fund can be taken as a tax-free lump sum – any further withdrawals are taxable as pension income under PAYE.
- If the client buys an annuity with the pension fund, they may not live long enough to enjoy the full benefit of it.
- If the client goes into flexi-access drawdown, there is a danger they will spend all of their fund before they die.
- The rules that apply to pension schemes can be complicated and can require specialist advice.
- Pension funds can be ‘locked up’ for many years, as the benefits cannot usually be taken before age 55 (the current normal minimum pension age, which increases to age 57 in 2028).
- The death benefits (under both DC and DB schemes) paid out where the member dies on or after age 75 are subject to the recipient’s marginal rate of tax.

C3 Pension tax relief

The tax efficiency of pensions varies considerably according to the client’s circumstances and depends largely on the amount of tax relief on the contributions compared to the tax paid on the benefits.

The most advantageous tax position is for a client whose pension contributions are funded by their company and who would otherwise pay tax at 40% or 45% as well as National Insurance contributions (NICs) directly or indirectly on their remuneration. Their income tax relief is therefore effectively at a theoretical maximum of 45% plus 15.05% employer’s NICs plus 3.25% employee’s NICs. This tax efficiency is enhanced further if, on retirement, such a client becomes a basic-rate taxpayer and consequently pays only basic rate tax on taxable pension income.

The least advantageous position is an employee or self-employed person who makes their own contributions, receives just basic-rate tax relief and then pays income tax at the higher or additional rate in retirement.

Such a situation might also arise for a highly successful person who makes pension contributions in the early years of their career when they might still have been a basic-rate taxpayer. It might also occur in years of temporarily low taxable income later in their career.

C4 Self-invested personal pensions and investment choices

A pension plan is essentially a tax wrapper (like an investment bond or a collective) with tax (and other) advantages and drawbacks. This has several implications for investment strategy:

- It is important to keep costs to a minimum. If there are extra costs in having a ***self-invested personal pension (SIPP)***, these need to be justified. With large enough schemes, there may be cost savings.
- The investment strategy should be integrated with the rest of the client's investments. It should be complementary in risk, asset allocation and fund/sector selection. However, a different timescale may need to be taken into account, as well as the requirement to fund a cash payment of 25% of the fund value at some point in the future.

C5 Pension switching advice and transferring out

Advice is often given as to whether to switch existing pension arrangements, possibly into a personal pension or a SIPP. It is sometimes beneficial to consolidate existing pension contracts where a client has taken out several plans over a period of time.

Only firms that have the FCA's permission to advise on pension transfers may advise on them. A scheme member is required to obtain pension transfer advice where the value of their unreduced safeguarded benefits (usually defined benefits) is £30,000 or more. The advising firm will need to make clear the loss of any safeguarded benefits and the consequent transfer of risk to the client, including investment risk, longevity risk, and the risk that products may not be available or cost effective to meet the client's needs in retirement.

On the Web

For the FCA's latest rules and guidance on pension transfer advice, visit: *www.fca.org.uk/publications/policy-statements/ps20-6-pension-transfer-advice-feedback-cp-19-25-final-rules*.

C6 Gap in future retirement provision

The gap in a client's retirement provision may be easily covered, or it might take a substantial reduction in current expenditure to achieve it. The fact-find and current cash flow projection should establish how realistic a client's savings intentions are, but some clients will not be able to save enough to bridge the gap between their resources and their target pension fund. Therefore, they may need to consider alternative strategies:

- There may be other potential resources which the client could use. They may be able to earn in retirement or downsize their home or even let part of it. These possibilities should be explored where appropriate.
- If there is still going to be a shortfall even after increasing the level of saving, it might be worth questioning whether the client should be prepared to adjust their risk profile. In other words, it might be appropriate to ask whether investing in more volatile investments would be worthwhile to increase the likelihood of achieving the target. If the timescale is long enough, increasing the equity exposure might reduce risk and increase the chances of achieving the target. In the short term, however, the increase in risk becomes considerably more of a gamble. The chances of achieving the target are increased, but so are the chances of missing it by a greater margin than with lower-risk investments.
- The other assumption that can be questioned is the target itself, i.e. the timing of retirement. For example, by postponing retirement by three years, a client would have the equivalent extra time in savings, and growth on the accumulated pension funds and other investments, as well as three years' less time in retirement, which for those wishing to buy an annuity would usually be reflected in a higher annuity rate.
- Ultimately, to meet their target, the client may have to borrow in retirement using some form of equity release. The financial planner should determine whether there is likely to be enough equity in the property to finance the level of borrowing required, the age of the client when the borrowing will take place and the range of interest rates that might apply.

Refer to
For a more detailed discussion of lifetime cash flow tools, see *Lifetime cash flow projections* on page 4/26.

Lifetime cash flow tools are particularly useful in quantifying retirement planning needs. The projections provide a form of year-on-year gap analysis, which aims to see whether the client can maintain their lifestyle and meet their financial goals.

If the client cannot achieve these aims, the lifetime cash flow can identify the point at which they are likely to run out of money and the financial planner can ensure appropriate plans are put in place. However, lifetime cash flow models are not infallible. They rely not only on the assumptions being used by the model itself regarding the future growth of, say, salaries, expenses, investments and inflation, but also on the data input into the model by the financial planner.

C7 Planning at retirement and beyond

When clients stop work, they will need to depend on their accumulated assets. The chances are that their main source of retirement income will be their pension contracts, but it is necessary to take into account their other income and assets.

C7A Overview of choices

When clients start drawing from their pension contracts at retirement, the main issues are likely to include:

- whether to take the tax-free PCLS;
- how much control they want over the remaining pension fund;
- the investment of the PCLS together with other investments to generate (preferably a rising) income;
- the repayment of outstanding liabilities, including, in many cases, the mortgage;
- the provision of an adequate, preferably inflation-proofed, income from the pension element of the retirement plan;
- the provision of an income for a surviving spouse or partner; and
- the establishment of arrangements that take into account the health of the client and their spouse/partner.

The type of scheme largely determines the choice available to the client.

DB schemes
The main question likely to arise with members of ***DB pension schemes*** is whether to commute the pension and take the tax-free lump sum.

Clients rarely refuse to take the tax-free lump sum because:

- The lump sum is certain and is not contingent on the pensioner's survival. This is unlike the pension which, beyond any guarantee period, will cease on death, although possibly with a small minimum payout if the death is very early in the retirement period.
- The commutation of some of the pension does not usually affect the size of the survivor's pension benefits.
- The lump sum is tax free, whereas the pension is taxable. This is a greater consideration for clients who are higher-rate taxpayers but, even for basic-rate taxpayers, the tax factor is important.
- Most clients need the lump sum as part of their financial planning – especially to pay off liabilities or to make capital purchases.

However, it is always worth checking the basis for commutation, particularly for clients whose major concern is income. The conversion factors used are often unrealistically low, so that exchanging pensions for cash can be poor value. A few clients prefer an index-linked lifetime income to the tax-free lump sum.

Reinforce

While the pension freedom rules apply to DC schemes only, members of DB schemes wanting to take advantage of the additional flexibility may be able to do so by transferring out.

The existing scheme must permit transfers into a DC scheme and, where the unreduced transfer value under consideration is greater than £30,000, the member must take regulated financial advice from a suitably qualified individual before the transfer takes place.

DC schemes

Following the pension freedoms rules, members of ***DC schemes*** now have three choices:

Lifetime annuities	• Annuities remain a popular choice for clients looking for a secure income. • Payments from lifetime annuities are now permitted to decrease as well as increase. • The ten-year restriction on guarantees has been removed. This means that the annuity can continue to pay an income to the client's estate for any pre-determined period of time.
Flexi-access drawdown	• Flexi-access drawdown allows clients over the normal minimum pension age (currently 55, increasing to 57 in 2028) to take their tax-free PCLS with any further funds taken, whether as an income or a lump sum, taxable as pension income under PAYE. • Once a client enters flexi-access drawdown and withdraws an amount greater than their PCLS, they will trigger the £4,000 MPAA. • Flexi-access drawdown replaced all existing flexible drawdown plans from 6 April 2015. No new flexible drawdown plans can be entered into. • Existing capped drawdown plans can continue, providing the client remains within the Government Actuary's Department (GAD) limits. These clients still benefit from the full £40,000 annual allowance. However, any withdrawals in excess of the GAD limits will lead to the plan being converted to flexi-access drawdown and the £4,000 MPAA being triggered. No new capped drawdown plans can be entered into.
Uncrystallised funds pension lump sum (UFPLS)	• UFPLSs are generally provided by DC schemes that do not wish to provide a full flexi-access drawdown plan. • Each time an UFPLS is paid out, 25% of it will typically be tax free, with the remainder taxable as pension income under PAYE. Any funds remaining in the pension pot will be uncrystallised. • Once an UFPLS is taken, the member becomes subject to the £4,000 MPAA.

Under personal pension plans and DC occupational schemes, it is nearly always best to take the PCLS, even if the objective is to maximise income. The reinvestment of the tax-free lump sum in a purchased life annuity (PLA) generates a higher net income than a fully taxable pension annuity because the return from the PLA is partly exempt, with only the interest element being taxable as savings income.

C7B Defined contribution secured pension – lifetime annuities

The most common way to draw benefits from a personal pension or a retirement annuity contract has always been to take the maximum tax-free lump sum and use the balance of the fund to buy a conventional lifetime annuity. A conventional lifetime annuity refers to the type of annuity that was available prior to the implementation of pension freedoms, i.e. annuities that can only vary in line with certain HMRC prescribed circumstances.

- Annuities have to be bought from insurance companies that buy the appropriate types of investment to back up the annuity purchases, although they are not generally matched precisely to individual annuities.
- The price of the annuity is based on the life expectancy of the annuitant when the annuity payments begin. Some annuitants will live longer than others and receive more in payments than they have put into the fund, plus interest. Others will not even receive their money back. This cross-subsidy can mean that the person who survives beyond their normal life expectancy may receive a high return from the funds invested, in addition to being sure that they will receive income for the duration of their life.

- The annuity is paid throughout the annuitant's life and, if necessary, throughout the life of their spouse/partner. There is no danger that it will run out, though its value may be reduced in real terms by inflation over the years.
- It is possible to inflation-link an annuity in whole or in part, but the costs are generally such that it takes many years before the increases compensate for the reduced initial income.

On the Web

In 2018, the FCA published the findings of its Retirement Outcomes Review (ROR) – the first major study into how the retirement income market has changed since the introduction of pension freedoms. It can be found at:
www.fca.org.uk/publications/market-studies/retirement-outcomes-review.

As a result of the ROR, the FCA has implemented a range of remedies, including:

- age-based packs designed to show pension consumers the value of their savings;
- a one-page summary including information on when a consumer's pension savings are likely to run out; and
- the introduction of investment pathways, cash warnings and actual cost and charges information.

An increasing number of providers now offer investment-linked annuities on a with-profit or unit-linked basis. In comparison with the conventional fixed annuity:

- The investment-linked annuity offers the potential for higher overall return because part (or all) of the underlying fund is invested in equities.
- There is less certainty of income. The initial payment is based on an assumed investment return or bonus rate, and future income payments will depend on the extent to which this assumption is met.
- The investment risk may not be appropriate for clients who prefer to take a more cautious approach to investment in their retirement.

Example 6.3

Lucy's pension

Lucy, aged 67, is in good health and in receipt of the State Pension. She has a pension pot of £235,000, which she now wants to convert into an annuity to replace the income from a part-time job she has just left. She is single and has no dependants. She has no other sources of income and very little capital, so she decides to take 25% of the fund as a tax-free PCLS. With the remaining fund, she buys a single life annuity without capital protection to maximise the level of secure income. She decides against an escalation option, as she feels this is too expensive. Instead, she invests her tax-free lump sum and plans to draw on this in a few years' time, should inflation become an issue.

Although HMRC rules allow a lifetime annuity set up on or after 6 April 2015 to offer unlimited flexibility in payments, this does not mean that all lifetime annuities set up on or after this date are considered to be flexible lifetime annuities.

From 6 April 2015, an insurance company can set up a lifetime annuity in one of three ways (in terms of variation income):

1. Level income or rising by a fixed amount (e.g. 2.5% each year).
2. An income that varies by one of five methods (indexation, with-profit variations, indexation/with-profit combination, a selected rate of growth linked to indexation or with-profits variations or indexation/with-profit combination, and flexible withdrawals).
3. An income that decreases by any method set out in the contract.

Where the contract uses either option 1 or 2, the resulting annuity is a conventional lifetime annuity. Where the contract uses option 3, the resulting annuity is a flexible lifetime annuity.

A member is considered to have flexibly accessed their benefits when they start to receive an income from a flexible lifetime annuity and this in turn means they become subject to the £4,000 MPAA. In contrast, a member who starts to receive an income from a conventional lifetime annuity is not considered to have flexibly accessed their pension benefits and so they retain the full annual allowance for money purchase pension input.

C7C Defined contribution – flexi-access drawdown

Individuals entering into a drawdown contract on or after 6 April 2015 will enter ***flexi-access drawdown***. Personal pension plan holders can defer taking their pension in the form of an annuity and instead take withdrawals directly from the pension fund. The PCLS can be taken immediately; the balance of the fund continues to be invested, and an income or ad hoc lump sum taxable as earnings can be withdrawn from it.

Attractions of flexi-access drawdown
Flexi-access drawdown is especially attractive in the following situations:

- **Tax-free lump sum but no income**. The client wants to take a substantial tax-free lump sum and little or no income.
- **Control**. The client desires full control over how and when to use their pension fund after the age of 55 (rising to 57 in 2028) or an earlier protected pension age, or has satisfied any ill-health criteria if younger.
- **Relatively young**. The member and/or their spouse/partner are relatively young at the time pension benefits begin. This makes annuity purchase relatively less attractive (because of the lower mortality factor) and allows a longer timescale in which to take on the rewards and risks associated with equity-based investment.
- **Availability of non-pension income**. The client is not entirely dependent on the income from the pension plan and can therefore afford to see fluctuations in its level. It is sometimes preferable that income withdrawals are kept as low as possible to avoid poor investment performance eroding the value of the fund. This is not, however, always the case and other financial planning opportunities can arise if the pension fund is diminished more rapidly.
- **Annuity rates are low**. The client believes that interest rates and therefore annuity rates are temporarily at low levels and might increase again. However, this should not be the only reason for using flexi-access drawdown, because annuity rates may continue to decline in the future.
- **Income flexibility**. The client needs a flexible income that can be relatively low at the start, but might need to be higher after a few years have elapsed.
- **Availability of non-pension assets**. The client has substantial investments outside the pension plan.
- **Guaranteed income from elsewhere**. The client has a significant level of guaranteed income from other pension/investment sources.
- **Large fund size**. The fund from which the withdrawals are to be taken is large enough to absorb the administration costs. Some insurance companies stipulate a minimum fund of about £100,000 after taking the lump sum. Where death benefit considerations are paramount and particularly where the client is in poor health, substantially lower funds may be suitable for pension drawdown. The alternative of an enhanced pension annuity because of ill health could also be considered.
- **Sophisticated investor**. The client is a reasonably sophisticated investor who understands the nature of investment risk and can approach the relative complexity of the arrangement with some equanimity.
- **Death benefits**. The client has in mind people who might benefit from the fund if the client dies prematurely. Withdrawals may be more advantageous than annuity purchase for:
  - a surviving spouse/partner who is in poor health. In that case, it may not be clear whether a survivor’s pension is needed. The withdrawal facility avoids clients being locked into providing a widow or widower’s pension that may not be required; and/or
  - a policyholder who is in poor health, although it should be compared carefully with any available impaired life annuity if a high level of income is required.
- **Estate planning**. The client prioritises estate planning. The funds, while they remain invested, should be outside of the client’s estate for IHT purposes. This enables a larger

Chapter 6

sum to be left to beneficiaries than might otherwise be the case. On death, the fund can remain within the pension environment meaning:

- the fund can continue to receive income and make gains free of tax, increasing the potential for growth;
- the choice of fund can be aligned to the beneficiary's risk profile;
- the beneficiary can use the fund to provide them with an income and/or lump sums in their own retirement;
- the beneficiary can pass on the fund free from IHT to a further beneficiary of their own choosing; and
- the beneficiary can time future withdrawals to suit their own tax status. While there is no income tax payable where the original pension member died before the age of 75, if they died on or after that age, income tax is charged at the recipient's rate. In these circumstances, higher- or additional-rate taxpayers, may wish to delay any withdrawals until they are basic-rate taxpayers. Care should also be taken so as to not lose the personal allowance or become subject to a further tax charge (such as the High Income Child Benefit Charge) as a result of a withdrawal taking them over the appropriate income threshold.

Potential drawbacks of flexi-access drawdown
Flexi-access drawdown involves various disadvantages:

- **Charges**. There are often relatively high charges levied by both the financial planner and the pension provider for the considerable amount of administration and advice involved in running pension drawdown.
- **No mortality cross subsidy**. By investing in safe investments like cash and/or fixed-interest securities, it is likely that the member will receive a lower lifetime income than is available from an annuity, which has the advantage of the mortality factor.
- **Required degree of investment risk**. Investing in assets that might provide the extra returns that could outperform an annuity, such as equities, involves a degree of investment risk. Clients would need to have a relatively adventurous attitude towards risk in order to cope with the fluctuations they might see in the value of their pension fund, as well as the risk capacity to endure shortfalls.
- **Annuity levels**. Annuity levels might seem historically low at a particular time, but interest rate fluctuations are never easy to predict. The annuity purchase could easily end up being postponed to a period of even lower interest rates.
- **The MPAA**. Taking a withdrawal of the taxable element of the plan will trigger the MPAA.
- **Potential for capital erosion**. Taking high levels of income could lead to significant capital erosion and an increased likelihood of the client using up all of their pension fund before they die.
- **Complexity**. Flexi-access drawdown as a concept is complex. It is therefore only really suitable for clients who can fully understand the financial implications and risks involved.

C7D Uncrystallised funds pension lump sum

An alternative way for DC scheme members to access their pension fund flexibly is through an ***UFPLS***. The member can take the value of their uncrystallised DC funds either as a single lump sum or as series of lump sums. Normally, 25% of the value of each lump sum will be paid tax free, with the remainder taxable as pension income under PAYE.

When taking an UFPLS, the following conditions must be met:

- The member must have reached the current normal minimum pension age of 55 (57 from 2028), or an earlier protected pension age, or have satisfied any ill-health criteria if younger.
- If the member is under 75 when the UFPLS is made, the amount of the UFPLS is restricted to the amount of the lifetime allowance remaining, with any excess taken being a lifetime allowance excess lump sum and subject to a 55% tax charge.
- If the member is 75 or older when the UFPLS is made, they must have had at least some lifetime allowance remaining at age 75. The UFPLS can potentially be more than the remaining lifetime allowance at age 75, but the 25% tax-free element will be restricted to 25% of the remaining lifetime allowance at age 75.
- The lump sum must be payable from uncrystallised rights held under a DC arrangement.

There are certain circumstances where an UFPLS will not be permitted, and these mostly relate to members with an enhanced lifetime allowance or protected PCLS.

The following table shows the advantages and disadvantages of accessing a pension fund using an UFPLS.

Table 6.6: Accessing a pension fund using an UFPLS

Advantages of an UFPLS	Disadvantages of an UFPLS
• For those in need of an upfront payment, an UFPLS is a straightforward way of achieving this. • The first 25% of each payment is tax free. • Previously, only those with funds within the trivial commutation limits were able to access their pension in this way. • The fees associated with an UFPLS are less than those charged for flexi-access drawdown, making an UFPLS a more cost-effective way of accessing benefits flexibly for clients with smaller pension funds.	• Although the first 25% of each payment is tax free, the remainder is taxable as pension income under PAYE. Withdrawals, particularly large ones, may take the member into the higher- or additional-rate tax bands. • As with flexi-access drawdown, there is a danger that the client will outlive their fund. • Not all pension providers may offer UFPLSs, so a client may need to transfer their fund to another provider to take advantage of it. • Taking an UFPLS will trigger the £4,000 MPAA.

C7E Phased retirement

Phased retirement is another method of taking retirement benefits from a personal pension plan. Its main objective is to provide a greater degree of control and flexibility over the member's pension fund in the early years of retirement. Over the years, both the value of the funds and the annuity rates should rise as the member gets older, although this is not guaranteed, and the member may have no intention of ever purchasing an annuity.

- Under a phased annuity, an individual decides the amount of net income required for the coming year and then encashes sufficient funds to meet this need. The income is made up of a tax-free PCLS, which is usually 25% of the amount crystallised, with the remainder being taxable annuity income. This process is then repeated for the following years.
- With phased drawdown pension, once the net income is decided on and the PCLS taken, the remaining income required is drawn from the fund directly under the applicable flexible/capped drawdown rules.

Both an UFPLS and flexi-access drawdown can be used to facilitate phased retirement. However, the ability to take periodic withdrawals via either UFPLSs or flexi-access drawdown is of course dependent upon the pension provider's willingness to offer the facility to do so and the charges that they levy for actually doing so.

Flexi-access drawdown may be the preferred choice where the member intends to make significant future pension contributions or wants more flexibility and control over the amount of income tax they pay. If, for example, they only access their PCLS and do not withdraw any income from the fund, the MPAA will not be triggered and future contributions will still benefit from the full annual allowance. If they withdraw in excess of their PCLS, this would trigger the MPAA, but the member could still limit the withdrawal to their available personal allowance to avoid paying income tax on it.

Example 6.4

Simon and Susan

Simon, aged 61, is married to Susan, aged 48. He has sold his business for a significant sum following a health scare. His pension pot is currently valued at £440,000. He has no need to take his PCLS at present and does not wish to tie himself to an annuity, as he believes long-term gilt rates are on the rise. Susan's earnings cover the majority of their outgoings at present, so only a small income is needed for now. Once Susan retires in around eight years' time, Simon may need to increase the level of income he takes.

Simon is comfortable with the idea of his pension pot being exposed to investment risk in return for a potentially higher level of income in the future. Because the proceeds of his business are more cautiously invested, he feels he has the financial capacity to do this. Therefore, phased retirement via UFPLSs or flexi-access drawdown may be the most suitable option for Simon, depending on how much flexibility he needs and the option(s) made available to him by his pension provider.

Advantages of phased retirement

Phased retirement is likely to be suitable for clients who:

- Have significant funds available in their pension plans. The fees for administration mean that £100,000 is the minimum fund that should usually be considered.
- Do not need a tax-free lump sum at retirement. They almost certainly have other capital and income assets available for this use.
- Are concerned about flexibility of income.
- Are uncertain about their health, and the health of their spouse/partner and/or dependants.
- Can afford to postpone annuity purchase in those years when investment conditions are generally adverse.
- Believe annuity rates are low and will increase in the future.
- Are prepared to consider taking a significant investment risk. There is no investment advantage in phased retirement (or flexi-access drawdown) if the fund is primarily invested in cash and fixed-interest securities. An annuity will almost certainly provide a better return because of the mortality factor and the economies of scale.
- Are willing to undertake a plan of considerable complexity where the costs of administration and advice are likely to be relatively high.

Disadvantages of phased retirement

There are certain drawbacks that must be fully considered before proceeding. Many of these are shared with flexi-access drawdown.

- The main drawback is that the client loses the benefit of having the tax-free lump sum in one payment early on in retirement. If the client decides the lump sum is needed, the phased retirement plan may not be suitable. Access is possible later but, by that time, the amount available in this form may be reduced. If a member has significant other capital, this may not be a major consideration.
- Even when interest rates are historically low, there is always the possibility that they may decline further. Annuity rates generally do rise as the member grows older, but this is not guaranteed.
- The value of the member's pension benefits could decline if the fund reduces because of adverse investment conditions. There is no guarantee that the pension fund investment will outperform inflation, or even provide as good an overall return as the full annuity purchase option.
- Some clients may consider withdrawing from a DB occupational pension scheme where the income benefits are guaranteed and where there may be inflation protection. The investment return under the phased retirement plan could give better or worse results than the occupational scheme.

The decision to go into phased retirement is most likely to be driven by considerations regarding meeting income needs, managing income tax and the desire to make future contributions.

C7F Short-term annuities

After taking the tax-free lump sum, part of the remaining drawdown fund can be used to buy ***short-term annuities***. The annuity provides the immediate income and the remaining investment is used to buy the next short-term annuity when the first one ceases. The structure is similar to full flexi-access drawdown and has broadly the same advantages and drawbacks.

The main advantage of this arrangement is that it is simpler, and therefore cheaper, to administer than full flexi-access drawdown. It also provides more security of income in the short term.

The main drawback is that the client has not bought long-term security for their income. The rate of growth on the invested part may be inadequate and future annuity rates may decline.

Activity

Using the internet, identify any providers of short-term annuities in the UK market. In what set of circumstances do you think their product offering would be suitable for a client?

C7G Risk

Table 6.7: Risk and return of pension products

Product	Capital	Income
Conventional annuity	No investment risk.	Guaranteed for life.
With-profits annuity	Remaining capital is at risk, as it is exposed to the returns of the with-profits fund. Bonuses are not guaranteed, because they depend on the financial strength and investment performance of the firm.	Income depends on the insurance company's annuity rates and the bonuses (if any) added to the fund. It may need to be reduced if too much is paid out initially and/or bonuses are lower than expected.
Unit-linked annuity	Remaining capital is at risk. The extent of this risk will depend on the risk profile of the pension fund itself.	Income depends on the fund's performance. It may need to be reduced if too much is paid out initially and/or returns are lower than expected.
Flexible annuity	No investment risk.	Income can vary in line with the terms laid out in the annuity contract at outset.
Flexi-access drawdown	Remaining capital is at risk. The extent of this risk will depend on the risk profile of the pension fund itself.	Income generated directly from the fund is not guaranteed, and will vary depending on the value and performance of the underlying assets. It may not last a lifetime.
UFPLS	Remaining capital is at risk. The extent of this risk will depend on the risk profile of the pension fund itself.	Lump sum payments only, no income is payable from an UFPLS.
Phased retirement	Risk is determined by how much of the capital is converted to an annuity, the amount that remains in the fund and the risk profile of the fund itself.	Income security depends on how much of the fund is converted into conventional annuities, with the remainder dependent on fund performance in future years.

D The 'two pools' approach to asset allocation for retirement income

The ***'two pools' approach*** to asset allocation is of relevance to people who need to start drawing income from their investment portfolios within the next eight years or so.

The essence of the plan is to divide the client's assets into two main pools:

1. A very safe pool with a short- to medium-term time horizon. The purpose of the 'safety first' part of the portfolio is to provide a pool of investments that should be safe for the client to draw on until the more adventurous part of the portfolio has recovered from any market downturns.
2. An adventurous pool with a much longer time horizon. The aims of this portfolio – mostly equities – are to provide long-term capital growth to replace the 'safety first' pool when it has run out and provide another long-term pool for the next few years.

D1 The safety first pool

For this approach, the financial planner and the client need to decide how long they expect it to take for investment markets to recover in the event of significant falls. The past can offer some guidance here.

After the 1974 UK stock market crash, it took share prices with reinvested dividends some eight years to recover to peak values. A more extreme example is the US stock market, where the peak values of 1929 were not achieved again in terms of the index until the mid-1950s. The most pessimistic case would be based on Japan, which has still not regained its peak since the 1980s.

It might be appropriate to agree on five to eight years before recovery to previously high levels could be assumed.

The financial planner and the client should calculate the amount of income the client needs each year and multiply that by the number of years that they believe the recovery will take. So, if the client needs spendable gross income on top of their pensions of £20,000 a year and the estimated recovery period is five years, the safety first pool should be £100,000. This figure might be reduced to some extent to reflect the income and growth on these investments or, more conservatively, these could be excluded to build in a measure of inflation protection during the period.

The pool should consist of cash, National Savings and Investments (NS&I) products and short-dated government securities, as well as possibly investment-grade corporate bonds and other very stable investments.

Over the course of the period, the pool would be topped up from the long-term adventurous pool.

Example 6.5

Jake's pension

Jake retires at age 65 with a pension fund, after taking the PCLS, of £260,000. His other pensions bring him an annual income of £25,000 after tax, but he needs another £10,000 a year to live on. He believes that he should have a safety first pool that will last him six years.

Jake's portfolio is therefore divided into £60,000 for immediate income and £200,000 is invested into assets that he believes should grow. The aim is that, in the six-year period, the £200,000 will grow enough to replace the £60,000 plus inflation – say, £70,000, assuming 2.5% annual price rises. That would need an annual rate of growth of just over 5%.

With an annual return of, say, 8%, the total return would be just under £317,400, of which £70,000 could be recycled into the safety first pool and the balance of £247,400 would be invested in the long-term pool.

If the portfolio had not recovered to its initial amount, there would be less to invest for the following period, but the client may have more time to prepare for this, possibly cutting current consumption to lengthen the period.

D2 The long-term adventurous pool

With the knowledge that the income cash flow for the next few years is reasonably secure, there is plenty of time for the client to be prepared to take a greater risk with the remainder of their investments. These might be invested in equities, property and possibly some alternative investments, such as commodities, private equity and hedge funds.

D3 Advantages and drawbacks of the 'two pools' approach

There are several advantages and drawbacks to the two pools approach, as detailed in the following table.

Table 6.8: Advantages and disadvantages of the 'two pools' approach

Advantages	Disadvantages
• The strategy provides a very strong defence against severe market downturns, where most asset allocation models based on recent past experience have failed. • The client's spendable 'income' is reasonably secure for the initial chosen period. • The client can focus the rest of the investment portfolio on growth. • The strategy should allow the client to ride out a major stock market fall. • Capital growth is often less heavily taxed than income. • The strategy works if the market eventually recovers.	• The 'safety first' investments are not immune to some kinds of risk, e.g. in the 1970s, the value of the safety first pool would have been severely reduced by inflation. • It is not possible to protect against major investment disasters. • The client may seriously underestimate the recovery time for the market and have to sell assets before it occurs. • In most time periods since World War II, a very defensive portfolio would have significantly underperformed.

E Post-retirement planning – long-term care

It is dangerous to make generalisations about people's needs in retirement. However, most financial planners will agree that clients who retire in their 60s and early 70s tend to need relatively high incomes but, after this, they often gradually slow down and spend less on themselves. The one big exception to this pattern is if the client needs ***long-term care***.

Planning for long-term care provision is likely to be based on:

- Providing for future possible needs. This might involve building up enough assets to provide for long-term care and possibly the change of ownership of assets, such as the client's home. It might also involve the use of specialist long-term care insurance, although the market in these products is very limited at present.
- Providing for immediate needs where the client or close relative is receiving (or is about to receive) care. This is likely to involve advice on investment strategy to provide enough funds to cover the costs of long-term care. The planning might involve recommendations about the use of specialist immediate care plans.
- Ensuring that if the client loses mental capacity later in life, they have made arrangements in advance using a lasting power of attorney (LPA) to address their financial and/or welfare needs, or have an existing enduring power of attorney (EPA) in place.

Example 6.6

Ravi

Summary

- Ravi's mother is seriously ill.
- She seems unlikely to survive more than about six months, although the doctor has said that it is possible that she might live longer.
- The current cost of the nursing home fees is £900 a week and might rise again.
- Her house is worth £800,000, although Ravi's mother is not keen to sell it.

Recommendations for long-term care issues

- Ravi's family can just about afford to pay for two years of fees at an annual rate of between £45,000 and £50,000 from their own savings, in the expectation that they could sell Ravi's mother's house after her death and receive the money back from her estate.
- The family should lend the funds to Ravi's mother, as this would be a debt against the estate at her death.
- The family could be repaid out of the estate on her death.
- The loan should be documented to make sure the debt is a deduction for IHT purposes and to prevent misunderstandings with other beneficiaries.
- The loan should not be from savings that have been accumulated from any gifts previously received from Ravi's mother.
- The house could be let to provide extra income for Ravi's mother. Assuming a yield of 5%, the gross income would be £40,000 before costs and tax. However, the rent could, of course, be less than this and they might have trouble finding a tenant.
- Alternatively, at some point, it might be necessary to sell the house. It should be free of CGT as the main residence. In the short term, selling the house now might be difficult.

Be aware

Social care funding

From October 2023, the Government will introduce a new £86,000 cap on the amount anyone in England will need to spend on their personal care over their lifetime.

In addition, the upper capital limit (UCL) – the point at which people become eligible to receive some financial support from their local authority – will rise to £100,000 from the current £23,250. The UCL of £100,000 will apply universally, irrespective of the circumstances or setting in which an individual receives care. The lower capital limit (LCL) – the threshold below which people will not have to pay anything for their care from their assets – will increase to £20,000 from £14,250.

The cap does not cover the daily living costs for people in care homes, and people will remain responsible for their daily living costs throughout their care journey, including after they reach the cap.

As a result of the relative certainty over costs brought about by these changes, it is hoped that more people, encouraged by their local authorities, will seek financial advice regarding their long-term care needs and that product providers will respond to this by producing long-term care plans with greater flexibility to meet their needs.

F Post-retirement planning – estate planning

The other issue that becomes increasingly important to many clients as they grow older – and especially after retirement – is the estate they will leave to their families.

The main aims that a client could have to plan for in this area are that:

- their estate does not suffer more IHT than necessary;
- their assets are not largely eroded in their old age by the costs of long-term care;
- there is someone to make decisions about their finances and personal circumstances if they lose capacity to do this for themselves; and
- their assets are distributed in the way they wish when they die.

Financial planners should help clients to understand the tax and other issues surrounding their estates and to decide on their intentions.

Advantages of estate and IHT planning
Clients ensure that assets are passed to those they intend to benefit, preferably without IHT impacting on those assets.

Disadvantages of estate and IHT planning
Estate planning may involve clients forgoing income or capital, or indeed both. In addition, there is no guarantee that the IHT strategy will not be affected by changes in the law or will not be challenged by HMRC. Inevitably, assumptions will have to be made about when death may occur and the size of the estate at that time, but these assumptions are unlikely to be 100% accurate.

F1 Wills

Many clients do not get around to making ***wills*** or, if they do, they often fail to keep them up to date.

Wills are important because they:

- give the client the peace of mind that comes from knowing that their affairs are in order;
- name executors, which ensures that a client's estate is dealt with by people they trust to do the job well;
- make sure that assets go to the people the client wishes to benefit;
- allow the client to make provision for vulnerable family members by setting up suitable trust and financial arrangements;
- provide for the guardianship of children if both parents were to die;
- reduce the administrative burden and excessive time that can be associated with dealing with an estate where no will has been made; and
- facilitate tax planning.

For a married couple/civil partnership, the percentage of any nil rate band and/or residence nil rate band unused on the first death can be inherited by the survivor and set against their estate on their subsequent death.

The amount of nil rate band that a surviving spouse or partner inherits is based on the percentage of the nil rate band that was not used at the first death. This remaining percentage is then applied to the nil rate band as at the date of the second death, thereby increasing it.

Example 6.7

Bill and Joan
Bill died in 1975, leaving his wife Joan two-thirds of the then nil rate band of £15,000; he left £5,000 cash to his children. When Joan died in January 2023, she had her own nil rate band of £325,000 plus two-thirds of Bill's applied to the nil rate band at the time of her death, i.e. two-thirds of £325,000 = £216,667. So, her total nil rate band is £541,667. In addition, provided Joan had a residential property to leave to the children, her estate could also benefit from two residence nil rate bands of £175,000 each.

Nil rate band discretionary trusts may still be appropriate for some clients. Clients may wish to protect assets by passing them into such a trust, although their significance has been reduced by the ability to transfer the unused proportion of the nil rate bands on first death to the estate of the second.

Note that a will is not revoked on divorce but will be read as though the ex-spouse/partner is no longer alive (unless the will has a provision to the contrary). It is therefore important to ensure that divorcees update their wills to be appropriate for their new circumstances.

F1A The laws of intestacy

Individuals who die without having made a valid will are said to have died 'intestate' and their estate has to be distributed in accordance with the rules of intestacy. It is important to recognise that an individual's estate refers to assets held only by that individual. This could be assets held solely by the individual or jointly with another as a tenant in common. Assets held by the deceased as joint tenants automatically pass to the survivor and therefore are not affected by the intestacy rules.

Where an estate is to be distributed under the intestacy rules, there is a clearly defined path that must be followed in deciding to whom the estate is distributed. This very much depends on whether the deceased was married/in a civil partnership at the date of death, whether there are children and the value of the estate.

- If there are surviving issue (children, grandchildren or other direct descendants) of the deceased and the estate is valued at more than £270,000, the spouse/civil partner inherits:
  - all the personal property and belongings of the person who has died;
  - the first £270,000 of the estate; and
  - half of the remaining estate outright, with the surviving issue taking the other half.
- If the estate is worth more than £270,000, and there are no issue, the spouse/civil partner inherits everything.

Be aware
The £270,000 legacy amount to the spouse/civil partner is reviewed every five years and will generally increase by the CPI, rounded up to the nearest £1,000.

F2 Inheritance tax mitigation plans

Many clients are keen to mitigate IHT, but it is important for them to be clear about the implications of most tax mitigation schemes, which will reduce their flexibility and access to capital or income to a greater or lesser extent.

F2A Capital plans

IHT planning is likely to include making lifetime gifts of capital and/or regular annual amounts either outright or into trust for their beneficiaries. In the case of gifts of most investments, the aim is to pass the assets out of the estate so that any growth in their value accrues free of IHT and the assets are no longer taxable seven years after the date of the gift.

- Where the donor reserves a right to draw an 'income' from the gifted asset, the amount of the gift is discounted for IHT purposes, and if the donor dies within seven years, it is the discounted gift (not the full amount of the transfer) that is included in the estate. These plans are relatively inflexible, but achieve relatively high IHT savings if the donor dies prematurely.
- Loan-based plans are generally where the donor gifts a small amount into trust and lends the major part of the funds to the trustees. They may be more flexible but they achieve relatively little IHT saving on the early death of a donor.

The following table shows a capital plan summary and comparison of discounted gift trusts and loan trusts with their respective advantages and disadvantages.

Table 6.9: Capital plans summary

Discounted gift trust	Loan trust
• The donor (settlor) gifts a cash lump sum into a trust (either bare – in which case the gift is a potentially exempt transfer (PET) – or discretionary – in which case the gift is a chargeable lifetime transfer (CLT)). • The trustees (one of whom can be the settlor) typically use the cash to buy an investment bond (alternatively, the settlor can buy an investment bond and assign it into trust). • The gift is made subject to a condition that the trust makes fixed payments on fixed dates for the life of the settlor (or until the trust fund is exhausted) – the 5% tax deferred withdrawals available under investment bonds are typically used to facilitate this. • The value of the gift for IHT purposes is less than the amount actually gifted because it is discounted to take into consideration the fixed payment stream and the donor's life expectancy (medical underwriting is required). • The donor should ensure they spend the income so that it does not accumulate back into their estate.	• The settlor (donor) establishes a discretionary trust, then makes an interest-free cash loan to the trustees; the loan is repayable on demand. • The trustees (one of whom can be the settlor) typically use the cash to buy an investment bond. • The original capital is not outside of the estate and must be paid back to the settlor on or prior to death – loan repayments can be made on a regular basis using the 5% tax deferred withdrawals available under investment bonds, or as ad hoc lump sums as and when required. • When calculating any periodic or exit charges, the amount owed to the settlor is deducted from the value of the trust – there is no exit charge on loan repayments.
Advantages • The gift is effective for IHT purposes, and the donor can retain a regular income without the gift with reservation rules or pre-owned asset tax applying. • The transfer value is less than the amount transferred, leading to an immediate tax saving if the donor dies within seven years. • For discretionary trusts, there is no immediate charge to IHT providing the discounted gift is under the nil rate band, and there are no periodic or exit charges if the trust fund remains under the nil rate band.	**Advantages** • Any growth on the investment bond is immediately outside of the estate for IHT purposes. • The settlor has access to their capital whenever they wish. • The settlor can take an 'income' stream.
Disadvantages • The fixed payment stream is inflexible and, after 20 years, if 5% is taken per year, this will be exhausted. • Investment bonds can be inefficient from a CGT perspective.	**Disadvantages** • The outstanding loan remains in the settlor's estate and is repaid to their estate on death. • If the settlor takes the 5% withdrawals, repayments will stop in 20 years. • If the settlor does not spend the withdrawals, the money will remain in their estate. • It takes time to benefit from a loan trust from an IHT perspective. • If the trustees make payments to another beneficiary during the settlor's lifetime, they should ensure that the trust fund has enough left in it to repay any outstanding loan.

F2B Inheritance tax business relief plans

Business assets may qualify for 100% business relief and will pass down free of IHT if the client transfers them as a lifetime gift or bequest at death more than two years after acquisition. In many cases, this relief applies to businesses where clients have been personally involved in the management. However, there has been a growth of 'off the shelf' business assets plans, including EIS, SEIS and AIM schemes that qualify for business relief. The client can either pass them down as lifetime gifts without any IHT liability or, more usually, retain the assets until death and pass them down tax free through their wills.

- The advantage of this approach is that the client retains control of the asset and any income from it until death, with no need for a lifetime gift.
- The main drawback is that these investments are generally high risk and the possible loss on the investment could outweigh the tax saving. The client also needs to survive at least two years from the date of acquisition to benefit from this approach.

F2C Life assurance-based plans

A well-established approach to IHT planning is to take out life assurance written in trust to cover the potential tax liability.

Life assurance can be useful in several ways in IHT mitigation:

- It can ensure that there are sufficient funds to pay the IHT on lifetime gifts if the donor dies within seven years of making those gifts.
- It can provide cash with which to pay IHT on death, which is especially helpful if the client leaves a large illiquid asset that the beneficiaries wish to retain.
- It can also be helpful in maximising the use of the annual/normal expenditure from income exemptions, so that a substantial amount passes free of IHT even if the client dies early on in the programme of gifts.

The main drawback of insurance is that it can tie up resources that clients may wish to use for other purposes, either for themselves or to provide immediate spending money for the beneficiaries. Insurance also usually involves a regular commitment that the client has to meet and they may feel that this reduces their spendable income.

F3 Using trusts for estate planning

Trusts are widely used in estate planning. Making gifts into trust is a useful way to pass assets out of an estate while still maintaining a substantial amount of control over them.

Be aware

A trust created by a will or intestacy for a minor child of a deceased parent can vest the benefit absolutely in the child between the ages of 18 and 25. If the benefit vests absolutely at age 18, there will be no exit charge. However, the discretionary trust (known as the relevant property) regime will start when the beneficiary has reached 18 years for the purpose of calculating the exit charge.

The maximum charge after ten years is 6% of the value of the trust that exceeds the available nil rate band, but this is reduced according to the number of quarters (i.e. three-month periods) that the property has been held in the trust. So, if the beneficiary becomes absolutely entitled at age 25, the charge will be 4.2% (6% × 28 ÷ 40). If the beneficiary becomes absolutely entitled at age 21, the maximum exit charge would be 1.8% (6% × 12 ÷ 40).

F3A Advantages and disadvantages of trusts

Using trusts in estate planning can have a number of advantages and disadvantages, as shown in the following table.

Table 6.10: Advantages and disadvantages of using trusts in estate planning

Advantages	Disadvantages
• Beneficiaries usually cannot have access to the funds without the trustees' agreement. This might be helpful if a beneficiary is financially unreliable or perhaps involved in marital difficulties. • The funds can be used for other purposes if necessary (e.g. the client's spouse/partner could be a potential beneficiary). • There can be flexibility for tax planning (e.g. the assets could skip a generation). • They can be used to hold assets for the benefit of a minor.	• Trusts can be complicated to understand and may lead to conflicts. • Trusts may be expensive to administer and can only be broken in very specific circumstances. • Trusts can lead to additional income tax, CGT and IHT liabilities, although these costs can be reduced by planning. It is important to understand the main tax rules that apply to trusts.

F3B Disclosure of tax avoidance schemes

Schemes that promote the avoidance of IHT fell into the disclosure of tax avoidance schemes (DOTAS) regime from 6 April 2011. Most schemes in existence prior to this date do not need to have their full details disclosed to HMRC, but all new ones created after this date need to do so. HMRC has expanded the DOTAS rules to impose a more extensive set of hallmarks in relation to IHT planning. Loan trusts, discounted gift trusts and reversionary interest trusts are still acceptable under established HMRC practice, but there is now no specific exclusion from the regime for these trusts.

G Product evaluation, research and selection

Once the adviser has formulated the main financial strategy for a client at a generic level, the next stage is to evaluate and select the most suitable products and providers to meet the client's needs. Effective research and due diligence are central to the financial planning process and provide much of the value in client advice.

Advisers and paraplanners should undertake this research in a systematic and analytical way, taking into account the client's objectives and comparing like-with-like products and services. They then need to document their work clearly and fully.

Increasingly, advisers depend on paraplanners to undertake the research and initial selection process. Good communication between them is very important at the start of the selection process when setting the criteria and agreeing the final selection.

The process of product selection may be for new plans, but often includes the review of a client's existing products to determine their continuing suitability and possible replacement.

Investment solutions generally form a specialised and very large part of the product selection process. This may involve delegating the choice of investment products to a specialist, who could be in-house or in a separate organisation.

Independent advisers should research the whole of the market in seeking the appropriate products. Restricted advisers should research products within their remit.

G1 Main areas of research

Advisers need to undertake research, sometimes called due diligence, into a range of products and services. The criteria they should use for assessment are the closely related issues of cost and general suitability. The financial resilience and administrative competence of providers are also important for all products and services. The main areas for research are detailed in the following sections.

G1A Protection products

The key criterion for selection is likely to be cost, and it is important to ensure that the comparisons are made on a like-for-like basis. Where clients present underwriting problems because of age, health or lifestyle, this will also affect product selection. The financial strength of insurers is an important consideration in making a choice.

Sources of data are widely and easily available to advisers.

G1B Investment funds

Selection of funds should be based on their asset class, markets, income or growth objectives, management style and other characteristics. Cost is likely to be an important criterion for selection, especially for index trackers but also for actively managed funds.

Advisers should take into account the past performance of funds with circumspection, both in terms of investment returns and volatility, or other measures of risk. Past performance can be used as a guide, but it is not a reliable one. Understanding the fund management processes, structures and objectives can help with selection. Structured products are in a category of their own with specific criteria to consider – especially counterparty risk.

Sources of data are widely and easily available to advisers.

G1C Discretionary investment management

Refer to

See *Discretionary investment management* on page 3/34 for more on DIMs.

DIM firms provide a service that allows the adviser to outsource their fund selection and portfolio management activities to specialist firms or departments. Selection criteria should include cost, the DIM firm's ability to match clients' risk profiles in the portfolio management, benchmarked performance against agreed metrics and the quality of the DIM firm's communications with both clients and advisers. DIM firms have different minimum levels of portfolio and a range of service propositions. Most adviser firms tend to deal with no more than two or three DIM firms.

There are relatively few sources of reliable data on the performance of DIMs. Judgments tend to be subjective to a considerable extent.

G1D Tax wrappers and platforms

Refer to
More information on platforms is given in *Platforms* on page 7/4.

The selection of ISA, bond and pension wrappers is usually – but not always – a separate issue from the selection of the underlying funds. Very often, wrapper selection goes hand in hand with the choice of a platform.

- Cost is an important factor, but so are strengths in administration and communications.
- Some clients may have special needs to buy certain funds or types of investment, and this could restrict the choice.
- It is important to recognise that platforms are not appropriate for all clients. Firms tend to choose a limited number of platforms with which they place business.

G1E Product Intervention and Product Governance Sourcebook

The Product Intervention and Product Governance Sourcebook (PROD) is a relatively new FCA rulebook. Its primary aim is to improve firms' product oversight and governance processes.

Under the FCA's PROD rules, financial planners should ensure that they fully understand their client bank. This will enable them to design investment solutions and advisory services that work for their clients and segments of their clients.

On the Web
The PROD rules are available at: *www.handbook.fca.org.uk/handbook/prod/1*.

G2 Consistent product and service selection processes and criteria

Advisory firms have been under pressure from the regulator to provide greater consistency of advice, notably under the previous Treating Customers Fairly (TCF) initiative (now no longer an initiative but seen as 'business as usual' by the FCA – the regulator instead refers to the 'fair treatment of customers'). Many firms have taken steps to centralise their product and service selection processes, or at least provide advisers and their paraplanners with clear and prescriptive guidance. A consequence of this has been the development of centralised investment propositions (CIP).

Refer to
See *Centralised investment propositions* on page 3/33 for further details on CIPs.

Many firms now undertake their research and selection process on a more comprehensive basis, compiling portfolios that match their investment philosophy, selecting preferred providers and/or platforms to deliver that service and undertaking regular reviews of their approach. The result is a more consistent approach; all advisers within a firm have broadly the same focus, and the firm saves time and costs because the analysis does not need to be repeated for each client.

However, the CIP approach will not be appropriate for all clients. Each firm needs a process that allows advisers to go 'off-panel' and source other investment solutions for such clients.

G3 Research methods

When conducting research, there are a number of available sources to support the adviser and paraplanner. Each method will be appropriate at different times.

Table 6.11: Methods to support research

Source	Advantages	Drawbacks
Providers	Usually free to access and dedicated support available to help explain.	Information may not be impartial, e.g. the timeframe of fund performance may be selected to show the best returns.
Press	Usually impartial and also free.	May not cover whole of market and not always sufficiently expert or up to date.
Third-party research systems	Typically independent, expert and comprehensive.	Can be expensive.
In-house research departments	Can focus on the areas of advice most suited to the firm and planners, and is regularly updated.	Not available in all adviser firms, and may suffer from the drawbacks listed.
Face-to-face contact	There is no substitute for meeting the people who run and represent the business – the more senior, the better.	Meetings are time-consuming and may provide little additional information.

G4 Reviewing existing products and services for clients

Replacing an existing product with a new one requires advisers to exercise special care. In general, advisers should recommend the product that best suits the client's needs, taking everything into account, including the costs. However, it may not be worthwhile to replace a client's existing product with a new one if that involves additional initial or ongoing costs.

A client's existing plans are usually analysed in terms of:

- **Structure**. Does the product or service provide the appropriate tax structure for the client? Does it make the most of the client's available tax allowances?
- **Asset allocation and fund selection**. Is the client's investment portfolio invested in line with their investment objectives (e.g. for income) and risk profile? Are there more appropriate funds to switch into? If so, would the costs of switching or CGT charges make this too expensive to be worthwhile?
- **Charges**. Could the existing products be replaced with ones that provide better value, or are more suitable in other ways? Would the costs of switching be worth incurring?
- **Performance**. How have the existing portfolio or individual funds performed on a risk-adjusted basis compared to their benchmarks and sector averages?

G5 Recording and presenting findings

Advisers and paraplanners should record their research and reasons for their recommendations in a way that is clear to both the adviser and anybody else who reviews the file in future. The suitability report should clearly set out the product/service selections and the justifications for them.

Where a paraplanner has undertaken the research and produced the draft recommendations, it is essential that the adviser who is taking responsibility for the advice should clearly understand the basis of the selections. Full documentation is also essential for any review by a compliance specialist, both immediately after the case is completed and in the longer term, when the adviser may have forgotten many of the details or may not be available to provide further background information.

The file should clearly state the client's objectives and the criteria, sources and methodologies used in the research process, as well as the plans that were shortlisted. The records should also explain why the unsuccessful shortlisted products were not chosen. This can be a simple file note, but it must clearly document the steps taken, so that a third party looking at the file would understand the reasoning.

An analysis of existing products often takes the format of a table or spreadsheet to demonstrate a clear comparison between the client's existing products and the proposed new ones in terms of charges, asset allocation, performance, volatility, etc.

H Planning for particular events and circumstances

There are certain common ***life events*** and circumstances in financial planning that need particular attention.

H1 Marriage and civil partnership

Marriage or the start of a civil partnership is a good time for the parties to have a proper discussion about their financial planning. Compatibility in the financial arena is important to the survival of the relationship. Since March 2014, same-sex couples have been allowed to marry in England and Wales. Existing civil partners can convert to civil marriages, if they wish. Civil partnerships were extended to mixed-sex couples in December 2019.

Much will depend on the age of the two parties and whether they have been married or in other long-term relationships before. A full discussion before the marriage/civil partnership with a financial planner is probably the best way to cover the main issues, which include:

- **Merging bank accounts and other assets or keeping them separate**. There may be a joint bank account for joint expenses and separate accounts for other expenses, or everything might be separate or together.
- **Income and expenditure planning**. If the couple has been living together for some time, there may be no great change in their level of income and expenditure. However, in some cases, marriage or civil partnership also involves new living arrangements and new patterns of expenditure. The income position may change as well. The lifetime and other cash flow projections will probably need to be recast.
- **Wills**. Now is the time to make a new will, possibly in contemplation of the marriage or civil partnership. Any existing will that was not made in this way is nullified by the marriage or civil partnership ceremony.
- **Spending and saving**. Attitudes to spending and saving should be discussed early, with a full consideration of financial goals, including buying a home, children and their education, investment issues, business and career ambitions, retirement and estate planning. Some people spend more than they earn, some break even and some save a lot of what they earn. Compatibility, or at least an understanding of each other's financial behaviour in this area, is also important.
- **Financial protection**. The parties should discuss what life and health insurances they need, and how much they are prepared to pay for them.
- **Domicile**. Where one of the spouses is not UK-domiciled, the death of the other spouse could have IHT implications. Life assurance for the potential IHT based on the value of the home and any other assets would be prudent. The non-UK-domiciled spouse could consider setting up an excluded property trust for non-UK situated assets for the other spouse and children, etc. to move the assets held within it outside the scope of IHT on a very long-term basis.
- **Pre-nuptial agreements**. Marriage, civil marriage or a civil partnership involves both parties expecting the relationship to last for their lifetimes. However, from a legal point of view, this is the best time to consider the financial and other issues that might arise if the relationship breaks down, even though, from a romantic point of view, such discussions can be destructive. Pre-nuptial agreements are increasingly falling under the consideration of the courts, following recent legal precedents.

H2 Divorce and civil partnership dissolution

A financial planner can be of considerable help to a separating couple – or, at least, to one of the parties. The key relationship is likely to be with the lawyer, but the financial planner may also be very important.

Areas in which the financial planner may be involved include:

- **Income and expenditure planning**. Both parties will be faced with new patterns of expenditure and the income position is likely to change. The lifetime and other cash flow projections will need to be recast.

- **Valuing investments and splitting them where this is required**. This will involve reinvesting funds to meet the new circumstances of the client. In many cases, the need will be for more income.
- **Valuing pension entitlements**. The planner may need to advise on the most appropriate course of action between offsetting, splitting or a pension attachment order, depending on the circumstances and the party the planner is advising.
- **Rearranging mortgages for house purchases**.
- **Rearranging life and health insurance**. It is important for an ex-spouse/ex-partner who is being financially supported or who is mainly responsible for the upbringing of the children that the party providing the support has enough life and health insurance.
- **Rewriting the will**. It will also be important to change any EPAs or LPAs where an ex-spouse/ex-partner may be an attorney.

Activity

Jane and Rod have just separated and are in the process of getting a divorce. In their current wills, they leave everything to each other on first death and then to their two children on second death. How will their divorce affect their existing wills?

Visit *www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm12075* if you need help with your answer.

H3 Relationship breakdown

The position regarding a relationship breakdown is very similar in principle to a divorcing couple or the dissolution of a civil partnership. The same issues of property splitting arise, but:

- The dependent partner has far fewer rights than a spouse/civil partner in the same position.
- The range of options for dealing with pension rights is more limited in most respects than with a divorce or dissolution.
- There may be CGT consequences on passing over assets from one party to the other (e.g. for investments or property).

H4 The birth or adoption of a child

The birth or adoption of a child is a major financial event in a household, and many of the preparations should take place before the event if possible.

- Couples not in a legally recognised relationship should consider the advantages and drawbacks of marriage or civil partnership from a financial point of view. The tax and legal positions of couples in legally recognised relationships are generally – although not in all respects – more advantageous. The main advantage is on assets passing between spouses/civil partners, as these are IHT-free where they are both UK-domiciled. Assets passing between spouses/civil partners who live together do not attract CGT at the time they are transferred.
- The family will have additional expenses and probably a reduction in income at least for a time while one of the parents (or possibly both) stay at home to look after the child.
- It is worth compiling a short- and long-term budget for the often very considerable immediate expenses, and then the longer-term implications for maintaining and educating the child. On the basis of the income and expenditure budgets, the financial planner should draw up a new lifetime cash flow.
- A new child will almost certainly mean the need to review the family's life assurance and health protection needs. The prospective parents should aim to take out the additional cover as soon as possible.
- There might also be a requirement to move home to a larger property, possibly needing a larger mortgage.
- The wills should be made or reviewed if the parents have not already done so. The intestacy rules may be acceptable for married couples/civil partners, but if the couple is not married or in a civil partnership, the surviving partner may not benefit at all under the intestacy rules. It is also important for the child to have a legal guardian if both parents were to die; such a person should be nominated in the will.

H5 Helping a grown-up child to buy a property

Parents, and indeed grandparents, are increasingly being called upon to help otherwise financially independent children buy their first property. According to Saga, around 60% of first-time buyers get help from their parents. The help offered might include:

- buying a house for a child to live in or becoming co-owners of a property with their child;
- giving or lending their child the money needed to buy a house;
- mortgaging their own home to release funds to give to their child, perhaps via equity release;
- guaranteeing their child's mortgage loan by having parental income taken into account when determining the amount that can be borrowed or allowing a charge to be placed on their own property as security; or
- using a family offset mortgage.

Whichever method is chosen, care should be taken to ensure that the client understands the implications of what they have agreed to. For example, where a guarantee is made, the client should consider what would happen in the event of the child defaulting and the guarantee being called upon. This may have a serious impact on the parents, their standard of living and any plans they might have for the future.

Where a child is gifted the money, perhaps as an advance on their inheritance, the parents might like to amend their wills to ensure that any other children they have who have not received such help receive a greater proportion of the estate on death. A note should be made of the date and amount of gift for IHT purposes.

Consideration should also be given to what will happen to the child's mortgage in the event of the parents dying. Life cover may be a solution here – providing the funds to pay off the mortgage in full in such circumstances. The policy should be written in trust, for the benefit of the child.

Where a loan is made to a child, to avoid potential fall outs in the future, it might be best to draw up a loan contract stating repayment terms, the interest payable and the timescales. Parents should consider whether they can afford to make the loan and what will happen if the child does not pay them back. The loan should be protected in the event of the death of the child, with the policy being written under trust for the benefit of the parents.

H6 Inheriting a lump sum or a property

People who benefit from a substantial inheritance should consider their position with care. Such an event could transform the beneficiary's financial position, but they usually need impartial advice from a financial planner to help ensure that they make rational choices.

Ideally, the client should reconsider their aims and goals in light of the greater financial freedom, leading to the financial planner's production of a revised lifetime cash flow. The client's income and expenditure could be affected immediately, or the client could decide to provide for the future, depending on their priorities.

Even if the inheritance has already been taken into account in the pre-inheritance cash flow projection, the certainty of receiving it, as well as its timing and value, would now be set and should usually have an impact on improving the projections.

H6A Endowment effect

The financial planner should emphasise the importance of investing the inheritance in ways that are suitable for the client rather than simply retaining whatever assets they have been left in their current form. The person who made the bequest would probably have had different needs and wants, and would have lived in different circumstances.

There is a real danger that clients will want to hold onto the assets they have inherited simply because they have inherited them, rather than because they want them for any other purpose. Behavioural finance experts call this well-known phenomenon the 'endowment effect', and experiments have shown that it affects many people. The explanation for the endowment effect is complex and amounts to much more than sheer inertia, often reflecting regard for the person who left them the asset.

It is important to explain to the client that this is a very common emotional response and that if it really makes sense to continue to hold the investment or property, then they should do so. However, they should try to look at the issue in a rational way. The questions to ask relate to whether the client would have decided to buy the asset or investment if they had just been left cash. For example, do the assets help the client meet their own investment objectives, perhaps by increasing diversification or the potential for long-term growth and/or income? If so, then it may be worth keeping them. On the other hand, if the asset adds to their investment risk, does not match their own attitude to risk or exposes them to additional types of risk, such as currency or credit risk, it may be better to encash the assets and reinvest the proceeds in an investment that is more in keeping with their own investment objectives.

H6B Risk

Another danger is that the client takes too much – or sometimes too little – risk with the inheritance. Some clients may be tempted to take an 'easy come, easy go' gambling approach to having excess funds suddenly and take large risks by investing in new businesses, property ventures or other projects.

H6C Choice of strategies with inheritances

Any inherited investments or property should usually be sold, and the proceeds used to meet the client's real needs based on their circumstances and aims.

Depending on the amount involved and the stage in life the client has reached, the impact on their affairs could be:

- repayment of the mortgage;
- a fund for paying school fees;
- the building up of substantial retirement funds;
- the purchase of a larger home or another property;
- starting a business; or
- early retirement.

H6D Lump sum or periodic payment

Where a client has a choice of taking an inheritance or other form of settlement as either a one-off lump sum or a regular payment, there are a number of factors to consider, which are outlined in the table that follows.

Table 6.12: Settlement – lump sum or income

Source	Advantages	Drawbacks
Lump sum	• Immediate receipt of funds. • Control over how money is invested. • Not reliant on income provider to make timely payments. • Cannot be reclaimed by income provider on early death.	• Money received as a lump sum may be less than the income option. • Money might be spent too quickly. • Recipient bears all the investment and inflation risk. • Adds to the recipient's estate and may push them over the nil rate band threshold.
Income	• May live longer than expected and receive a greater total sum. • Income provider bears investment and inflation risk. • May be able to inflation-proof income. • No impact on recipient's estate if income is spent rather than saved.	• No access to capital sum in the event of a capital need. • Reliant on income provider for income. • Income likely to stop on death of recipient. • Inflation-proofing may have limits.

H7 Death of a spouse or partner

The death of a spouse or a civil or unmarried partner can have considerable financial consequences, depending on the age of those involved and the general circumstances.

Where the financial planner is asked to help after a bereavement, the client may or may not be new to the firm. If the deceased was a client of the firm, the survivor may or may not have been closely involved in the relationship with the financial planner. Whatever the circumstances, the client is in a new financial relationship with the planner and, in many respects, should be treated as such. It is likely the financial planner will need to spell out the key issues of financial planning and what the client can expect from the firm.

As with any client, the first financial planning task is to discover the facts of the situation, before going on to deal with the decisions and problem-solving. The key issues are:

- **The new personal circumstances**. In particular, where the survivor and family intend to live. In some circumstances, there may be more than one set of beneficiaries and family members to take into account, especially if the deceased had been married more than once or had several long-term relationships.
- **Disposal of assets**. These may have been the subject of a will, intestacy, an existing trust or the ownership of assets under a joint tenancy. The ownership of the home is a particular concern.
- **Adequacy of provision for the survivor and other dependants or claimants**. The most urgent issue is whether the survivor and any other dependants have enough to live on and meet all commitments after taking into account the deceased's liabilities. Key items will include:
  - pension scheme death benefits, both lump sum and survivor pensions, and who they have been left to;
  - the survivor's own continuing earnings or pension income;
  - proceeds of life policies;
  - investments and other property;
  - rights of the survivor and other dependants under trusts; and
  - ownership of any business assets and whether any ongoing business will continue to be viable without the participation of the deceased.
- **Deed of variation**. It may be advisable to change the provisions of a will or the outcomes of intestacy. This has to be done within two years of the deceased person's death if HMRC is to treat it as if the transfer of the asset(s) had been made by the deceased. It is generally very difficult if the rights of a minor are being varied. For a deed of variation to be effective, the following conditions also apply:
  - it must be reported to HMRC within six months;
  - all the original beneficiaries must be over the age of 18 and of sound mind;
  - it must not be made for any consideration in money or money's worth;
  - it must be in writing and signed by all the beneficiaries who would lose out;
  - if the amount of IHT due will increase as a result of the variation, the legal personal representatives must also sign to indicate their agreement;
  - it must clearly state the inheritances that are being changed and how they are being altered; and
  - the same inheritance cannot be varied twice.

  Providing the conditions have been fulfilled, the original beneficiaries will not be treated as having made a transfer of value.
- **Financial capability of the survivor**. Sometimes, the survivor has very little understanding of investments and financial issues generally, and has not been involved in the family's or couple's financial decision-making. The financial planner may need to approach such a person's financial planning and risk profile very differently than when the deceased was the client. It may well require a change of plan from the original approach envisaged by the deceased.

H8 Need for short-term finance

Where a client is in need of short-term finance, it is important to have the requisite permissions to provide this kind of advice. This may be the province of a specialist adviser, but the financial planner may wish to retain an overall watching brief and consider the following steps:

1. Define the level and duration of the need. It is usually advisable to ensure that the maximum requirement has been quantified. Going back for further finance is often more expensive and less likely to be possible, as it may demonstrate a lack of planning.
2. Check that the client will be in a position to repay the loan, otherwise strongly urge the client to find another way to deal with the situation.
3. Check that there really are no immediate sources of finance. There might be assets that could be encashed or borrowed against on highly advantageous terms (e.g. as is still the case with a few old life policies from certain companies). There might be family members who can help. Employers may be forthcoming in some circumstances. The client might be a beneficiary under a trust or qualify for a government initiative.
4. Seek the most inexpensive form of borrowing, taking into account all the costs. In some cases, for a small and rapid source of finance of short duration, the client could even borrow from credit cards. It may be worth adding to the mortgage to save costs, but it should be remembered that the loan will then be secured on the client's home.

When the loan has been repaid, it is worth impressing on the client the benefits of having adequate liquid resources to meet emergencies.

H9 Redundancy

The financial planning for a client who has lost their job will vary considerably depending on the wide range of possible circumstances that could apply.

The crucial issue is generally how quickly they are likely to be re-employed. A few clients may have sufficient assets that will allow them to not need to work – for them, the considerations are very different from those of the majority. Some may be rightly confident of being recruited very quickly.

It is often difficult to assess how realistic a client is being about their job prospects. It is generally prudent to assume the worst and have a series of steps mapped out depending on their progress. These steps should be agreed as early on as possible so that the client can prepare themselves and the family for what may happen. They could involve economising on expenditure, the other partner working more, selling assets, selling the home and taking early retirement (for those who are old enough to take this option).

Example 6.8

Len and Sonya
Len has been made redundant with a settlement of three months' salary. As a qualified human resources manager, he believes he will find another job reasonably quickly at roughly the same salary he was earning with his previous employer. He has two children at private day schools and his wife Sonya works part-time for the council. The couple has some cash reserves, but the financial planner's projection of income and expenditure shows that the situation will be tight. The projection is based on Sonya's earnings, assuming she can go full time or, if that is not possible, on State benefits, their savings and the proceeds of the redundancy settlement.

With their financial planner, they work out the following programme of possible actions if Len does not find replacement work.

Immediately
Economise on household expenditure and deal with debt:

- Cut costs as far as possible, e.g. no more eating out, cheaper food and stop the household help/cleaner.
- Cancel overseas holiday plans.
- Pay off all credit card and consumer debt.
- Inform the mortgage lender and explore the possibilities of temporarily switching to an interest-only mortgage or extending the term.

As soon as possible
Sonya takes on full-time work.

After six months
The children leave their private schools.

After one year
The family aims to sell the house.

Other financial planning
Len's previous job came with a number of benefits, and his financial planner discussed these with the couple:

- He had an occupational DC pension scheme. Following the financial planner's recommendations, the plan is assigned to Len and converted to a SIPP.
- The life cover and income protection ceased. The financial planner arranged the cheapest possible short-term life cover. Against the financial planner's advice, Len did not take out a replacement income protection plan.
- Len previously had a company car, but the couple decided not to replace it and use Sonya's car instead.

H10 Serious illness

Planning for a client who has a serious illness during their working life will depend on the nature of the illness and the overall circumstances. Generally speaking, the problems will be unemployment plus ill health.

There will usually be the following main issues.

The prognosis for the illness
This involves the stages of the illness and when/if the client is likely to recover. If the client seems likely to recover and go back to work, it is important to gain some indication of the likely timespan.

If the condition is long term and the client will almost certainly be permanently affected, the planning will be different and may involve obtaining early access to the pension fund if possible.

With many situations, the prognosis may be uncertain. For example, the chances of surviving for many years following a heart attack are much better than they used to be. Doctors may be reluctant to make predictions about a patient's life expectancy or recovery chances. Even where they are prepared to make some kind of estimate, it is bound to be approximate and may turn out to be wholly inaccurate.

The client's work situation
The client may have an employer who is prepared to provide long-term sickness pay and may ultimately be able to take the employee back after the illness if that is appropriate. At the other end of the spectrum is the client who is either self-employed or an employee of a company that only provides Statutory Sick Pay.

The chances of re-employment
If the client is likely to recover, how likely are they to get a new job?

The financial circumstances can vary very widely indeed. Some clients are well provided for with IPI and might have a condition on which their CIC policy pays out. If they have built up adequate assets for retirement as well, planning will essentially involve creating a portfolio that generates an adequate level of lifetime income.

In most cases, it will be necessary to make considerable economies of expenditure for redundancy, along the lines of those shown in the example of Len and Sonya (see Example 6.8 on page 6/43). As in those circumstances, it is generally desirable to make the adjustments to expenditure as quickly as possible.

H11 Entry into long-term care

Generally, people enter long-term care in their 80s or later, but it can happen much earlier in life. It is often hard to predict how long a client who enters a care home will continue to live, yet that would probably be the most important information for the financial planner to have.

A significant aspect of the case from the very start will be the client's financial aims. Some clients focus on making sure that the State pays for their long-term care. This is a specialist area, which is outside the scope of this text, and is difficult for a client who has significant assets.

Other clients are keen to not only spend their final years in comfort, but also to make sure that their finances last as long as possible and, preferably, to have some left over to leave to their relatives.

Most clients have some pension income, some investment assets and one or more properties. The costs of long-term care homes are very often substantially more than the client's income could possibly cover. The challenge, therefore, is to use up capital year by year and invest it in such a way that it is secure but provides a reasonable return:

- **Cash deposits** have generally been widely used and are probably unavoidable to some extent. However, cash deposit yields fluctuate considerably and, at the time of writing, are generating very low returns.
- **Gilts and fixed-interest investments** may generate higher incomes than cash, but the capital values are not reliable unless they are held to redemption. Zero dividend preference shares offer relatively secure returns, but they may be considered too risky in volatile markets and the timing of maturities is irregular.
- **Equities** hold the prospect of long-term growth but are very volatile in the more important short term.
- **Property** may provide reasonable levels of income, although it is not necessarily dependable. In addition, disposing of a property may take longer than expected, and a loan on the security of the property may be possible.
- **A purchased life annuity (PLA)** is generally the most reliable way to turn capital into a lifetime income, with much of the regular payment free of tax because it is treated as capital. At current yields from annuities, all or virtually all the payments from a PLA will be treated as capital. People going into a care home may well qualify for an impaired life annuity, providing higher than normal returns. It is also generally possible to provide capital protection for annuitants. This means that if they die before the gross annual payments equal the purchase price of the annuity, the balance of the purchase price will be returned. An extension of the PLA is an immediate needs annuity where the payments are paid directly to the care home, thereby tax free and not affecting any entitlement to State benefits.

  Nevertheless, most clients are very reluctant to buy annuities. Conventional lifetime annuities are inflexible and the death benefits are generally poor.

Clients most often want to hold onto their assets as long as possible, making some adjustments to reduce the risk by investing in fixed interest assets and selling their homes as late as they can.

It is important to arrange for the client to set up and register an LPA as soon as possible, ideally before going into a care home, and certainly well before they are in danger of losing physical and/or mental capacity.

I Explaining and justifying the recommendations

A financial plan must be set out in a report for the client. Writing an effective report is therefore at the heart of compiling a successful plan. In most cases, the report should provide the main agenda for the meeting, in which the advice is provided orally.

- Clients increasingly expect to see reports from financial planners.
- The FCA expects financial planners to produce ‘suitability’ reports.
- Research by the FCA has revealed that clients place considerable weight on the suitability report’s contents.
- The report will be the focus for the briefing of other professional advisers involved in the client’s affairs, as well as, where appropriate, other members of the family.
- The report provides a permanent reminder of the strategy and detailed recommendations, which otherwise might be forgotten or become distorted by memory.

In the past, firms have generally not charged separately for the specific work involved in preparing the plan and the report that sets it out for the client. Increasingly, however, the client is expected to pay for the production of the plan and the client report even if they decide not to implement it. There is therefore often an explicit charge for this work. The client might have to pay for this separately, or it might be payable if the client does not go ahead with the recommendations that generate various fees. However, if the client report is to be paid for, it is very important that the client understands the position in advance of the firm undertaking the work.

In many cases, it is not possible to immediately carry out all the recommendations contained in a financial plan. The report, with suitable updating and amending, provides the long-term plan for action. It also outlines an agenda to which both the client and the financial planner can return in the future, and revise in the light of changed needs, aims and circumstances.

I1 Functions of the report

The main functions of the report are to:

- set out the current position of the client;
- set out the client’s objectives; and
- make recommendations about how changes should be made in order to achieve the objectives. This may or may not include the sale of financial services products.

The aim of the report is that clients should understand the position they are in and the recommendations being made, and then agree with the recommendations. If the client does not read, understand and agree with the main aspects of the report, it will not be effective.

I2 How to make the report effective

Many people find reading about financial matters unfamiliar and difficult. It is therefore important to make sure that the report is attractive and easy to read, paying particular attention to:

- logical structure;
  - introduction stating the purpose of the report;
  - the client’s current position;
  - the client’s aims and needs;
  - recommendations;
  - review procedures and further work; and
  - revisions, review and monitoring;
- economy of length;
- accessible language; and
- attractive layout.

I2A Logical structure

The client will find it much easier to read the report if it follows a logical order and structure. There is no single set order that should be followed for all clients and all situations.

One possible template for most reports is presented here:

Introduction: the purpose of the report
The client needs to be clear about the aim of the report:

- In general, most financial planners' reports provide advice and recommendations about clients' financial positions.
- If there are particular areas about which the client is or should be concerned, these could be mentioned briefly at this stage, in order to provide a degree of focus to the report.
- The introduction might also be a good time to introduce the concept of financial planning and the main steps.

The client's current position
The starting point for any recommendations is the client's current financial position. This should be set out clearly and succinctly, so that the financial information is easy to follow:

- Where possible, information should be set out in tabular form to ensure that the figures (and especially their inter-relationship) are apparent. Notes about individual items can be set out below the tables to provide additional detail.
- Generally, it is worth dividing up the main aspects as follows:
  - assets (what the client owns);
  - liabilities (what the client owes);
  - estate planning and IHT;
  - current cash flow;
  - lifetime cash flow projection; and
  - contingent cash flows (e.g. on death or incapacity).
- There may also be additional aspects that should be taken into account, such as ill health, an overseas perspective, or a business or tax problem.
- Where there are complicated schedules (e.g. of detailed investments), these could be set out at the back of the report, so that they can be referred to if necessary. Only the outline of the information (e.g. the main sector allocation) should be retained in the main body.
- There may need to be a detailed explanation of a particular aspect of a client's affairs (e.g. the CGT position of a property might be relatively complicated). This could be covered in a special section, either in the main body of the report or the relevant appendix.

The client's aims and needs
After setting out the client's current position, the report should then identify their various aims and needs. The client's risk profile must be noted and a statement of how recommendations have been selected in line with their stated attitude must be shown.

A typical report covers the main issues under the following needs and objectives:

- current cash flow needs;
- mortgage needs;
- protection issues;
- retirement income;
- investment; and
- estate planning.

Recommendations
The next part of the report usually contains the recommendations in each of the areas where needs have been established:

- In many cases, the recommendations will be backed up by product details and projections, providing much of the detail of the specific recommendations. The purpose of the descriptions in the report is to:
  – provide an outline that makes the brochures easier to digest;
  – put the products into the context of the client's needs and objectives; and
  – provide the client with the potential disadvantages of the product or strategy as well as the advantages.
- There are also bound to be large parts of the report that are not concerned with particular products. For example, a recommendation might be to rearrange the ownership of some assets in order to gain an income tax or CGT advantage. These recommendations need to be sufficiently comprehensive for the client to understand the detail, yet written in a readable and accessible format.
- The order of this section of the report usually follows the sequence established in the needs and aims section.
- The recommendations should be drawn together in a tabular summary. This makes it easy to discuss the issue of balance between the various elements of the recommendations.
- All costs incurred in the recommendations must be set out clearly in both percentage (%) and monetary (£) terms. While these will be sent out in the accompanying illustration, a summary may also be included in the report.

Review procedures and further work
The report should conclude with a summary of the basis on which further work is to be conducted, in terms of additional meetings, consultations with other professionals, reviews and the basis of remuneration (however, the charges for the work carried out to date should have been established before the report was started).

Refer to
Implementation and review is dealt with in greater detail in chapter 7, starting with *Implementation of the plan* on page 7/2.

Revisions, review and monitoring
The report should emphasise the importance of keeping the plan under review because of the client's changing needs and circumstances, as well as the evolving financial environment. The assumptions on which projections have been made may change, together with markets, laws, tax and the economy generally.

I2B Economy of length

There can be a substantial amount of information to convey in a report to a client. If it appears that the report is becoming overwhelming because of its length, it is worth re-examining the contents to see if:

- more text could be taken out of the main body of the report and put into schedules or appendices – this would help to make the main body of the report more digestible;
- the report duplicates detail that is adequately covered in the brochures and key features documents that must be provided to the client; and/or
- the writing is more long-winded than is strictly necessary. It often takes more time to write a concise summary than a rambling description that strays from the point.

I2C Accessible language

It is essential that reports are written in language that clients will understand and find easy to read:

- Jargon is very convenient for financial planners. It can express ideas very succinctly and clearly – but usually only to other professional advisers in the same area of activity. Clients do not understand most jargon and resent it when it is used in reports intended for them. It is best to avoid jargon wherever possible. Sometimes it is not possible to avoid technical words; in these circumstances, it is important to explain the technical word clearly and always give the full meaning of any acronyms used.
- Pompous language should be avoided. It is always better to 'use' (not 'utilise') a short word instead of a long word, if both words have the same meaning.
- Most people find it easier to read short sentences and reasonably short paragraphs. They also respond well to diagrams and graphs, which help them to understand the recommendations being made.

I2D Attractive layout

The way that a report is laid out helps to make it easier to read and more effective in conveying the relevant information and recommendations to clients:

- Headings help readers see where they are in the document and remind them of the point being made.
- Breaking up the report into clear sections makes it less intimidating.
- Setting out quantitative information in tables is far easier to follow than a narrative.
- Diagrams, graphs and charts illuminate important trends not apparent from rows of figures.
- A clear summary is important to ensure that clients genuinely appreciate how the whole financial plan fits together.

Consider this…

Compare your own business's suitability reports/financial planning reports with the suggestions outlined here. How do your reports compare? How do you think you could improve them?

I3 Financial planning reports and suitability reports

The financial planning report should also act as the suitability report required by the FCA where the client is being recommended to buy financial products.

In some cases, it might be appropriate to reissue the financial planning report with the necessary amendments so that there is a permanent record to return to in the future, while issuing a cut-down suitability report for immediate consumption to save the client having to wade through a full report again.

I4 Revising the plan to meet client views

Once the client has received the 'final' plan, there may need to be further changes. In some cases, it is only after they have seen the whole presentation that they can come to conclusions about their priorities. This may especially be the case where there are several different areas for action, and the client can see the respective costs and benefits of each course of action.

Example 6.9

Clive

Clive has been presented with the following list of actions:

- save for retirement through his pension scheme at the rate of £1,000 a month gross, £600 a month net (although basic- and higher-rate tax relief are obtained in different ways);
- provide additional life cover at a cost of £55 a month; and
- provide IPI at a cost of £70 a month.

After seeing the extra benefit that he will get from the IPI compared to the costs of having more pension, he decides that IPI is a higher priority than he originally thought and reduces his proposed increase in pension contributions by £50 a month net.

This needs to be documented in a revised suitability report.

I5 Providing financial planning answers under exam conditions

Exam conditions are artificial in a number of respects, partly because of the time constraints and the limit on the computer and other resources that are usually available to a working financial planner. Instead of requiring candidates to provide complete financial plans, the R06 exam usually focuses on asking questions about specific aspects of a case. These may relate to the overall strategy or more specialist areas.

Some questions need to be answered as if they were part of a report to a client, and the instructions in the exam paper will make that clear. In such cases, it is important to phrase the answers in a way that the client would understand. In other questions, it is important to be clear and logical. Bullet-style answers are generally required and widely used technical terms, such as ISA and SIPP, are acceptable.

Case study: John and Margaret Williams – recommendations

Based on the summary and analysis, John and Margaret would like to have recommendations for financial planning.

The position after the summary and analysis stage

Margaret would prefer not to go back to work until the children are both at junior school at the earliest, in about five years' time. However, she may be prepared to start sooner, perhaps on a part-time basis, if it were really necessary.

John and Margaret are very confident that John will be able to earn about £15,000 a year after expenses, but they would not want to depend on him earning more than that. They think it would be prudent to assume that this will last about seven years.

They feel, on reconsideration, that they can cut about £14,000 a year from their current expenditure with some certainty. So, the projected cash flow summary (figures rounded) for the first full year after John stops being employed (based on 2022/23 tax rates) is:

	£	**£**
John's gross income	33,000	
John's net income		28,433
Margaret's gross income incl. Child Benefit	16,885	
Margaret's net income		16,339
Total net income		**44,772**
Less current expenditure		**51,155**
Plus estimate annual reduction in expenditure		14,000
Net positive cash flow		7,617

School fees

In addition, they will have to pay school fees until Margaret goes back to work, which are estimated to be:

Academic year	**£**
2023/24	5,775
2024/25	12,128
2025/26	15,628
2026/27	19,448
2027/28	20,421
Total	**73,400**

The estimated fund required to generate these is £66,494.

Questions

1. John and Margaret have a choice of either:

- drawing on their cash reserves to pay the school fees over the next five years and postponing drawing on the pension scheme; or
- paying off the £53,000 mortgage and starting to draw on the pension now for the PCLS from about half the value of John's overall pension fund, i.e. £270,000. Note that John decided to consolidate his various schemes into two separate schemes.

They would like to have a list of the advantages of each strategy, and a recommendation.

2. John and Margaret have asked whether it would be prudent to sell Margaret's investment property and reinvest the proceeds in a range of funds based on the agreed asset allocation. What would be the main advantages and disadvantages?

3. The model asset allocation that has been produced for John and Margaret is 50% fixed interest, 40% equities and 10% property. In the light of their circumstances, is this the asset allocation that should be recommended for their pension portfolio?

4. John has decided to draw on half of his tax-free PCLS now and leave the balance of the crystallised fund in flexi-access drawdown to accumulate. He intends to start drawing on the remaining funds in about five years. He has to think about whether he will then be likely to buy a conventional annuity or take withdrawals from the flexi-access drawdown fund:

a. What issues should he take into account in making the choice between a conventional annuity and flexi-access drawdown withdrawals?

b. What are the main alternatives?

c. What difference, if any, would the decision make to the investment strategy for the crystallised benefits for the next five years?

5. You have obtained the following quotations for life assurance, income protection insurance and critical illness insurance for John and Margaret:

- the maximum income protection insurance that a non-earning homemaker can have is assumed to be £200 a week; and
- the maximum income protection insurance in relation to earnings is assumed to be 60%.

Life assurance monthly premiums for John – sum assured £100,000

Term	**Level term £**	**Convertible term £**	**Critical illness with term assurance £**
To age 65	35	–	206
10 years	48	68	–
15 years	62	89	–
20 years	74	110	–
Whole life	230	–	–

Life assurance monthly premiums for Margaret – sum assured £100,000

Term	**Level term £**	**Convertible term £**	**Critical illness with term assurance £**
10 years	7	9	30
15 years	8	10	42
20 years	9	11	44
To age 65	10	13	46
Whole life	73	–	–

Income protection insurance for Margaret – £200 benefit a week

Deferral period	Level benefit to age 60	Level benefit to age 65	Indexed benefit to age 60	Indexed benefit to age 65
	£	£	£	£
4 weeks	70	90	100	135
13 weeks	35	48	46	70
26 weeks	25	32	34	44
52 weeks	20	26	27	36

The income multiples that can be used for the purpose of calculating lump sum life assurance needs are:

Income multipliers

Period	Factor
5 years	5.0
10 years	10.0
15 years	14.5
20 years	18.5
25 years	22.5

a. John and Margaret have now decided that they need life and health cover on Margaret's life for the 20 years that the children are likely to be dependent on them. What is the case for having a longer term?

b. Calculate how much life assurance and critical illness insurance Margaret should have. They have calculated that if Margaret were to die, there would be little or no saving on the expenses that she incurs. John has decided that if Margaret died or were seriously ill, he would have a long-term need for about an extra £35,000 a year in real terms and the children would need about £15,000 a year plus the cost of the school fees. Assume John could obtain 4% net return from his pension fund. Margaret has agreed to take out the maximum amount of income protection. The maximum that the insurance company will provide as critical illness insurance is £300,000.

c. What life cover would you leave in place on John's life?

d. What policies would you recommend from the above? The overall protection budget is £3,000 a year excluding the private medical insurance. Preferably, it should be less.

Answers

1. **Postponing drawing the pension fund**
   - Any growth would take place in the tax-free environment of the pension fund, which should provide a higher return than the majority of investments held directly.
   - Any growth in the fund would increase the PCLS sum, so a proportion of the fund growth would be tax free.
   - The pension could be greater than it would be if drawn immediately, because the fund generating it should have grown and the (joint) annuity rate should be higher as the couple will be older (although this cannot be guaranteed).
   - If John died before drawing on the pension fund and before age 75, the entire fund could be paid out to his beneficiaries with no tax charge. If he dies aged 75 or over, then the fund would be subject to the beneficiary's marginal rate of income tax. This would be the case whether it is paid out as an income or as a lump sum. It should also be outside his estate for IHT purposes.

   Advantages of paying off the mortgage and drawing on the pension fund
   - The immediate rate of return would be the interest rate saved on the mortgage of 3.99% (4.99% gross for a basic-rate taxpayer and 6.65% gross for a higher-rate taxpayer). This is a risk-free high return.
   - The pension fund might be able to generate such a return, but not on a risk-free basis.
   - It is only necessary to pay out the tax-free cash from the pension fund. The rest of the fund can remain invested to generate a higher income/annuity return in, say, five years' time.

Recommendation

- Pay off the mortgage with the cash available now.
- Draw on the PCLS from the pension fund immediately or in annual tranches.
- Postpone further withdrawals for at least five years.

2. **Advantages of selling the property**
   - Selling would reduce their excessive exposure to property, which is 64% of their total assets of £1,753,600.
   - The new portfolio would provide them with more overall balance in the asset classes.
   - The investments are undiversified and the risks are: a fall in property prices, either due to economic activity in general or to a localised issue, such as development plans for a new road or airport runway; void periods; the possibility of unreliable tenants; and unexpected and uninsured costs.
   - Equity-based investments are generally more liquid and accessible.
   - John and Margaret would be able to invest in more liquid assets, where it is easier to make use of the CGT annual exempt amount.

   Disadvantages of selling the property
   - The costs of the transaction, leaving less money for reinvestment and income generation.
   - The potential CGT liability, leaving less money for reinvestment and income generation.
   - The difficulty in finding alternative investments that should broadly keep pace with inflation.
   - The yield on this property is higher (7.5%) than the yield on John's property (6%), meaning it will be harder for another investment to achieve this return.
3. **Asset allocation**
   - Apart from investment property, John and Margaret have very few assets outside the pension scheme, so, in principle, the overall asset allocation profile should be applied to their pension portfolio.
   - However, with their high exposure to property outside the pension scheme, the recommendation is that they should not buy more investment property, even in a different form.
   - The proportion of the recommended portfolio that is allocated to property should be distributed equally between fixed interest and equities, i.e. 55% fixed interest and 45% equities.
   - With the short timescale of five years until benefits are drawn, it may be worth holding some of the assets in cash deposits rather than fixed interest if that would generate higher secure returns.
4. a. **Conventional annuity vs. flexi-access drawdown**

   Conventional annuity
   - The conventional annuity provides a guaranteed income for the remainder of John and Margaret's lives. Unlike payments under flexi-access drawdown, an annuity can never run out, although it can now be reduced in certain pre-agreed circumstances.
   - The income is guaranteed and secure.
   - Inflation protection can be included, but this will mean the initial income is greatly reduced.
   - Capital protection can be included in the annuity to provide additional death benefits in the early years of the plan, although this would diminish the annual pension income.
   - The benefits from the annuity are enhanced by the cross-subsidy from early mortality.
   - John and Margaret would probably not benefit from the additional income from an impaired life annuity.
   - A joint life and survivor annuity for both John and Margaret may seem very expensive because Margaret, who will still be in her 30s at the time of purchase, is very young to buy an annuity.

- Death benefits would include a widow(er)'s pension and the balance of any guaranteed payments.

Flexi-access drawdown

- The level of income can be varied to meet their requirements, which, in this case, may change from year to year.
- The investment returns required to match the returns from a conventional annuity require that the fund invests in relatively high-risk asset classes.
- There are no guarantees that the fund will continue to provide an adequate income or last the length of their retirement.
- The fund is exposed to the dangers of sequencing risk and reverse pound cost averaging.
- The costs of the arrangement are typically relatively high.
- The death benefits are likely to be better.

b. **The alternatives**

The main options are:

- secured income investment-based annuity – either unit-linked or with-profit;
- flexi-access drawdown;
- taking an UFPLS; and
- buying a short-term annuity.

c. **How the choice affects the immediate investment strategy**

- If the aim is to invest in an annuity, the investment fund would have to be very short-term and low risk. The timescale would be five years, and the selection would have to be for cash or short-dated high-grade fixed interest funds, holding either corporate or government bonds.
- If the aim were to continue with flexi-access drawdown after five years, it would be possible to take a longer-term view and therefore a higher-risk approach to investing the fund.

5. a. **Term**

- John might well live into his 90s – i.e. for 30 to 40 years. If he were dependent on Margaret to look after him, her death would cause a substantial financial loss.
- There is a case for a 30- to 40-year policy on her life or even a whole life policy.
- Convertible term assurance might also provide the solution, so that the term policy could be converted to a whole life if required.
- The disadvantage of convertible term compared with ordinary level term is the extra premium cost of about 30%. However, the difference in the absolute amount is not large.

b. **Calculating Margaret's protection needs**

Life cover on Margaret's life

If Margaret were to die, John and the family's financial needs would be to:

- ensure that John has enough long-term income for his own long-term needs;
- cover the expense of looking after the children while they are still dependent; and
- provide enough funds to pay for the school fees.

Any deficiency of potential income from such resources as investments, State benefits and John's pension scheme can be made good by life assurance on Margaret's life.

John's long-term personal needs for a net income of about £35,000 a year could be covered by the investment income from the properties and by drawing on his pension, assuming that he would not be able to continue with his work in the circumstances.

Shorter-term needs for the children's living expenses are estimated to be £15,000 a year.

- The Child Benefit of £1,885 would continue.
- So, the income multiple that should apply to the income needed of £13,115 (£15,000 – £1,885) for the children is 18.5 (20 years). Therefore, the life cover needed for short-term needs is £242,628 (£13,115 × 18.5) or £243,000 in round terms.

In addition, the school fees would need to be covered by life assurance. It has been calculated (see summary and analysis) that the capital required to provide the total school fees costs over the children's lifetime would be about £250,000. This should form the basis for insurance. The amount of cover will need to be kept under review as the years go by, and the capital sum needed should decline. The amount of life cover on Margaret's life can then be reduced as necessary. Ideally, the cover should be arranged on a level basis in case there is a substantial and unexpected inflation in school fees. However, some or all of the cover could be arranged on a decreasing term assurance basis to reduce the initial costs. The total cover needed over the shorter term is therefore £243,000 for income and £250,000 for the school fees, i.e. £493,000.

Critical illness

- In principle, the income needed if Margaret were to suffer a serious illness would be broadly the same as if she died.
- However, there would be a deduction for the benefits of approximately £12,000 a year net payable under the proposed income protection policy and various State benefits, depending on the circumstances.
- The suggested income protection benefits and some of the State benefits would be payable until Margaret reaches age 60, 65 or SPA, and would cover the short-term income needs.
- The school fees of £250,000 would need to be covered by critical illness insurance.
- So, the total need for critical illness cover is £250,000. This should be written to her age 65 but should be kept under review.
- The income protection policy provides more comprehensive cover than critical illness insurance, but the amount that can be arranged is greatly limited. Critical illness insurance is the next best alternative and could pay out in certain circumstances when income protection will not provide benefits, e.g. during the deferral period and if Margaret is still well enough to undertake some work.

c. **John's current policies**
- John's whole life policy should be cancelled.
- It provides relatively little cover for a large premium.
- He does not need whole life cover. His period of earnings will probably last another five to ten years, but not the rest of his life.
- They have stated that IHT mitigation is a low priority.
- The life cover from his employer will cease shortly and should therefore not be taken into account.
- They should try to maintain John's term assurance at a premium of £200 a year and his income protection at £20 a month if possible for the next five years. There would be some financial loss if he died or fell ill during this period when he is expected to be earning. The premiums are inexpensive in relation to the costs of starting new policies now.

d. **Recommended policies**
- The combined term assurance and critical illness insurance policy for Margaret for the long term to cover school fees of £250,000 will cost £1,380 a year to age 65.
- The maximum income protection insurance for Margaret would be £200 a week. The cost of an indexed 26-week deferral, again to age 65, would be £44 a month or £528 a year.
  – The costs escalate considerably for a shorter deferral period and do not reduce much for a 52-week deferral period, which could cause considerable hardship.
  – Indexed cover and benefit is needed if the insurance is not to become irrelevant in the long term as a result of inflation.
- A stand-alone term assurance policy for Margaret to meet the short-term income shortfall of £243,000 will cost £262.44 a year.
- The total cost of Margaret's cover would be £2,170.44 a year (£1,380 + £528 + £262.44).
- They can both keep John's cover and start Margaret's new protection within the £3,000 budget that they have set themselves.

Key points

The main ideas covered by this chapter can be summarised as follows:

Longer-term saving and investment

- The financial planner should set out the investment strategy for the client in the investment policy statement.
- The foundation of investment strategy is asset allocation rather than fund or stock selection.
- The financial planner needs to establish whether ethical considerations are the overriding criteria for fund selection.
- The client's requirement for income or growth is a key determinant in portfolio design.
- The financial planner needs to select between (or combine) active and passive fund management, funds of funds or individual funds, as well as decide between various management styles.
- The financial planner should judge a portfolio of funds by its overall performance in terms of risk and return.
- Tax wrappers are structures for holding investments that are taxed in different ways and may be subject to other restrictions.
- When considering the tax position of a wrapper, the financial planner should think in terms of:
  - the initial input;
  - the growth or income; and
  - encashment.
- When making a recommendation for a longer-term investment, the financial planner should consider whether it would be better to repay any outstanding debt and whether the client will need access to the capital at a particular point in the future.

Providing for the costs of education

- Advance financial planning to meet the cost of private or higher education is best achieved by quantifying the expenditure with the help of a cash flow projection.
- Future educational commitments should be reflected in the client's life and health protection planning.
- The longer the timescale until the money is needed, the more risk the investor can afford to take.
- As with all investments, it makes sense to keep investment planning for educational needs flexible.

Retirement planning

- A key aim for most clients is to provide enough income in retirement to support a comfortable lifestyle for themselves and their dependants.
- In saving for retirement, a client may be a member of a defined benefit (DB) and/or defined contribution (DC) scheme. It may also be appropriate to use individual savings accounts (ISAs), collectives, and UK onshore and offshore policies.
- The main advantages of using a pension plan are tax relief on the contributions, tax-free growth and normally 25% of the fund at retirement is available as a tax-free lump sum.
- The main disadvantage is that the rules that apply to pension schemes can be complicated and can require specialist advice.
- The current cash flow projection should be used to establish how realistic a client's savings intentions are.

Key points

- Clients have a range of options at retirement depending on their scheme type:
  - With a DB scheme, the main choice is whether to take the tax-free lump sum or not.
  - DC schemes, depending on the scheme type, can offer a much wider choice of benefit structures:
    - conventional lifetime annuity purchase including with-profits and unit-linked;
    - flexible lifetime annuities;
    - flexi-access drawdown including short-term annuities;
    - uncrystallised funds pension lump sums; and
    - phased retirement.

The 'two pools' approach to asset allocation for retirement income

- One popular approach to asset allocation for clients who need to draw income from their investment portfolios in retirement is to split their investments into two main pools.
  - The 'safety first pool' is a very safe pool with a short- to medium-term time horizon. This provides the pool of investments from which the client draws an income.
  - The 'long-term adventurous pool' provides long-term capital growth to replace the 'safety first pool' when it has run out.

Post-retirement planning – long-term care

- Long-term care can be provided for in advance:
  - by building up assets;
  - through the use of specialist long-term care insurance; and/or
  - by providing for immediate needs by:
    - adjusting existing investment strategy; or
    - the use of specialist immediate care plans.
- The financial planner should also ensure that the client makes suitable arrangements in advance (via a lasting power of attorney (LPA), or check whether they have an existing enduring power of attorney (EPA) in place), in the event that they lose mental capacity.

Post-retirement planning – estate planning

- Estate planning ensures that assets are passed to the intended beneficiaries in a tax-efficient manner, i.e. by minimising inheritance tax (IHT).
- The financial planner should recommend that the client has an up-to-date will.
- IHT can be mitigated in different ways including:
  - making lifetime gifts of capital and/or regular income; and/or
  - using business relief plans, such as enterprise investment schemes (EISs), seed enterprise investment schemes (SEISs) and AIM schemes.
- IHT can be provided for by using a life assurance policy written in trust to cover the potential tax liability.
- Trusts can be used to pass assets out of an estate while still retaining some degree of control.

Product evaluation, research and selection

- Effective research and due diligence are central to the financial planning process and provide much of the value in client advice.
- Planners should undertake this research in a systematic and analytical way, taking into account the client's objectives, and comparing like-with-like products and services.
- Past performance of funds should be taken into account, with circumspection both in terms of investment returns and volatility or other measures of risk.

Key points

- Advisers and paraplanners should record their research and justification of their recommendations in a way that is clear both to the adviser and to anybody else who reviews the file in future.

Planning for particular events and circumstances

- Common life events will require careful financial planning, such as:
  - **Marriage and civil partnership**. This is a key time to discuss and organise financial planning issues, including bank accounts, income and expenditure, wills, savings, protection, domicile and pre-nuptial agreements.
  - **Divorce and civil partnership dissolution**. Areas where the financial planner may be particularly involved include expenditure planning, valuing and splitting investments and pensions, and rearranging mortgage, protection and will arrangements.
  - **Birth or adoption of a child**. This often incurs additional expenses immediately and in the long term.
  - **Helping a grown-up child buy a property**. Parents and, indeed, grandparents are increasingly being called upon to help otherwise financially independent children buy their first property.
  - **Inheriting property or a lump sum**. Clients will need to evaluate their priorities and balance risk. Planners should help clients avoid the 'endowment effect' and use any inheritance to its full effect.
  - **Death of a spouse or partner**. A planner can advise on disposal of assets, making adequate provision and changing deeds or wills, as well as provide guidance in light of the changed circumstances.
  - **Redundancy**. A planner can help a client be realistic about their means and how to meet their needs.
  - **Serious illness**. A number of problems may arise, including length of time the illness may last, returning to work and making provision for family.
  - **Long-term care**. A planner can help those entering long-term care to arrange their affairs to balance the need to fund care immediately with holding on to long-term assets. Setting up an LPA is a key issue.

Explaining and justifying the recommendations

- Writing an effective client report is at the heart of putting together a successful plan. Reports should:
  - set out the client's position;
  - set out the client's objectives; and
  - make recommendations on how to achieve the objectives, possibly including specific financial services.
- Reports should be:
  - logical;
  - economical in length;
  - clearly written in accessible language; and
  - well laid out.
- The financial planning report should act as a suitability report to meet FCA requirements and should be revised regularly to meet changing client circumstances.

7

Implement and review

Contents	Syllabus learning outcomes
A Implementation of the plan	5.1
B Platforms	5.1
C The need for regular monitoring and review	5.2
D The different ways financial planners charge for their services	5.2
Case study: John and Margaret Williams – second annual review	
Key points	

Learning objectives

After studying this chapter, you should be able to:

- explain how the financial plan will be implemented;
- describe the appropriate services and timescale for a review of the financial plan; and
- conduct reviews at appropriate times and using suitable benchmarks.

Key terms

This chapter features explanations of the following ideas:

Adviser charging	Client reporting	Collective investment funds	Disclosure of costs
Fixed fees	Insurance underwriting	Investment reports to clients	Off-platform tax wrappers
On-platform tax wrappers	Platform charges	Platform services	Platform technology
Regular monitoring	Review frequency	Specialist funds	Time-based charging

A Implementation of the plan

The implementation of the plan is step 5 in the International Standardization Organization's ISO 22222 financial planning process. In most cases, the financial planner who provides the recommendations will also implement the plan.

This could require the involvement of several different professionals apart from the financial planner, such as accountants, lawyers, stockbrokers or other investment managers, bankers and consulting actuaries.

A1 Best execution

The principle of best execution means that all sufficient steps must be taken so that the transaction is carried out on the best terms available, including price, speed, cost, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

Where the recommendations have included a proposal for life or health insurance, a copy of the proposal form should be sent to the client for checking, especially where the adviser has helped to complete the form.

A2 Disclosure of costs

Before transacting any investment business, the financial planner's firm must tell the client in writing the charges for carrying out the business (***disclosure of costs***).

Advisers must explain all costs relating to investment business 'ex ante' (i.e. an estimate, before the client invests) and 'ex-post' (actual costs, afterwards). The pre-sale illustration must show estimated costs for the recommended fund, the platform (if used), the advice and the cost of investment research. A post-sale illustration, showing actual and anticipated costs, must also be provided. The client will need to be sent an annual personalised statement of aggregated costs incurred for the preceding twelve months.

A3 Use of specialists

It is increasingly necessary to use specialists to implement financial plans. They could be within the financial planner's own firm, or such tasks might be outsourced.

Refer to

The specialists that might be involved in implementing a financial plan are discussed in *Special considerations with specialist advisers* on page 3/31.

It is important that the financial planner undertakes due diligence on the track record, competencies and qualifications of the specialists they use, as well as monitoring their progress during the implementation process.

A4 Transactions and the use of platforms

Financial planners often use platforms to transact purchases and disposals of investments, and to provide comprehensive and convenient reporting on investments. However, platforms are not necessarily suitable for all clients and circumstances:

- It may be the same price or cheaper to buy investments through a platform than through other methods, but many platforms involve additional costs. If there are extra initial or annual charges, these need to be justified in terms of their direct or indirect value to the client.
- The platform may restrict choice of investments. Some do not hold onshore bonds or small self-administered schemes (SSASs), but only offshore bonds and self-invested personal pension schemes (SIPPs). Therefore, the choices available may influence the advice inappropriately.
- Existing investments often cannot be moved onto a platform without incurring charges, e.g. as a result of their disposal and reacquisition. These extra costs (and perhaps tax charges) may be worth incurring, but they have to be reasonable and justifiable.
- Some platforms are more efficient than others at conducting transactions and reporting accurately. In some cases, it may be easier to move an investment onto a platform than to move it off. The financial planner should undertake due diligence to check on the effectiveness of the management.

Refer to

Further information on platforms is given in *Platforms* on page 7/4.

A5 Reporting on implementation to the client

It is desirable to provide clients with a clear summary of what has been arranged in the implementation process (known as ***client reporting***). This usually includes details of all the products and funds that have been set up, as well as any other actions that have been taken and how they fit into the financial plan. The following table illustrates this.

Table 7.1: Critical illness insurance policy

Acme Insurance	**Policy no. 123456**
Insuring Peter Matthews. The policy will pay out if he is diagnosed with a serious illness or permanent total disability as defined in the policy.	
Level of insurance cover: £150,000	The policy will end in August 2037.
Monthly premium by direct debit:	£123

The table clearly demonstrates to the client:

- the name of the product provider;
- the identifying reference of the new policy;
- what cover the plan is intended to provide;
- how much would be paid in the event of a successful claim;
- the period over which the cover will be available; and
- the monthly financial commitment they will have to make.

The details of the plan provided should be clearly linked to the needs and objectives agreed, and an explanation should be provided as to how this fits into the overall financial plan.

A6 Updating the suitability report

Financial planners usually provide their suitability reports as part of the recommendations. Where investment advice has been given, suitability must be assessed and a report issued before a transaction is concluded, and regardless of whether it goes ahead or not.

In the implementation process, there may be a change from the original proposals. This might arise for a variety of reasons; for example, the clients may have changed their minds, tax rules may have changed or investment markets moved. In addition, a new product may have appeared or an old one may have been withdrawn, or an insurance company may have offered protection on less attractive terms after the underwriting process.

The suitability report will need to be amended, particularly the relevant section, and reissued.

A7 Insurance underwriting issues

Arranging protection products for clients is often problematic in terms of various ***insurance underwriting*** issues such as completing application forms and persuading clients to proceed with rated (i.e. non-standard) acceptance terms. Personal illustrations are always issued based on standard terms; however, lifestyle or health issues specific to the client may mean that the terms actually issued result in higher premiums than initially quoted or less comprehensive cover being offered.

Clients may sometimes be reticent to provide full details of their medical history, so the importance of full disclosure and the potential impact of not providing all the information requested must always be stressed.

A7A Completing application forms

Financial planners or their staff often help clients to complete proposal forms, especially where they are making multiple applications. If a client does not disclose a material circumstance to an insurer relating to a question that has been asked, it could lead to the voiding of the contract or an appropriate reduction in payment if there is a claim. The financial planner should make this very clear to the client.

Making multiple applications is time-consuming but can be helpful if the client may potentially have underwriting problems. Different life offices may take a range of views about clients' insurability and issue different underwriting terms.

A7B Rated acceptance terms

If the insurance company has underwritten a client and the terms are more expensive or restricted than in the illustration, the financial planner then needs to decide what action to take. The initial step is to explain the situation to the client. Some clients will not proceed with the insurance if it turns out to be more expensive than they expected. In such cases, the financial planner should explain that the need for the insurance has not changed as a result of the underwriting decision; indeed, it might arguably be greater.

Ideally, the client should go ahead with the cover at the level that was originally recommended and pay the higher premium. However, this may not be affordable, or the client may feel that the extra cost has made some other aim, such as saving or estate planning, relatively more attractive. Where this is the case, one option would be to reduce the sum assured to the amount that the life office would be prepared to offer for the original premium quoted.

B Platforms

Platforms are not products in themselves. They are a set of services brought together by technology that allows them to be delivered in an efficient, scalable and repeatable fashion. A platform is best thought of as a way to access products, investments and services. There are three main types of platform operating in the market today:

- **Advised platforms** are designed to support the specific needs of advisers and their clients.
- **Direct platforms** deal directly with consumers (generally on an execution-only basis).
- **Workplace platforms**, which employers may put in place for their employees to use as part of the implementation of a workplace benefits package.

B1 The core services that platforms provide

Platforms are large relational databases capable of managing massive amounts of information. Most platforms offer a technology-based facility to hold information on:

- investors;
- the investments they hold; and
- the tax wrappers within which those investments are held.

They also offer a way to transact (or ‘deal’) those investments.

Behind that seemingly simple concept stands a complex set of services and processes underpinned by technology, the breadth and detail of which can vary considerably from platform to platform and depends on the particular market that each is targeting.

It is important for advisers recommending platforms to have a good grasp of the detail of these services and processes and their associated technology, the way that they interact and what that means for the client. Advisers will also want to be confident that a platform service provider is able to support the provision of its services in a robust and compliant fashion.

Consider this…
When assessing the suitability of platforms, advisers must understand enough about the mechanics of their construction to make informed judgments.

The following sections give a brief introduction to the technology that underpins platforms and the core services that platforms provide (as illustrated in the following figure).

Figure 7.1: A simplified overview of core platform services

B1A Technology

Although it is not necessary for planners to be technology experts, a working understanding of the basic components of ***platform technology*** will assist the adviser in assessing the relative merits of different platforms.

UK investment platforms tend to be web-based services. This means that users are not required to install software from a platform service provider onto their computers. Instead, users access services through a secure website hosted by either the product provider or a dedicated technology company.

Platform services are also often ‘live’, meaning that the keystrokes entered onto a client account immediately change the record and even buy or sell investments. Older product provider administration systems tend to use ‘batch processing’, which means that instructions to make changes are just messages that are stored and implemented later (typically overnight, when other system usage is light).

This delay creates an opportunity for quality control and verification of transactions by the product provider which, unless they are deliberately set up with in-built process checks, is missing from live systems. This places a greater responsibility for accuracy on advisers who enter information or instruct investment deals through platforms. It can also present some challenges for integration between ‘live’ and ‘old’ batch processing systems.

Reinforce

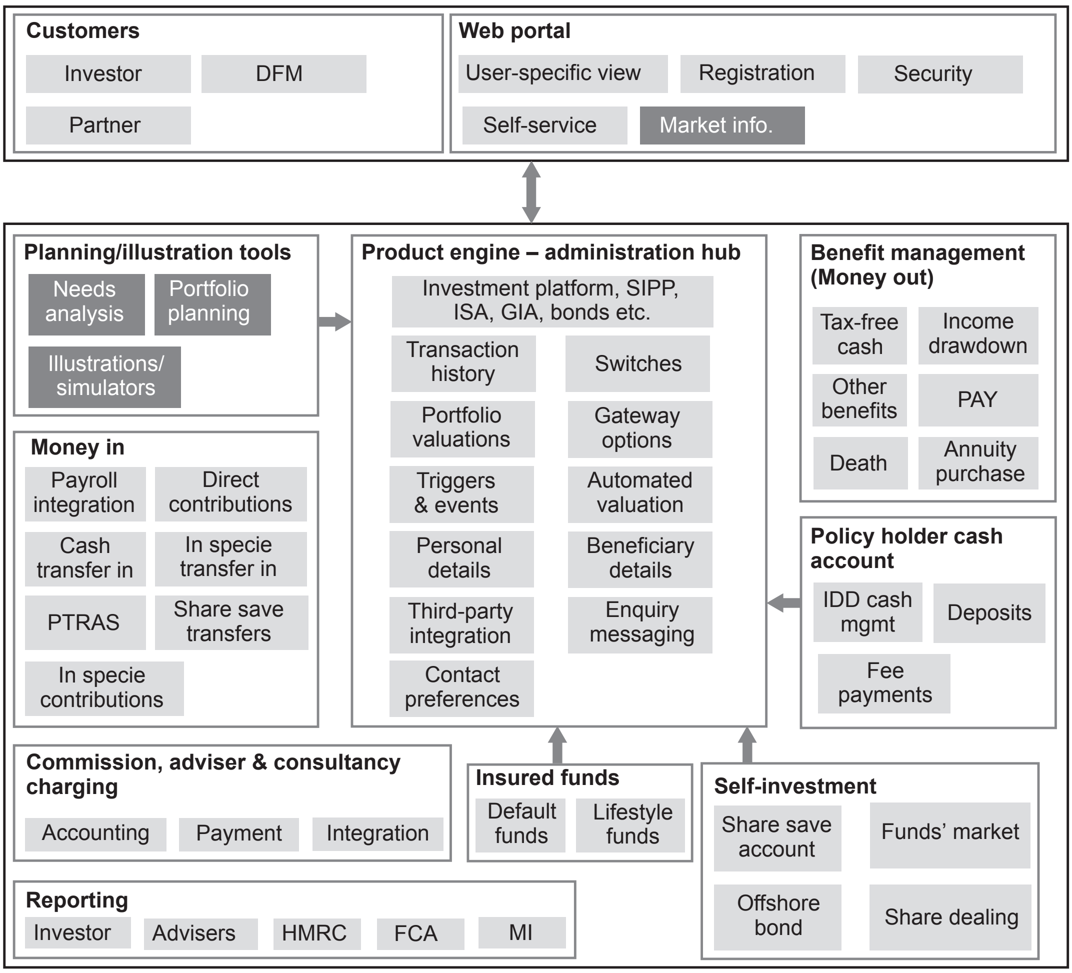
When selecting a platform, advisers are, in effect, entering into an outsourced technology arrangement. During the due diligence process, it is vital to understand the technology requirements for users (e.g. minimum requirements for operating systems). It is also reasonable to expect providers to supply sufficient information on system stability, availability, security and disaster recovery to give advisers and clients confidence.

The following flow diagram gives a sense of the many different elements of technology that go into an investment platform. It is important to note that platforms are expected to integrate with other systems, including:

- life office and product provider systems;
- accounting and general ledger systems;
- adviser back office systems; and
- trading and settlement systems.

While a platform is a relatively simple concept in theory – a place where advisers can hold and control investments – it becomes much more complex and multi-faceted in practice.

Figure 7.2: The modular and complex nature of investment platforms



Source: *GBST*. Used with permission and thanks.

B2 The cost of platforms

All platforms must levy an explicit charge for their services. This is a regulatory requirement and, in theory, might be expected to make it relatively easy for advisers to compare the cost of platform services when recommending them for clients. The reality is more complex.

B2A How platforms charge

Platform charges are calculated in two basic ways:

1. **Percentage-based (or 'ad valorem') charges** – the platform service provider charges based on the value of a client's platform assets, with the charge often reducing as that value increases.
2. **Fixed charges** – a set amount is charged for providing a particular service.

Charging on a percentage basis is the most common approach in the advised platform market. Many platforms also combine their percentage charges with fixed charges for specific services. Fixed dealing charges for exchange-traded investments is a common example.

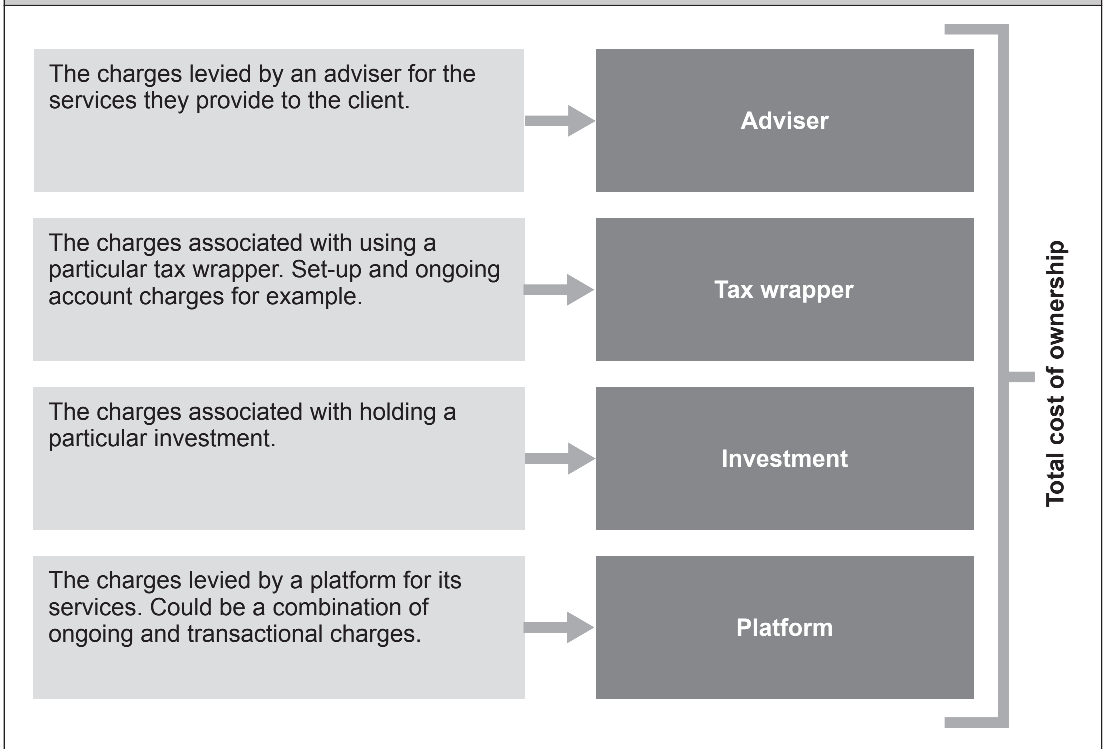
These different approaches mean that the value of a client's assets, both now and in the future, the services they might access and how frequently they access them will all have a bearing on platform costs in their particular case.

All other things being equal, percentage-based charging tends to be more cost-effective for investors with lower value portfolios. That is because, in terms of platform revenue streams, their costs are effectively subsidised by other investors on the platform with higher value portfolios. On a fixed charging approach, the theory is that each investor covers their own costs for the services they access. This tends to make fixed charging relatively expensive for investors with lower value portfolios but potentially far more cost-effective for those at the higher end of the spectrum.

B2B Total cost of ownership

As well as a platform's own charges, the way it puts its services together (whether it offers its own tax wrappers or facilitates access to those offered by third parties, for example), its relative size and bargaining strength with fund managers can have an impact on what is often referred to as the 'total cost of ownership' for a client of investing through a platform. See the figure that follows.

Figure 7.3: The total cost of ownership



Regulatory change has had a hand in the evolution of platforms. One specific change has been a growth in the differential pricing of funds between platforms through the introduction of so-called 'super-clean' share classes. So, the specific investments a client is interested in may be cheaper on one platform than on another and, in making suitability assessments, this needs to be balanced out against all the other costs the client may incur as a result of a recommendation to use a particular platform.

A similar issue potentially applies with tax wrapper charges. Some platforms provide their own 'vanilla' tax wrappers, and these are often priced very competitively or come at no extra charge above the platform charge itself. Others facilitate access to third-party tax wrappers with which additional charges may be associated.

An annual statement has to be sent to clients, setting out:

1. The platform charges for the year.
2. The adviser charges for the year.
3. The fund charges for the year.

This also has to be sent out before and after any transaction.

B2C Payments to and for clients

Cash rebates of product provider charges
An important change that took effect from 6 April 2014 was a ban on platform service providers paying rebates of product provider charges to retail clients in the form of cash (if these rebates are more than £1 a month per fund).

Cash rebates were banned because the FCA said in its policy statement 13/1 that they 'had the potential to cause confusion for consumers and make the platform or adviser charge appear free'.

The FCA still permits rebates for new business where certain conditions are met. The entire rebate agreed by the fund manager must be credited to the client and rebates should not be credited in cash (beyond a *de minimis* level of £1 per fund per month) but instead used to buy more investment units. Rebates of this type are referred to as 'unit rebates'.

An example of how two charging structures would work using this model is shown in the table that follows. Fund 1 gives a standard rebate to the client, while Fund 2 gives them a higher rebate.

Table 7.2: Impact of varying unit rebate amounts on the total charge to the client

	Fund 1	Fund 2
Fund AMC	1.50%	1.50%
Unit rebate to client	0.75%	0.95%
Net cost to client (effective fund manager charge)	**0.75%**	**0.55%**
Adviser charge	0.50%	0.50%
Explicit platform charge	0.35%	0.35%
Total charge to client	**1.60%**	**1.40%**

In the table, the entire rebate agreed by the fund manager was credited to the client. The platform then made an explicit charge (of 0.35%), as did the adviser (of 0.50%); so, the better the discount that the platform negotiated, the lower the price that the client paid. As rebates now have to go to the client in their entirety, there is no impact on the platform, which sticks to its published charges.

Where unit rebates are being used, advisers should ensure that they fully understand the rebate reinvestment policy and (where applicable) the process for the platform service providers they are considering, as there is likely to be some variety of practice across the market.

Be aware
HMRC has confirmed that both cash and unit rebates of product provider charges count as taxable income for the recipient, unless paid within an approved tax wrapper such as an individual savings account (ISA) or pension.

Adviser charges
A core function of a platform service in the advised market is to facilitate the payment of adviser charges. Platform service providers have various obligations under the FCA rules in

providing this service, which can be found in the FCA's Handbook in various sections of the Conduct of Business Sourcebook (COBS):

- They must obtain and validate evidence that a client has agreed to any adviser charge that the platform service provider has been asked to facilitate (COBS, 6.1B.9R).
- They have to offer enough flexibility for ***adviser charging*** so they do not unduly influence or restrict the charging structure that an adviser using the platform service can offer to its client (COBS 6.1B.9R and COBS 6.1B.10G).
- They must pay adviser charges out to advisers broadly as they recover them from the client. Advances and alternative payment arrangements are not allowed, other than where they are in the client's best interests and in line with the FCA's separate rules (in COBS 2.3) on providing credit and other benefits to advisers (COBS 6.1B.9R and COBS 6.1B.11G).
- Ongoing adviser charges can only be taken for an ongoing service or a regular payment product (COBS 6.1A.22R), meaning that a platform service provider needs to have a process for handling a situation where a client wishes to sever the relationship with an adviser for whom that platform service provider is currently facilitating an ongoing adviser charge arrangement.

Activity
Go to the FCA Handbook at *www.handbook.fca.org.uk/handbook*, look up COBS 6.1B.9BG and make a note of the four ways that the FCA says a firm (a platform service provider) may facilitate the payment of adviser charges in practice.

B3 Investing through platforms

A core purpose of platforms is to offer access to a wide range of investments, allowing these to be managed on a portfolio basis through a range of different tax wrappers and according to a client's needs.

B3A The investments available through platforms

Collective investment funds
Collective investment funds tend to be the mainstay of platforms targeting the advised market. Different platforms offer access to different types of collective investments. Some offer pretty much unfettered access to open-ended investment companies (OEICs), investment trusts, exchange-traded funds (ETFs) and even cross-border instruments such as SICAVs (Société d'investissement à capital variable). Others limit their available investment range to OEICs only.

Fund ranges on platforms can be very large, with ranges of over 4,000 available at the open architecture end and a range of 1,200 to 1,500 being common at the more limited end. When contrasted with the very limited range of funds typically available inside traditional packaged insured products (where 100 to 200 funds might be considered a good range), it is clear that platforms provide a great deal of access and investment flexibility. Platforms also typically add new funds as they become available, whereas the range on offer from an existing packaged insured product is not usually increased.

Specialist or sophisticated investor funds
As well as standard collective investment funds, some platforms may also offer access to ***specialist funds*** or sophisticated investor funds. These could include:

- institutional funds;
- subscription funds (such as film funds);
- hedge funds;
- offshore funds; and
- unapproved funds.

Platforms offering these funds should have controls to ensure that only individuals with the appropriate status invest in them. These controls may include specific declarations that individuals and advisers have understood the risks and high minimum investment levels or a requirement that an individual holds sophisticated investor status.

Refer to
See *Distributor-influenced funds* on page 3/34 for more on distributor-influenced funds.

In addition, platforms may offer distributor-influenced funds (DIFs). These are funds manufactured by advisory firms or their affiliates, and then recommended to clients. Particular care should be taken in assessing these funds, given the potential for conflicts of interest. At a general level, advisers have a regulatory responsibility to ensure that any platform they use presents retail investment products without any bias.

Securities
Along with investment funds, many platforms offer links with stockbroking systems to allow investors to purchase listed securities. These links may also integrate with investment analysis and research systems, giving active investors the ability to research and execute investments quickly and easily. Many direct-to-consumer platforms have their origins in listed securities trading and added the option to trade in collective investments at a later stage.

The range of assets available through stockbroking links varies. Some offer access to FTSE-listed shares only; others offer shares listed on other markets in the UK and overseas, such as AIM, Euronext and NASDAQ.

Other asset classes available through these links can include investment trusts, corporate bonds, gilts, exchange-traded products (such as ETFs and ETCs) and derivatives. An increasing number of platforms are also making an effort to include structured products in their investment range. Some structured product providers are striving to provide a secondary market in their products which allows early redemption. This will enable the regular valuation and trading potential that platforms are designed to facilitate.

Dealing in many of these instruments can carry a higher level of risk than collective investments. Therefore, advisers must exercise due care to ensure that investment portfolios stay within investors' attitudes to risk.

The platform may levy an additional charge for holding them on top of any dealing charges that may apply. Alternatively, the platform may include assets held in exchange-traded products in the overall calculations for its platform charges. It is important for advisers to take all charges into account when recommending that these investments are held on a platform; in some circumstances, it may be more advantageous for investors to hold assets off-platform.

B3B The tax wrappers available through platforms

The tax treatment of investments remains a key area of potential advantage or disadvantage for investors, and platforms attempt to allow investors access to a range of tax structures to maximise benefits.

The types of tax wrapper available
Types of tax wrappers available on platforms include:

- individual savings accounts (ISAs) and Junior ISAs;
- personal pensions and SIPPs, often including access to 'at retirement' features such as flexi-access drawdown and, in a few cases, to the annuity market;
- onshore investment bonds;
- offshore investment bonds; and
- qualifying savings plans.

Refer to
See *Tax wrapper selection* on page 6/6 for more on tax wrappers.

In addition, all platforms in the advised market (and many in the direct-to-consumer market) offer an 'unwrapped' general investment account (GIA) that offers no tax advantages. GIAs may be presented as a type of 'product' in platform literature alongside various tax wrappers, and this can be a potential source of confusion for investors.

GIAs can be held within wrappers (e.g. as assets of an offshore bond) or by pension scheme trustees, corporates and charities. Clients may have more than one GIA, with different investment strategies designed to meet individual financial objectives, e.g. a school fees account with relatively low-risk investments even for a high-risk tolerance investor.

Some specialist platforms may also offer access to other wrappers, such as:

- small self-administered schemes (SSASs);
- section 590 plans;
- section 32 plans; and
- trustee investment plans.

In addition to tax wrappers for investment, a few platforms also offer access to protection products that will ensure the payout of a client's target portfolio value on their death. Some platforms even provide a service that will allow platform investments to be held through various different types of trust (for which the platform service provider supplies the relevant paperwork) for estate planning purposes.

Be aware

The FCA has made it clear that advisers should not allow their advice to be influenced by the availability of certain types of tax wrapper on their favoured platform. The needs of the client must always come first, even if this requires investments to be held on an alternative platform (or indeed off-platform).

On-platform versus off-platform

Tax wrappers may be 'on-platform' or 'off-platform'. ***On-platform tax wrappers*** are integrated into the platform and offer a seamless experience in terms of dealing, reporting and administration. The money invested into these wrappers is held on the platform by the custodian, and it benefits from the trading terms the platform has negotiated with investment managers. The trading terms are also usually taken into account for any charge discounts that apply for larger portfolios. In this model, the platform takes on (or delegates) the role of a product provider (e.g. a pension scheme administrator or ISA plan manager) and ensures that the relevant approvals and permissions are maintained.

In contrast, ***off-platform tax wrappers*** involve the transmission of money to the third party administering that wrapper. The third party will have its own charging structure, which may be on top of the platform's own charges. As a result, when using third-party wrappers through a platform, advisers should check that the identical investment and product is not available directly from the third party at a lower cost.

Some platforms are keen to ensure that advisers have access to the widest possible range of structures and offer off-platform wrappers for that purpose. An alternative approach is for a platform service provider to offer one core range of standard on-platform tax wrappers, but to use off-platform products for highly specialist wrappers that are outside its risk appetite or skill set.

Advisers thinking of using off-platform products should familiarise themselves with the administrative and integration arrangements to ensure that the client receives a timely and accurate service.

B4 Reporting on investments to client

A key service that platforms provide for both advisers and their clients is to make investment reporting easier. The need to contact multiple product providers to get portfolio valuations is removed, and advisers can be confident that all valuations are provided at the right time. Where investment advice has been given, quarterly valuations must be issued to clients. In addition, portfolio managers with discretionary powers must send a communication to their client where the value of their portfolio falls by 10% over a single reporting period.

Be aware

The FCA initially issued flexibility for six months (until October 2020) over the requirement for firms to report a 10% portfolio drop within 24 hours, in light of the impact of the COVID-19 pandemic on stock market volatility.

This has subsequently been extended until the end of 2022 and no longer applies to professional clients.

Because platforms record a great deal of information about investors and their portfolios and transactions, a reporting facility is crucial for making sure that advisers and clients can access important information that may help them make decisions.

A common suite of ***investment reports to clients*** might include:

- portfolio valuation;
- asset allocation;
- largest holdings;
- performance (absolute or relative to benchmark);
- transaction history;
- adviser charges paid;
- realised gains; and
- unrealised gains.

These reports may be available at both an overall portfolio level and at tax wrapper level, allowing advisers to show, for example, activity exclusive to a pension wrapper. It is also common practice for platforms to allow advisers to generate reports within specific date ranges. In this way, for example, an adviser doing a quarterly review for a client can show clearly the activity and movement in that client's portfolio since the last review and over other time periods.

Reports may be generated using a pre-formatted template, or it may be possible for advisers to download the data within the report for them to populate the information into their own standard templates. It may also be possible to extract the data to the adviser's back office or practice management system and generate reports from there.

C The need for regular monitoring and review

The sixth and final step in the ISO 22222 financial planning process is monitoring and reviewing the plan. Advice can become out of date because economic, tax or other external conditions have changed, or the client's circumstances may have moved on. In many cases, it is not possible to deal with all of the client's aims and needs at the first meeting or even after multiple meetings, and so it is necessary to come back to the other priorities at a later date.

There are a number of factors that drive the need for ***regular monitoring*** and reviews:

- Investments should be monitored to see if they have performed as expected and to determine whether they are still suitable. The use of platforms makes this process simpler, quicker and more cost-effective.
- The plans should be reviewed in light of how investments have performed and any other changes that might have taken place. For example:
  - A fall in the value of a portfolio might prompt the need to make switches or to attempt to make up any shortfall by additional saving to ensure the client's investment objectives stay on track.
  - A rise (or fall) in the value of some investments might prompt the need to rebalance the portfolio to make sure it still conforms to the benchmark asset allocation associated with the client's risk profile or objectives.
  - Changes may be needed to the plan for tax reasons to take advantage of ISA and pension allowances, the capital gains tax (CGT) annual exempt amount, to make gifts to use inheritance tax (IHT) exemptions or because of changes in tax legislation.
- The client's circumstances are unlikely to remain constant for very long. For example:
  - Changes in assets or income can take place relatively rapidly and have profound effects.
  - Life events – marriage, parenthood, incapacity, divorce, job move, retirement or receiving an inheritance – can happen in a planned or an unplanned way. The financial plan has to adapt to these events, which can lead to changes in income and expenditure requirements, either for better or worse.
- The client's views and experience can mature and develop. The death or illness of a colleague or friend could increase the client's awareness of the need for protection.

Increasing proximity to retirement could stimulate a greater interest in planning for the event, as well as changes in an investor's attitude to risk and capacity for loss.

- A financial review should also take place close to the time when a policy matures or when a mortgage or other loan is to be redeemed.
- New products enter the market. Economic and financial conditions change. Declining interest rates can prompt many investors to consider switching from deposit-based investments to alternative products for their savings.

C1 Frequency of review

With many clients, ***review frequency*** should be annual, although they can be more or less frequent depending on the speed of changes in the client's circumstances and their requirements. When providing ongoing services in relation to investment advice, firms must make periodic suitability assessments at least annually. The frequency of contact and review should be a key element of the service agreement with the client and must be reflected in the charging structure. The aim of the review process should be to keep the plan continually up to date.

How often a review takes place is determined by a number of factors:

- Unless dictated by regulation, frequency of review depends on what was agreed at inception. If the intervals between reviews need changing, then this should be discussed and agreed.
- When a life event has taken place or is being contemplated, this is an obvious prompt for a further financial planning review.
- Where the financial planner is providing active portfolio management services, frequent contact may be needed with the client. Such services should be distinguished from the strategic financial reviews. The daily fund management should be subject to agreed policies for income, risk, diversification etc. These policies generally do not need to be reviewed so frequently.

Consider this…
How does your firm categorise clients with regard to agreed frequency of review? Do the firm's back office systems actively support this? Is your firm doing what it agreed at the outset with the client?

C2 Direction and benchmarks for the review

The way in which the review is conducted partly depends on the interval since the initial main plan was compiled. In the first one or two annual reviews, the main focus of attention may be on the income and expenditure analysis. Afterwards, they may focus on questions such as:

- Is the plan working? Is it making the best use of the surplus funds without causing excessive difficulties in meeting expenditure? For example, if the client is increasing their level of debt, the plan may need to be changed.
- Is the client following the plan? For example, the agreed strategy might have been to make contributions into a pension plan as a fixed proportion of earnings. If earnings rise, it is quite likely that contributions have lagged behind at the old rate.

The analysis should also include a review of the investment performance. Very short-term investment performance (e.g. up to a year) is generally of less importance than longer-term trends over several years. The investment review should also show the costs over the period under review (e.g. fund charges, platform charges and adviser charges). If in percentage terms, the sterling equivalent should also be given.

In order to keep time costs to a reasonable level, it may not be feasible to provide a complete reappraisal of the plan at every annual review. However, the planner should:

- recalculate the current income and expenditure each time to see if there is an additional surplus to meet some of the other identified needs; and
- at least once every five years, carry out a complete review of the plan, virtually starting again from scratch, to ensure that the planner and client are still working to agreed objectives.

D The different ways financial planners charge for their services

There are several different ways in which financial planners charge for their services, although a greater degree of uniformity is now required since the implementation of the Retail Distribution Review (RDR). The key is that the client should understand the method that the planner is using and the charges that are incurred as a result.

Financial planners may be personally remunerated differently from the way in which their firms are paid. For example, the firm has to cover costs and overheads, and the planner's personal remuneration is only part of these. The financial planner's pay may be closely aligned to the firm's turnover or may diverge to a considerable degree. From the client's point of view, the way in which the firm as a whole is remunerated is generally most important, and so this aspect is the focus of this section.

The main ways in which planners' firms are remunerated for their services are set out in the following sections.

D1 Adviser charging

A central tenet of adviser charging is that any worthwhile professional advice cannot be free; advice adds value and must be paid for in a transparent way. Post-RDR, customers have more control and clearer information. Firms have to describe their advice services as 'independent' or 'restricted'. If firms do choose to limit their product range to certain investments or strategies, then this should be clearly set out for customers.

The key to the RDR philosophy is that the cost of advice is decided between the consumer and the adviser. Under the system of adviser charging, firms operate their own schedule of tariffs. Customers who do not want – or perhaps cannot afford – to make an upfront payment can have the product provider 'facilitate' the cost of the advice being included in the product cost on a matched basis (if this facility is available).

Firms must consider how to charge using any combination of:

- a fixed fee for a particular service;
- a percentage basis of the amount of money to be invested;
- time taken to provide the service; and/or
- a separate price for any initial discussions or meetings.

They must also consider how to deal with clients who choose not to go ahead or subsequently cancel.

Advisers need to determine what is considered new business and legacy business. If a particular product is unchanged, but is being amended or extended under options available to the customer when it was purchased, commission can continue to be paid on that product under legacy business. Otherwise, the new adviser charging rules apply to new business.

Advisers should not renegotiate the commission on past transactions, as this could lead to clients having to start paying additional charges for products and services they have already received.

Any ongoing adviser charges should be agreed in a way which is fair, clear and not misleading. In addition, they must only be made in exchange for tangible ongoing services (e.g. regular reviews).

D2 Time-based charging

Similar to most lawyers and accountants, some financial planners base their charges on the amount of time that they spend on each client's affairs (***time-based charging***). They keep timesheets to record the use of their time and make regular charges on the basis of the amount of time spent.

Calculating the charge-out rate on an hourly basis (or proportion of an hour) is based on the following:

- salary or expected income of the planner plus employer's National Insurance contributions (NICs);
- allowance for overheads associated with the planner (e.g. premises, transport, communications, compliance costs, insurance costs, dead time); and
- profit.

A very approximate rule-of-thumb method is to multiply the relevant salary cost by a factor of three or four and divide by the number of working days in the year – for example, about 220 days and divide by 7 hours.

So, a financial planner who was expecting to earn £60,000 personally would have a charge-out rate of about £800 a day, or roughly £135 an hour. Charges might be lower for other members of staff, e.g. paraplanners and administrators. Regional variations in charges occur because of differences in rents and other overhead costs, such as staff salaries.

It may be appropriate to charge a higher rate to a client for very high value work for which the responsibilities are greater, or for a project that has to be completed to a tight deadline that might involve the planner and their staff working unsocial hours.

Most clients expect to have an idea of their likely charges in advance, and this generally is considered to be a requirement under the FCA's fair treatment of customers principles. Financial planners should therefore be prepared to provide estimates of costs for work to be done. If it looks as if the amount of work and its cost will exceed the estimate, the client should be warned and asked if they still want the extra work to be carried out.

There might be a tariff of charges for specific types of work, such as arranging a life policy or providing a valuation.

D2A Advantages and disadvantages of time-based charging

The table that follows discusses the various advantages and disadvantages of time-based charging.

Table 7.3: Advantages and disadvantages of time-based charging

Advantages	Disadvantages
• Clients are familiar with the approach of charging on a time-cost basis, since other types of professionals such as solicitors and accountants use the same approach. • The basis of the charge to clients will generally seem fair in many respects. The charge for a long and complicated programme of work is higher than that for a short and relatively simple set of tasks. • Charges are not linked to the sometimes random increases and reductions in the value of the client's investments.	• Some clients react badly to fees based on the time taken to carry out a task, seeing it – however unfairly – as giving an incentive for inefficiency. Some may resent the length of time and the type of soft questioning involved in the fact-finding stage as being insufficiently practical and task-oriented. • Clients may have difficulty finding available cash to pay large bills for advice. • The fees are potentially subject to VAT (although this is rare), which is not the case if adviser fees are taken from the product.

D2B The financial planner's viewpoint on time-based charging

Fees charged on a time-cost basis can involve the need for careful positioning with the client and additional administration. Scoping and estimating time costs in advance are skills that take time and experience to master. Keeping timesheets, charging regularly and chasing invoices add to a practice's costs.

D3 Fixed fees

A number of planners have a tariff of ***fixed fees*** for certain types of work. These may be based on a variety of criteria, although the likely time cost and the value of the work tend to be the main components. There may also be an additional charge for larger investment portfolios where the potential risk for the planner is proportionately greater than that for smaller portfolios.

D3A Advantages and disadvantages of fixed fees

The table that follows covers the advantages and disadvantages of fixed fees to the client.

Table 7.4: Advantages and disadvantages of fixed fees to the client

Advantages	Disadvantages
• Clients know what they will pay for any given job, and there is usually no risk that it will cost more than the fixed fee. The client is free to get alternative quotations from other advisers. • Clients understand that services are linked to the cost of providing them and the value they derive from them. The costs are not linked to fluctuations in the stock market. • The approach is fair and transparent. • Unlike strictly time-cost based fees, clients are less likely to feel that every minute spent chatting to the adviser is chargeable and may therefore be less resentful of the system.	• There is a danger that fees may turn out to be excessive in relation to the work done. • Clients may have some difficulty in understanding the basis for the fees and therefore be reluctant to pay.

D3B The financial planner's viewpoint on fixed fees

A fixed fee basis is an attractive way to create a regular flow of ongoing income. Still, it carries with it a set of challenges for the planner – positioning with the client, the need to keep timesheets and the administrative issues of billing and collecting payments. The fixed fee approach also involves the risk that the fees are too low and do not cover the costs, or that they are too high and do not attract enough clients.

D4 Legacy trail commission

Refer to

See *Adviser charging* on page 1/13 for more on adviser charging.

With the exception of legacy business held on platforms and automatic enrolment schemes, trail commission on products sold before 1 January 2013 can continue to be paid for the time being. However, any changes made to the contract are likely to result in the legacy trail being switched off and the plan reverting to the adviser charging rules. The only exceptions are:

- automatic increases in premiums due to indexation set up before 1 January 2013;
- automated fund switches;
- automatic rebalancing of a portfolio at set intervals; and
- non-advised reinvestment of dividends or distributions into an existing investment.

D5 Conclusion

Each method of charging has its advantages and disadvantages. Some financial planners use just one approach, while others choose to employ a combination of the different charging methods to suit the client, the work to be undertaken and the circumstances.

The trend has been to align adviser charging to the aspect of the financial planning process that clients generally value most. In the past, the emphasis was more on choosing the appropriate products to meet each client's needs, for example, by selecting a range of pension products from different providers to achieve diversification. It was also natural for adviser remuneration to be linked to this process.

The more recent trend for planning has been to spend more time on advice rather than arranging transactions, with the emphasis being more on understanding each client's aims and risk profile, recommending the appropriate asset allocation and investment strategy and possibly selecting investment funds. The choice of the wrapper provider is typically becoming a more secondary consideration. Likewise, the charging structure has tended to reflect this shift in value towards charging for the advice rather than product selection.

Case study: John and Margaret Williams – second annual review

Outline of the situation

It is the second annual review and there have been a number of developments since the first financial plan for John and Margaret was implemented.

The first of John's consolidated pension schemes has not been crystallised and has grown to £310,000. The second scheme has been crystallised into flexi-access drawdown. John drew £67,500 from it and left the remaining fund to accumulate to £232,500.

John will not start to draw any further benefits from the flexi-access drawdown fund for at least two years and possibly longer. The two pension funds are invested as a single portfolio and when they were originally set up, they held a number of mutual funds that were 55% fixed interest and 45% equity.

The values of the respective funds are now as follows:

- In the £310,000 uncrystallised fund, the fixed interest funds are now worth £139,500, while the equity funds have grown to £170,500.
- In the flexi-access drawdown fund of £232,500, the fixed-interest investments are now worth £104,625 and the equity investments have grown to £127,875.

The recommended asset allocation has not changed for John and Margaret: the pension schemes should still be invested 45% in equities and 55% in fixed-interest securities. However, John is pleased with the performance of the equities and would like to leave the asset allocation as it is now.

Margaret has gone to work for a specialist agency where she is working part-time and is now earning £20,000 a year. This increase in her income has not had the effect of making Margaret a higher-rate taxpayer.

Their expenditure has crept up by about £10,000 a year – almost entirely related to the children – but they are saving an extra £5,000 from Margaret's salary. John continues to earn about £15,000 a year after expenses.

Questions

1. Regarding the pension scheme investments:
   a. Set out the current position of the pension schemes in a tabular format that the clients would easily understand.
   b. What should be done about the current distribution of asset classes in the pension fund? Explain briefly what changes should be made, if any. Give your reasons.
2. Now that Margaret has started earning again, what changes (if any) should she make to her life and health insurance arrangements?
3. Reflect on the factors that Margaret should consider in relation to whether to save her spare £5,000 a year into a pension or an ISA wrapper.

Answers

1. The pension scheme investments

a. Summary of pension funds

The original and current asset allocations and valuations are as follows:

	Uncrystallised scheme				Flexi-access drawdown scheme			
Funds asset class	**Original value £**	**%**	**Current value £**	**%**	**Original value £**	**%**	**Current value £**	**%**
Fixed interest	148,500	55	139,500	45	111,375	55	104,625	45
Equity	121,500	45	170,500	55	91,125	45	127,875	55
Total	**270,000**	**100**	**310,000**	**100**	**202,500**	**100**	**232,500**	**100**

b. The equity funds have grown and the fixed interest funds have lost value. To maintain the recommended asset allocation, the funds need to be adjusted as follows:

	Uncrystallised scheme				Flexi-access drawdown scheme			
Funds asset class	**Current value £**	**%**	**Transaction**	**Values**	**Current value £**	**%**	**Transaction**	**Values**
Fixed interest	139,500	45	Buy £31,000	170,500	104,625	45	Buy £23,250	127,875
Equity	170,500	55	Sell £31,000	139,500	127,875	55	Sell £23,250	104,625
Total	**310,000**	**100**			**232,500**	**100**		

- John has not changed his risk profile, but he has just seen a profitable short-term return from one asset class.
- His risk profile should determine the asset allocation rather than recent market results.
- Bonds are often negatively correlated with equities, so they usually provide valuable diversification.
- He should therefore rebalance the portfolio to make it less risky and to conform more closely to his risk profile.

2. Life and health insurance arrangements

- Margaret and John's expenditure on the children has increased by about £10,000 a year.
- Either they could agree that they would cut back on this expenditure if Margaret died or fell seriously ill, or they should provide enough life and health insurance to cover this increase in expenditure.
- If they decide to take out insurance, they need to apply the appropriate multiple to the £10,000. For the shorter term, this is a factor between the factor for 15 years of 14.5 and the factor for 20 years, which is 18.5. This is roughly 17.
- So, they need to increase the life cover on Margaret's life by £170,000.
- If they can, they should also increase the critical illness insurance (although this may not be possible if the £300,000 limit still applies).
- The extra life cover should be provided through a term or convertible term assurance.
- No change is needed to John's protection arrangements as a result of Margaret starting work.

3. **Tax wrappers**

   Pension

- Margaret has relatively little pension provision in her own name at present.
- She will be auto-enrolled by her new employer, but they may only pay minimum employer contributions.
- She could consider paying in over and above the minimum employee contributions to provide for her retirement.
- She would obtain basic-rate tax relief on her pension contributions.
- It is reasonable to assume that she will probably be a basic-rate taxpayer in retirement, taking into account the widow's pension from John's pension fund as well as the State Pension.
- Margaret would receive 13.25% employee's NIC relief on the pension contribution if her employer was prepared to operate salary sacrifice.
- Salary sacrifice would be especially advantageous if the employer was prepared to invest all or part of the employer's 15.05% NIC saving into the pension.
- John could also consider making pension contributions but, unless he becomes a higher-rate taxpayer (which is unlikely), Margaret's pension is the higher priority, because she should be able to benefit from NIC relief as well as income tax relief if salary sacrifice is used.

ISA

- The tax position of the ISA fund is the same as for a UK-registered pension fund.
- There is no tax relief on the contribution, but the proceeds are tax free.
- The ISA is more accessible for Margaret than any pension scheme, and they may need short-term access, e.g. for school fees.
- Margaret might decide to invest in the ISA for the next five to ten years. She could then dispose of the ISA and reinvest the proceeds in a pension scheme and obtain tax benefit from the tax relief. The £40,000 pension contribution annual allowance must be borne in mind, although Margaret may have some unused carry forward from the previous three years. In any case, her personal tax relievable contributions for a tax year are restricted to her relevant UK earnings (in her case, her salary). She will need to have been a member of a registered pension scheme in the year she is carrying forward the unused annual allowance to be able to use this facility. There may, of course, be further changes to tax legislation in the meantime.

Key points

The main ideas covered by this chapter can be summarised as follows:

Implementation of the plan

- The financial planner should carry out the transaction on the best terms available, i.e. best execution.
- The financial planner should disclose the charges and costs to the client before transacting the business.
- Platforms offer a comprehensive and cost-effective solution for many clients, but they may not be suitable in some circumstances and for some clients.
- Where the financial planner has issued the client with a suitability report and there have been changes from the original proposal, the report will need to be amended and reissued.
- Where an insurance company has underwritten a client and the terms are more expensive and/or restricted, the situation will need to be discussed with the client.

Platforms

- Platforms are not products themselves. They are a set of services brought together by technology that allows them to be delivered in an efficient, scalable and repeatable fashion.
- Platforms generally offer access to a very wide range of investment funds, with some also offering additional assets such as exchange-traded funds (ETFs), investment trusts, gilts, corporate debt and equities.
- Most platforms have a range of tax wrappers available, including individual savings accounts (ISAs), pensions and onshore and offshore bonds. Some have more sophisticated additional wrappers available, such as small self-administered schemes (SSASs), trustee investment plans and s.590 schemes.
- Platforms usually produce a wide range of adviser and client-facing reports to help with annual reviews, valuations and other client-facing activity. They may also have some adviser practice management reports, such as transaction histories and adviser charge reconciliations.

The need for regular monitoring and review

- Plans should be reviewed in light of how investments have performed and any other changes that have taken place.
- Changes can be in relation to the client's circumstances, their views, tax or legislative changes or maturing plans.
- For most clients, reviews should take place at least once a year. The frequency of review depends on regulatory requirements, the service agreement and what was agreed at the outset, as well as when any significant life events occur.
- The nature of the review depends on the interval from when the plan was originally implemented or last amended.
- For investments, longer-term trends in past performance are more important than those over the very short term, i.e. up to a year.

The different ways financial planners charge for their services

- The main ways advisers can be remunerated for their services are as follows:
  – time-based charging; and
  – fixed fees.
- The cost of advice is decided between the customer and the adviser. Customers are able to either make an upfront payment or have the product provider 'facilitate' the cost of advice being included in the product cost on a matched basis.

Appendix 1 Financial planning checklist

The following checklist can be helpful when reviewing a client's file to see what needs to be updated.

Day-to-day expenses

- Could the client save more from income?
- Is there surplus income to provide for life and health insurance, pension contributions and other financial needs?
- Is there any discretionary expenditure the client would be willing to reduce to better achieve their financial objectives?
- Are there any financial reserves, e.g. for a period of unemployment?
- Could the client save on tax and National Insurance contributions (NICs)?
- Are there potential costs that could be reduced on financial products/services (e.g. life assurance or mortgage interest)?

Mortgages and loans

- How much does the client want to borrow?
- Should the client reduce borrowings?
- Is the client aware of the cost of their mortgage and can they afford the repayments?
- Has the effect of an increase/decrease in interest rates been considered?
- Are loans covered by life assurance, health cover and redundancy cover?
- Could any of the client's loans be reorganised on a more cost- or tax-efficient basis?
- Does the repayment method meet the client's wishes and needs?
- Will the loan be repaid in good time (e.g. by retirement)?
- If the mortgage is interest-only, is there a means of repayment in place?
- If a re-mortgage, are there any early repayment charges?

Life assurance

- Would anyone suffer financially if the client died?
  - If so, has enough cover been provided for them?
  - How long are they likely to be financially dependent for?
- Is life assurance arranged in the most appropriate way (e.g. types of contract, flexibility, trust arrangements)?
- Are any loans or guarantees not covered?
- What is the shortfall?
- Could cover be arranged more tax- or cost-effectively?
- Would cover be lost in the event of pre-emptive claims, e.g. critical illness, first death joint policies?
- Is there anyone else whose death would affect the client's financial position (e.g. relative, employee, partner, borrower)?
- Is the £3,600 premium limit per beneficial owner for fully qualifying policies issued (or varied) from 21 March 2012 being exceeded?

Health insurance

- Has the client's health changed since the last review?
- Would the client's income reduce if they were incapacitated through sickness or accident, and could not work?
- If the income were reduced, by how much and for how long?

- Would there be any extra expenses if they were incapacitated and could not work?
- What are the terms of the client's employment contract in relation to long-term ill health?
- How would a period of incapacity affect the client's pension entitlement?
- Would their pension scheme pay an early retirement ill health pension?
- Has enough income protection been arranged?
- Is the cover competitively and appropriately arranged?
- Are there unacceptable exclusion clauses?
- Is there adequate waiver of premium or income protection cover for life and pension policies?
- Would there be a need for capital (e.g. loans, business needs, school fees) if the client suffered a serious illness?
- Does the client have enough critical illness cover?
- Does the existing critical illness cover provide broad enough cover?
- Is the critical illness cover competitively priced?
- Does the client need/have private medical insurance?
- Is the private medical insurance cover adequate?
- Would lack of funds for long-term care affect the financial position of the client's partner and/or the rest of their family?
- Is there any other person whose serious ill health would affect the client's financial position (e.g. relative, employee, business partner, borrower)?
- Should the client consider long-term care cover for themselves or a family member?

Pension provision

- Is the client and/or the employer funding their pension at an adequate level to provide enough income and capital in retirement?
- Is the current method/vehicle for providing their pension appropriate?
- What is the maximum that could be invested into pension provision? Are all potentially pensionable earnings being taken into account?
- Are the selected pension funds appropriate to the client's timescale and attitude to risk?
- How should the pension plans be arranged on retirement to maximise the tax-free lump sum?
- To what extent does the client want control over or access to their pension fund?
- Would the client prefer the security offered by an annuity, or are they able to tolerate the risk that comes with taking an income and/or ad hoc withdrawals from their pension fund?
- Is there adequate pension income for the client's spouse/partner and/or other dependants?
- Is there adequate inflation protection for pensions in payment?
- Have all the options for paid-up pensions from previous employers been examined?
- Have the options for increased flexibility on retirement been explored (e.g. flexi-access drawdown, open market option) and are they available from the client's existing pension arrangements?
- Has the client previously used up any of their lifetime allowance, and if so what percentage?
- Is the pension fund close to the lifetime allowance limit?
- Is the client eligible for any transitional protection(s)?
- Is the client's view on their planned retirement age unchanged?
- Are they willing to use other assets or investments towards their retirement provision?
- Are they aware of the changes that have affected defined contribution (DC) schemes since April 2015?
- Is the ability to leave their DC pension intact for their children important to them?

Investments and/or savings

- What does the client want and need: capital growth, balance of capital growth and income, or maximum immediate income?
- Do the current investments/savings plans match the client's needs and attitude to risk?
- Could the client's investments and savings be organised more tax-efficiently (e.g. by transfer to their spouse/partner)?
- Has the client used their tax-free personal savings allowance (if available) and dividend allowance?
- Has the client used their annual individual savings account (ISA) allowance?
- Is the client eligible for the Lifetime ISA?
- Has the client used their capital gains tax (CGT) annual exempt amount?
- Does the client have any losses available to offset any gains arising?
- Should investments and savings be arranged for a specific purpose, such as school fees?
- Should available finances be used to repay borrowings and/or increase pension provision?
- Are there any with-profit funds that need reviewing?

Estate planning

- Has the client made a will?
- Has the will been invalidated by marriage or civil partnership?
- Does the will continue to reflect the client's wishes and needs?
- Have arrangements been made in the will (or by other means) to provide for the client's children and other dependants?
- After one partner's death, will the surviving partner be financially secure?
- Are both spouses/partners UK-domiciled?
- Is there a substantial potential IHT liability on the client's death?
- Has the nil rate band been used to reduce IHT liability in the will or through lifetime gifts? Or are the clients willing to rely on the transferable nil rate band?
- Does any action need to be taken to ensure that the residence nil rate band is not wasted?
- Can the client use the annual exemptions/normal expenditure from income and the potentially exempt transfer (PET) provisions to make lifetime transfers?
- What trust arrangements should be made (including placing existing life policies under trust)?
- Are existing trust arrangements appropriate from taxation and personal points of view?
- Is jointly held property correctly arranged (e.g. as joint tenancy or tenancy in common)?
- Has the client made a lasting power of attorney (LPA) or an enduring power of attorney (EPA)?
- Have either of the clients been previously married and, if so, have they inherited a previous spouse's nil rate band and/or residence nil rate band?

Appendix 2
Case study 1: Lucy Smith

Step 1 – establish and define the client and financial planner relationship

1.1 Summarise the main steps in the financial planning process for the client, Lucy Smith

1. Establish and define the relationship that will exist between Lucy, as the client, and the financial planner.
2. Gather the data about Lucy and determine her goals and expectations.
3. Analyse and evaluate Lucy's financial status, setting out her net worth, and current and future cash flows.
4. Develop and present the financial plan to Lucy with recommendations.
5. Implement the financial planning recommendations for Lucy.
6. Monitor Lucy's financial plan and the financial planning relationship.

Step 2 – gather client data and determine their goals and expectations

2.1 The pre-meeting fact-find

Before the meeting, Lucy sends the financial planner a fact-find she has partially completed. The contents are as follows:

Part 1 Personal details

Name:	Lucy Smith
Private address:	Flat 2, 28 The Glade Glebeland Herts
Home telephone:	
Work telephone:	
Mobile telephone:	
Age:	82
Tax status:	UK resident and domiciled. Born in the UK.
Relationship status:	Widowed.
Health:	Reasonably active, non-smoker, blood pressure being treated by pills and has some other age-related conditions.

Part 2 Family details

Son:	James Smith, divorced, aged 60, in good health, retired and not financially dependent on me.
Daughter:	Megan Anderson, married, aged 53, in good health, human resources manager and not financially dependent on me.
Grandchildren:	Two grown-up grandchildren: Michael Smith, aged 27, and Erin Anderson, aged 24. Both married and not financially dependent on me, though they sometimes ask their parents for help.
Great-grandchildren:	Emma Smith, aged 2, and Ewan Anderson, aged 18 months.

Part 3 Employment details

Retired.

Part 4 Professional advisers

Accountant:	Wiltshire and Co, High Street, Glebeland, Herts
Doctor:	Dr Jones, Glebeland Health Centre, Glebeland, Herts
Financial adviser:	Fiscal Associates, Warnborough Heath, Herts
Solicitor:	Alistair Taylor, Glebeland, Herts
Stockbroker:	Willis-Willett, London

Part 5 Income and expenditure

Annual income	
State Pension benefits	£7,500
Private pension benefits	£12,227
Income from investments (dividends)	£6,200

Annual expenditure	£	%
Home-related expenses		
Council tax and water rates	1,700	
Property repairs, buildings and contents insurance	800	
Gas, electricity, telephone, TV, post	2,000	
Subtotal home-related expenses	**4,500**	**43**
Household expenses		
Food and household basics	1,900	
Magazines and subscriptions	150	
Clothes, shoes, hairdressing	800	
Other household	450	
Subtotal household expenses	**3,300**	**32**
Caring for children and others		
Presents for grandchildren and great-grandchildren	400	
Subtotal caring expenses	**400**	**4**
Leisure and entertainment		
Eating out	400	
Travel and holidays	1,000	
Other entertainment (e.g. theatre and shows)	720	
Subtotal leisure and entertainment	**2,120**	**21**
Total expenditure	**10,320**	**100**

- My daughter comes in to help clean the house once or twice a week.
- Expenditure should stay about the same in the next two years unless I have to go into a nursing home because of declining health.

Part 6 Assets

Asset	£	%	Income £
Home	200,000		
Contents	20,000		
Total used assets	**220,000**	66	
Portfolio of UK shares	110,000		6,200
Current account	3,000		
Total investments	**113,000**	34	
Total assets	**333,000**	**100**	

Part 7 Liabilities
None.

Part 8 Life assurance
None.

Part 9 Health insurance
None.

Part 10 Regular savings
No regular savings plan, although my income comfortably exceeds expenditure. I give most of any surplus to my son and daughter from time to time, as I am keen to save inheritance tax (IHT) on my estate.

Part 11 Pensions
- I receive the Basic State Pension plus a small amount of Additional State Pension, totalling £7,500.
- I also get the Widow's Pension from the scheme established by my late husband's employer, currently worth £12,227 a year.

Part 12 Inheritance
- I made a will about 20 years ago and the solicitor has a copy.
- The entire estate is left to my two children and divided equally between them.
- I have not made very large gifts to my children – perhaps £4,000 last year.

Part 13 Risk profile and capacity for loss
The client has not answered this section.

Part 14 Ethical investments
The client has not answered this section.

2.2 Asking more questions

The financial planner needs to find out more information than was contained in this initial fact-find and asks a number of additional questions in each of the main areas.

Part 1 Personal details

How long does the client feel she will be able to continue living on her own?	
Ask	The client.
Reason for asking	To see if and when she is likely to need to go into a long-term care home in the near future.

Would the client like to have more help around the home with cleaning, cooking or other tasks?	
Ask	The client.
Reason for asking	To see if there is likely to be an increase in her expenditure in the near future to pay for these additional services.

Is any family member able to spend more time helping the client?	
Ask	The client and her children.
Reason for asking	To see whether the client's son can help and possibly to identify whether her daughter's services might need to be replaced or augmented sometime soon.

Part 2 Family details

Do members of the client's family live nearby?	
Ask	The client.
Reason for asking	To see if there is any possibility that the son might help his mother if he lives locally.

Would the client like to be able to help financially with the grandchildren and great-grandchildren?	
Ask	The client.
Reason for asking	To find out if she would like to organise giving to younger members of her family – perhaps via a trust.

Part 3 Employment details

No questions.

Part 4 Professional advisers

How often does the client see or speak to each of her listed professional advisers?	
Ask	The client.
Reason for asking	To find out which, if any, are central to looking after her affairs.

Part 5 Income and expenditure

To what extent is the Widow's Pension from the scheme set up by her late husband's employer protected against inflation?	
Ask	The client – and possibly examine her monthly banking. Otherwise ask the employer and/or pension provider/scheme trustees.
Reason for asking	To see how far the pension will escalate in future in line with inflation.

Has there been a considerable change in the client's spending patterns in recent years?	
Ask	The client and her daughter.
Reason for asking	To see whether expenditure is rising or falling and the main trends for future budgeting.

What State benefits is the client entitled to, apart from her pension?	
Ask	The client and her daughter.
Reason for asking	To find out about the client's income.

Is the income from investments purely dividend income?	
Ask	The client and her stockbroker and/or check dividend payment slips/end-of-tax-year payment summaries.
Reason for asking	To be able to calculate her net income after tax.

Part 6 Assets

Can we please have a copy of the latest portfolio valuation?	
Ask	The client.
Reason for asking	To see how the portfolio is invested and the income it generates.

1. What is the base price of each of the shares in the portfolio of investments? **2. Does the stockbroker generally maximise the client's capital gains tax (CGT) annual exempt amount each year?**	
Ask	The stockbroker and/or look at the portfolio valuation.
Reason for asking	To calculate the potential CGT liability if it became necessary to cash in the portfolio.

1. How much is the client involved in the management of her portfolio of investments? How often does the client speak to the broker? 2. What is the aim of the portfolio? Is it growth or income, or both? 3. What sorts of investments would the client want to avoid? 4. Why does the client have a portfolio of individual shares rather than funds?	
Ask	The client.
Reason for asking	To check her approach to investment and understanding of investment risk.

If the client decided to let her home, what level of rent after expenses could she expect to receive?	
Ask	The client, other members of her family, local estate agent.
Reason for asking	This could be a valuable source of future income if the client needs to have residential care.

Part 7 Liabilities

No questions.

Part 8 Life assurance

No questions.

Part 9 Health insurance

No questions.

Part 10 Regular savings

How much surplus was there this year? How much did you give your son and daughter?	
Ask	The client.
Reason for asking	To assess the affordability of gifting.

Part 11 Pensions

See also Part 5 Income and expenditure about inflation protection of the pension income.

Is the client sure that the State Pension figure is correct?	
Ask	The client and/or bank statement.
Reason for asking	So that accurate net income figures can be calculated.

Part 12 Inheritance

Does the client feel that her will is up to date and reflects what she would like to happen to her estate?	
Ask	The client.
Reason for asking	To see if the will should be revised.

1. Has the client made a lasting or enduring power of attorney (LPA or EPA)? **2. Has the client any objection to making such a power?** **3. Who would the client appoint as her attorney(s)?**	
Ask	The client and/or the children and/or the solicitor.
Reason for asking	To check whether an EPA or LPA has been set up and, if not, alert the client to the need to do so.

1. When the client's husband died, did he leave Lucy all of his estate or did he leave bequests to anyone else? **2. Why does the client think there may be an IHT liability on her estate?**	
Ask	The client and/or the solicitor.
Reason for asking	To check the IHT liability on her death, if any. To check availability of her late husband's unused nil rate band and residence nil rate band.

Part 13 Risk profile and capacity for loss

1. What is the client's attitude to investment risk, and how does she feel about fluctuating stock market investments? 2. Would the client be willing to complete a risk-profiling questionnaire?	
Ask	The client.
Reason for asking	To help determine the client's attitude to risk and capacity for loss and decide whether the current asset allocation and portfolio is still suitable for her.

Part 14 Ethical investments

Are there any types of investments that the client would want to avoid on ethical grounds (e.g. tobacco)?	
Ask	The client.
Reason for asking	To find out whether the portfolio or any part of it should take into account ethical or socially responsible investment (SRI) objectives.

2.3 Revised fact-find

This is the fact-find that was completed after the various questions had been answered and after it had become clear that Lucy would have to move into a residential care home as a result of her deteriorating health. <u>The changes are underlined</u>.

Part 1 Personal details

Name:	Lucy Smith
Private address:	Flat 2, 28 The Glade Glebeland Herts
Soon to move to:	<u>Long Acres Retirement Home</u> <u>Glebeland</u> <u>Herts</u>
Home telephone:	
Work telephone:	
Mobile telephone:	
Age:	82
Tax status:	UK resident and domiciled. Born in the UK.
Relationship status:	Widowed.
Health:	<u>Reasonably active, non-smoker, blood pressure being treated by pills and has other age-related conditions. These have necessitated her move into the care home. The prognosis is that she could live many years in the new environment.</u>

Part 2 Family details

Son:	<u>James Smith, divorced, aged 60, in good health, retired and not financially dependent on the client. He lives in Sussex and comes to see his mother about once a month.</u>
Daughter:	Megan Anderson, married, aged 53, in good health, human resources manager and not financially dependent on the client.
Grandchildren:	Two grown-up grandchildren, Michael Smith, aged 27, and Erin Anderson, aged 24. Both married and not financially dependent on the client, though they sometimes ask their parents for help.
Great-grandchildren:	Emma Smith, aged 2, and Ewan Anderson, aged 18 months. <u>The client would like to help the grandchildren and great-grandchildren more but, given her current circumstances, she cannot see how she can afford this. Still, she would like to leave something to them in her will.</u>

Part 3 Employment details

Retired.

Part 4 Professional advisers

Accountant:	Wiltshire and Co, High Street, Glebeland, Herts
Doctor:	Dr Jones, Glebeland Health Centre, Glebeland, Herts
Financial adviser:	Fiscal Associates, Warnborough Heath, Herts
Solicitor:	Alistair Taylor, Glebeland, Herts
Stockbroker:	Willis-Willett, London

The client does not consult any of these advisers frequently. She receives quarterly valuations from the stockbroker and takes a little interest in the contents, especially in shares like Marks & Spencer where she feels she knows the business. She occasionally speaks to the broker when he calls her to suggest a major change in the portfolio.

Part 5 Income and expenditure

Annual income	
State Pension benefits	£7,500
Private pension benefits	£12,227
Income from investments	£6,200

The client currently does not claim any other State benefits. However, it is expected that she will qualify for the lower rate of attendance allowance of £3,216.20 a year (£61.85 × 52), which would be tax free and not means-tested. This is on the basis that she only requires assistance at night. If her health deteriorates further, and she finds she needs assistance both day and night, she may qualify for the higher rate in the future.

The private pension is limited price indexation (LPI) linked, i.e. retail prices index (RPI) up to 2.5% or 5% a year.

If the client were to let her house rather than sell it, she could expect an income after expenses of about 5% of its current value or £10,000 a year. However, the house needs about £20,000 spent on it to be let at this level.

Annual expenditure

The client's expenditure pattern will be very simple in the future.

The residential home fees will be £550 a week and have been rising at the rate of 2.5% a year above the consumer prices index (CPI) on average.

If the client needs full-time nursing care, the cost will roughly double.

The client estimates that she will need about £3,500 a year for out-of-pocket expenses, outings, alcohol, presents, clothes etc.

Part 6 Assets

Asset	£	%	Income £
Home	200,000		
Contents	20,000		
Total used assets	**220,000**	66	
Portfolio of UK shares	110,000		6,200
Current account	3,000		
Total investments	**113,000**	34	
Total assets	**333,000**	**100**	

The client's equity portfolio is managed by a stockbroker. It consists of about 18 different holdings, most of which are in the FTSE 100 and about four or five of which are in the FTSE 250. The stockbroker generally aims to make the fullest possible use of the CGT annual exempt amount.

The £6,200 income from the portfolio consists entirely of UK dividends.

The stockbroker aims to avoid any speculative shares and obtains all the overseas exposure that he feels is needed through UK international shares with a large overseas presence, such as Rio Tinto and British American Tobacco.

The portfolio is managed to provide a relatively high and rising income from equities, as well as some capital growth.

The client inherited the portfolio from her late husband, whom she regards as someone who 'really understood money and investments'. He believed in investing in shares and the client has always followed his lead in these matters.

The client owns her home, which is worth about £200,000. The client could either let the home or sell it. If the property were to be let, the agent thinks it could provide an income of about £10,000, i.e. 5% after expenses. The rent should increase in the longer term.

Part 7 Liabilities
None.

Part 8 Life assurance
None.

Part 9 Health insurance
None.

Part 10 Regular savings
There will be no savings in the future.

Part 11 Pensions

- The client receives the Basic State Pension plus a small amount of Additional State Pension, totalling £7,500. She has checked this figure.
- The client also receives the Widow's Pension from the scheme established by her late husband's employer, currently worth £12,227, which is subject to LPI, i.e. RPI up to 2.5% or 5% a year.

Part 12 Inheritance

- The client has a valid will, which she made about 20 years ago. It is lodged with the solicitor.
- The client has left her entire estate to her two children and it is divided equally between them.
- The client has not made very substantial gifts to her children – perhaps £4,000 last year.

The client would like to leave some of her assets directly to her grandchildren and their children, so it will be necessary to revise her will.

The client has never heard of an LPA and is a little resistant to the idea, but she would like to understand it better.

Part 13 Risk profile and capacity for loss
The client has not answered this section.

Part 14 Ethical investments
In the future, the client would like to avoid investing in anything that involves cruelty to animals, or tobacco or arms manufacture.

Step 3 – analyse and evaluate the client's financial status

Based on the final fact-find, it is now possible to produce a summary and analysis of each of the main areas.

3.1 Income

The client's income position is currently as follows:

	£
State Pension benefits	7,500
Private pension benefits	12,227
Dividends	6,200

The client will qualify for the lower rate of Attendance Allowance of £61.85 a week or £3,216.20 a year.

The level of nursing that the client needs is not thought to be enough to trigger the payment of State aid for nursing care at this stage in her life.

As long as the client spends about £20,000 on redecorating and updating aspects of the house, she should be able to let the house in a full year for about £10,000 a year.

Taking into account the rental income, the probable State benefits and the £20,000 reduction in her portfolio value to cover the refurbishment, the client's income before tax would be as follows:

	£
State Pension benefits	7,500
Private pension benefits	12,227
Income from investments (dividends)*	5,072
Rental income	10,000
Total	**34,799**
State benefits (tax free)**	3,216
Total income and benefits	**38,015**

*Dividend income adjusted to reflect £20,000 reduction in portfolio value ((£110,000 − £20,000) ÷ £110,000) × £6,200 = £5,072 (rounded down).

**Attendance Allowance of £3,216.20 (rounded down).

Reinforce

State support for care

In England, the State pays for the cost of 'nursing care', which is defined as the 'costs of registered nurse time spent on providing, delegating or supervising care in any setting'. In 2022/23, the level of payment to cover registered nursing care was £209.19 a week. It is paid directly to the care home and is tax free and not means-tested. In some cases, the NHS may provide nursing care directly where there is a need for continuing NHS care – although this situation is hard to define and is narrower than a lay person might predict. The amount seldom covers the full costs, especially in the south-east of England. The rules in Scotland, Northern Ireland and Wales vary.

The cost of care homes varies considerably. According to LaingBuisson, in 2021 residential care homes for older people in England needed to charge fees of £696 to £849 per week to generate a sustainable return. Nursing care costs between £969 and £1,075 per week.

3.2 Income tax position

In the current year (assuming the house is let), the client's income tax position is as follows:

Income	**£**	**£**
Pensions	19,727.00	
Dividends	5,072.00	
Rental income	10,000.00	
Total income		**34,799.00**
Personal allowance £12,570	0.00	
Pension and rental income of £29,727 − £12,570 = £17,157 taxed at 20%	3,431.40	
Dividend income of £5,072 − £2,000 (dividend allowance) = £3,072 tax at 8.75%	268.80	
Total income tax		**3,700.20**
Net income		31,098.80
Attendance Allowance		3,216.20
Total spendable income a year		**34,315.00**

Expenditure	**£**	**£**
Nursing home fees	28,600.00	
Out of pocket expenditure	3,500.00	
Total expenditure		**32,100.00**
Annual surplus		**2,215.00**

3.3 Future cash flow calculation

Calculate the client's net cash flow for the current year and the next ten years. When would she need to consider selling her home? Assume that:

- The client's income from her pensions starts at £19,727 and will increase by an average of 2.5% a year.
- Her State benefits will also increase in line with 2.5% a year.
- The client will continue to receive dividend income. Dividends grow by 2.5% a year, but this will be countered by her need to realise investments to meet her income shortfalls, so the overall dividend stream will decline.
- Her expenses will increase by 5% a year.

In setting out the cash flow, all the other income is assumed to rise at 2.5% a year, so it can all be aggregated after tax. The first line of the cash flow is therefore total spendable income less net dividend income, i.e. in the first year, £34,315 *less* £4,803 = £29,512.

The client's portfolio at the start of the period is worth £90,000, i.e. £110,000 less the £20,000 that she will have to spend on the home in order to bring it up to letting standards.

Cash flow projection based on the current equity portfolio

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
Net pension, rent and allowances	29,512	30,250	31,006	31,781	32,576	33,390	34,225	35,081	35,958	36,857	37,778	38,722	39,690	40,682	41,699
Dividends	5,072	5,327	5,554	5,745	5,891	5,981	6,003	5,943	5,783	5,504	5,083	4,493	3,703	2,677	1,372
Tax on dividends	269	292	311	328	341	349	351	346	332	307	270	219	149	59	0
Net dividends	4,803	5,035	5,243	5,417	5,550	5,632	5,652	5,597	5,451	5,197	4,813	4,274	3,554	2,618	1,372
Total net income	**34,315**	**35,285**	**36,249**	**37,198**	**38,126**	**39,022**	**39,877**	**40,678**	**41,409**	**42,054**	**42,591**	**42,996**	**43,244**	**43,300**	**43,071**
Expenditure	32,100	33,705	35,390	37,160	39,018	40,969	43,017	45,168	47,426	49,797	52,287	54,901	57,646	60,528	63,554
Annual surplus/ deficit	**2,215**	**1,580**	**859**	**38**	**-892**	**-1,947**	**-3,140**	**-4,490**	**-6,017**	**-7,743**	**-9,696**	**-11,905**	**-14,402**	**-17,228**	**-20,483**
Portfolio at start of year	90,000	92,215	93,795	94,654	94,692	93,800	91,853	88,713	84,223	78,206	70,463	60,767	48,862	34,460	17,233
Portfolio at year end	**92,215**	**93,795**	**94,654**	**94,692**	**93,800**	**91,853**	**88,713**	**84,223**	**78,206**	**70,463**	**60,767**	**48,862**	**34,460**	**17,233**	**-3,250**

- On the basis of the cash flow analysis, all being well, the client would not need to consider selling her home to finance her continuing stay at the residential home until the start of year 15. However, she will be running down her liquid capital.
- Although the deficit is relatively low in the early years, the cash and investments will run down rapidly as year-by-year expenditure rises and the income-producing capital falls.
- If the client were to need full nursing care, she would use up her available capital much more quickly.
- Capital losses and reductions in the client's income would also reduce the value of her capital more rapidly.

3.4 Change in cash flow assuming a £30,000 sale in year 4

- The following cash flow projection demonstrates what the impact would be if the client had to sell £30,000 of her portfolio to meet an emergency liability in year 4.
- The fund would be depleted before the end of year 12.

Cash flow showing the impact of a £30,000 sale at the end of year 4

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12
Net pension, rent and allowances	29,512	30,250	31,006	31,781	32,576	33,390	34,225	35,081	35,958	36,857	37,778	38,722
Dividends	5,072	5,327	5,554	5,745	4,025	3,960	3,811	3,562	3,194	2,684	2,007	1,132
Tax on dividends	269	292	311	328	178	172	159	137	105	60	1	0
Net dividends	4,803	5,035	5,243	5,417	3,847	3,788	3,652	3,425	3,089	2,624	2,006	1,132
Total net income	**34,315**	**35,285**	**36,249**	**37,198**	**36,423**	**37,178**	**37,877**	**38,506**	**39,047**	**39,481**	**39,784**	**39,854**
Expenditure	32,100	33,705	35,390	37,160	39,018	40,969	43,017	45,168	47,426	49,797	52,287	54,901
Annual deficit	**2,215**	**1,580**	**859**	**38**	**-2,595**	**-3,791**	**-5,140**	**-6,662**	**-8,379**	**-10,316**	**-12,503**	**-15,047**
Portfolio at start of year	90,000	92,215	93,795	94,654	64,692	62,097	58,306	53,166	46,504	38,125	27,809	15,306
Portfolio at year end	**92,215**	**93,795**	**94,654**	**64,692**	**62,097**	**58,306**	**53,166**	**46,504**	**38,125**	**27,809**	**15,306**	**259**

3.5 Asset statement (assuming sale of £30,000 of the portfolio at the end of year 4)

Asset	£	%
Home	200,000	70
Contents	20,000	7
Total used assets	**220,000**	**77**
Portfolio of UK shares	64,692	22
Current account	3,000	1
Total investments	**67,692**	**23**
Total assets	**287,692**	**100**

3.6 Summary of the financial planning aims for the client

- The main aim is to provide the client with a dependable cash flow from her investments to pay for the projected costs of the care home.
- If possible, there should be some assets for the client to leave to her family in her will.
- The investments should be low risk because the client will be drawing on them each year.
- The investments will need to be flexible to meet changing circumstances.

Step 4 – develop and present the financial plan with recommendations

4.1 The client is considering the most appropriate strategy for investing her capital and is looking at the choice between:

a. continuing with the current portfolio of equities;

b. buying a portfolio of government and corporate bond funds and cash; and

c. purchasing an annuity.

Question

Explain the main features of each approach, and the main advantages and disadvantages. State which strategy is likely to be the most suitable for the client.

Answer

a. Continuing with the current portfolio of equities

The client could continue with the current approach of having a stockbroker look after her portfolio of UK equities. The hope would be that the combination of dividend yield and capital growth generates sufficient returns for the client to be able to pay the rising costs of her care home fees. Shares in the FTSE 100 are generally less volatile than shares in smaller companies. Confining the shares to UK investments would eliminate any direct currency risk.

The advantages of the current portfolio of shares are:

- In the long term, the portfolio should provide both capital growth and income.
- For equities, they are relatively high yielding.
- Gradual disposal of the shares will almost certainly prevent the client from incurring a CGT liability on her disposal.
- The client is happy with the current arrangements because she is used to them.

The disadvantages are:

- Shares are highly volatile – even those in the FTSE 100. There is a serious risk that the value of the investment could decline very sharply. The client would still have to take substantial withdrawals at that point and deplete the fund even further when values were low.
- If the client had a longer timescale, this might matter less, but she is drawing capital and income from the fund every year. There may not be time for the fund to recover.
- The client's portfolio currently contains shares that do not conform to her feelings with regard to ethical investment.

b. Buying a portfolio of government and corporate bond funds and cash

The client could buy a range of gilts and UK investment-grade corporate bonds. As the client is a basic-rate taxpayer, high-yielding investments would be suitable for her. To eliminate short-term volatility, at least two years' fees could be held in the form of cash deposits. The maximum percentage of the portfolio should be in the form of cash and bond ISAs to generate tax-free income. Income from such investments outside of an ISA wrapper would benefit from the client's £1,000 personal savings allowance.

The advantages of bond funds and cash are:

- The level of volatility should be much lower than for equities.
- The chances of making total losses within bond funds are less than with equities.
- The yield could be higher than for equities if past trends are a guide.
- The spread of investments within the funds should reduce the impact of institutional failures on the portfolio as a whole.

The disadvantages of bond funds and cash are:

- The returns from cash and fixed-interest securities may not match the returns from equities.
- Corporate bonds can be very volatile, although they generally fluctuate less than equities.
- Gilts generally provide low returns and most have built-in losses if they are held to redemption.
- Funds do not generally provide the opportunity to investors to have the security of holding individual bonds to redemption.
- There may be a CGT liability on realising her investments to purchase bond funds.

c. Purchasing an annuity

The client could buy an annuity with a lump sum and in return receive a guaranteed income for her lifetime. The annuity could be capital-protected, guaranteeing that the total gross payments would equal the purchase price; any underpayment on death would be treated as a return of capital and would not be taxed. However, the income paid would be lower than from a non-protected plan.

The advantages and disadvantages of annuity purchase are shown in the following table.

Advantages	Disadvantages
• The client could be sure that the annuity would continue for as long as she lives. • The income would be tax free if it is paid directly to the care home as an immediate care annuity. • The client would probably benefit from a higher than average annuity rate because of her state of health. • The level of income would be high and guaranteed.	• The purchase would be irreversible and so the client would lose control of her capital. • The income would be fixed (although a fixed level of increase could be included or a flexible annuity purchased, which would allow increases/ decreases in line with the terms of the annuity contract), while the client's expenditure could rise more rapidly. • Depending on the type of annuity chosen, the death benefits could be poor or non-existent. • There is also a timing risk in the purchase of an annuity. A higher income might be available in future if medium- and long-term interest rates rise.

4.2 The client could sell her home now rather than let it. What are the advantages and disadvantages of selling the property?

The advantages and disadvantages of selling the property now are detailed in the following table.

Advantages	Disadvantages
• The proceeds could be invested in more liquid investments that could be sold year by year. • There would be no CGT liability because the property has been the client's main residence throughout the period she has owned it. • The income from quoted investments and bonds would be more secure than the income from property rent, where there can be voids or tenants who do not pay regularly. • If the property is retained, there might be unexpected additional costs involved in owning the property, e.g. repairs and renewals. • Investments could be much more diversified than is possible with a single residential property. • If the property is retained, it will need managing, which could involve cost and worry.	• The client could miss out on continuing CGT-free capital growth. If the property is retained, the last 36 months of ownership would be free of CGT, and there are other exemptions and reliefs that would almost certainly extend the period of CGT-free ownership. • It would be difficult to find an investment that produces such a relatively high and growing yield. • There would be transaction costs that would eat into the capital. • The client is used to the risks involved in holding the property.

Step 5 – implement the financial planning recommendations

In implementing the plan, the financial planner should generally act as quickly as possible to set up insurances, complete purchases or disposals and take other actions. Where there are delays, the client should be kept informed and understand the reasons for any hold-up. In some cases, a recommendation might have to change, perhaps because of developments in the market, underwriting difficulties or some other administrative reason. In such circumstances, the suitability report will need to be amended.

In Lucy's case:

a. If the client decides to continue holding her portfolio of shares, the financial planner has a number of actions to take:

- Discuss whether the existing investment manager should be retained, or whether it would be worth inviting different portfolio managers to pitch for the business.
- Brief the portfolio manager carefully about the overall situation and how their role fits into the plan.
- Ensure that the financial planning firm is provided with regular portfolio valuations and reports on the performance of the investments and the cash flow that they are producing for the client.

b. If the client agrees to buy a portfolio of recommended bond funds, it is important that this should be undertaken quickly in case there is an adverse movement in the market.

c. If the client agrees to the annuity purchase, this too needs to be implemented as soon as possible after the client agrees to the recommendation. Annuity quotes are time limited. This will create a deadline for action. In volatile markets where interest rates are rising and falling, a delay could mean a significant reduction in long-term income.

d. The client will need to let or sell the property. Dealing with property transactions is not generally the responsibility of financial planners. However, if the planner does take this on, it is important to do the task as efficiently and as quickly as possible. If a family member or some other person is to be responsible for the work, it is good professional practice for the financial planner to make sure that the person is aware that they are taking on the task and the expectations.

Step 6 – monitor the financial plan and financial planning relationship

Question

How often should the financial planner keep the situation under review, and what are the main issues to consider in the review?

Answer

Due to Lucy's age and her particular needs, her financial plan should be kept under regular review, on a six-monthly basis or possibly more frequently. The cost and frequency of the review should be clearly explained to the client and her agreement obtained. The financial planner needs to ensure that reviews are conducted at the intervals agreed at the outset. The aims of the review would be to:

- check on the client's needs and, in particular, how far costs have risen and whether she is likely to need significantly more expensive care;
- monitor the performance of the investments;
- dispose of investments as and when needed;
- review whether to dispose of the client's home; and
- consider whether to buy an annuity in light of the client's advancing age and possible deteriorating health, and the likelihood of increasing nursing home fees.

Appendix 3
Case study 2: Jackie Green

Chris and Jackie Green are aged 50 and 40 respectively, with two children aged 10 and 12. The couple separated in the current tax year (2022/23) and have now decided to divorce after 20 years of marriage. Chris works in a large financial services company. He is a member of his employer's defined benefit (DB) occupational pension scheme, in which he has built up 15 years' valuable pension rights. His normal retirement age is 65.

Jackie expects to earn £20,000 in her first year of self-employment, after many years out of work while she looked after the children. She expects her earnings from self-employment to continue but not to increase significantly. Although she is starting out as a sole trader, she would like to know more about becoming a limited company.

Jackie has not started any pension provision and has no previous pension entitlements. The family home has already been sold and Jackie has now moved into a modest cottage bought with her share of the net proceeds (£275,000). However, this has left her with a very small bank balance. Chris has used his share of the sale proceeds together with a mortgage to purchase a new flat.

The couple's remaining joint asset is a £500,000 investment portfolio, which is invested primarily in growth-oriented equities and yields just under £4,000 a year. Chris's estimated net income is £80,000 and his estimated annual expenditure is £60,000. Jackie's estimated annual expenditure, including the cost of providing for the children, is £35,000.

The divorce is proceeding on an amicable basis. It has been agreed that Jackie will have custody of the children and Chris has agreed that he will pay maintenance, although the amount has not yet been settled. Pensions and the division of the investment portfolio are now under discussion. Chris's advisers have proposed that half the portfolio should be transferred to Jackie and the pension benefits should be earmarked on a 50/50 basis.

Jackie has asked for advice on what she should do now. Her first priority is to have enough income to live on, but she knows that there are other issues to sort out.

Questions

To gain maximum marks you MUST show ALL your workings and express your answers to two decimal places.

1.		List the main areas of financial planning that Jackie should consider.	**(7)**
2.		Assuming that Chris pays £25,000 a year for the children's maintenance, what would Jackie and the children receive as net income in the first full year, assuming 2022/23 income tax rates and allowances apply, and that Jackie receives dividend income of £2,000 and pre-tax self-employed earnings of £20,000? Ignore Child Tax Credits and State benefits.	**(14)**
3.	**a.**	Is a pension attachment order on a 50/50 basis the most appropriate way to split Chris's pension entitlement from Jackie's point of view? Explain the **disadvantages**.	**(8)**
	b.	What might be the better approach to splitting Chris's pension entitlements from Jackie's point of view?	**(5)**
4.		What types of protection does Jackie need and what should be the term of each type of insurance policy?	**(16)**
5.		Once their divorce has been finalised, Jackie wonders if she needs to worry about Chris's insurance arrangements anymore. What are the main issues that make his insurance relevant for her?	**(4)**
6.		State four **benefits** and four **drawbacks** for Jackie of incorporating her business.	**(8)**
7.	**a.**	What would be the inheritance tax (IHT) position if Jackie died shortly after the divorce was finalised? Assume she leaves her entire estate to the children.	**(5)**

b. Is there any further action that she should take in order to mitigate the potential IHT liability on her death? **(2)**

8. What areas should be covered by the investment statement prepared by her financial planner? **(6)**

Total marks available for this question **(75)**

Model answer for case study 2

1. List the main areas of financial planning that Jackie should consider.

- Income and growth from her investments.
- The level of maintenance that she should be receiving from Chris for the children.
- Her retirement position in terms of the pension rights she should expect from Chris's scheme.
- Her retirement position with respect to her own future provision.
- Life assurance and health insurance on Chris's life to protect the future flow of maintenance income for the children.
- Life assurance and health insurance on her life.
- Estate planning for herself – especially her will.

2. Assuming that Chris pays £25,000 a year for the children's maintenance, what would Jackie receive as net income in the first full year, assuming 2022/23 income tax rates and allowances apply, and that Jackie receives dividend income of £2,000 and pre-tax self-employed earnings of £20,000? Ignore Child Tax Credits and State benefits.

	£
Income from self-employment	20,000.00
Income from dividends	2,000.00
Total taxable income	**22,000.00**
Personal allowance	12,570.00
Taxable income	**9,430.00**
Tax at 20% on £7,430 (£9,430 − £2,000)	1,486.00
Dividends of £2,000 within £2,000 dividend allowance	0.00
Net income after tax	**20,514.00**
Class 2 NICs (£3.15 × 52)	163.80
Class 4 NICs on £8,092 (£20,000 − £11,908 threshold) at 10.25%	829.43
Total NICs	**993.23**
Net income after tax and NICs	**19,520.77**

In addition, she would have children's maintenance of £25,000 a year, making a total of £44,520.77. The child maintenance is not taxable on Jackie as it is paid from Chris's taxed income.

3. a. Is a pension attachment order on a 50/50 basis the most appropriate way to split Chris's pension entitlement from Jackie's point of view? Explain the disadvantages.

From Jackie's viewpoint, a pension attachment order has some disadvantages, including:

- Jackie receives no benefit until Chris decides to draw his benefits. Chris could defer drawing benefits indefinitely, by transferring out of his employer's scheme before retirement.
- The share will be made after Chris has paid tax, which may not be tax-efficient for Jackie. Chris will probably be a higher-rate taxpayer in retirement, whereas she will almost certainly be a basic-rate taxpayer.
- The pension attachment order will cease if Jackie decides to remarry.

- She could lose all benefits when Chris dies (whether this occurs before or after his retirement). All or some of the pre-crystallisation lump sum could be part of the pension attachment order.
- The divorce is currently amicable, but if the relationship deteriorates in the future, Chris could take steps to reduce Jackie's pension benefits, e.g. by opting out of his employer's scheme and making alternative pension arrangements.
- There can be no clean break from Chris. Jackie will need to keep in contact with the trustees or administrators of Chris's pension arrangements.

b. What might be the better approach to splitting Chris's pension entitlements from Jackie's point of view?

- Pension sharing may be a better solution for Jackie, as it would provide her with immediate pension rights that cannot be terminated if Chris dies or decides not to take benefits, or if she decides to remarry.
- Within permitted limits, Jackie will have control over her pension when it becomes payable.
- Pension sharing also provides a clean break once the maintenance ends when the children have ceased to be dependent.
- The financial planner should check that the cash equivalent transfer value (CETV) placed on Chris's pension and used to calculate Jackie's pension credit is fair.

Reinforce

Pensions and divorce
The three main ways to deal with pension benefits on divorce are offset, pension attachment orders and sharing. The treatment is the same for civil partnerships.

Offset is the most popular way to deal with pension rights. It takes into account the value of the rights as part of the overall assets of the divorcing spouses (although, in Scotland, only the pensions that have accrued since marriage are taken into account). The divorce settlement then carves up the assets, leaving the pensions untouched. Typically, one party ends up with the pensions but little/no other assets. It is easy to understand and implement.

Pension attachment order – as suggested for Jackie and Chris – is less popular. The court issues an order to the pension trustees or pension provider requiring a proportion of the benefits, possibly including the lump sum, to be paid directly to the ex-spouse when the member retires, in effect, as a deferred maintenance order. You should be aware that these were formerly referred to as earmarking orders.

Pension sharing has the advantage of giving a clean break. Each party is 'given' their share of the benefits. The split is decided by the court and is based on the CETV (for a DB scheme) or a percentage share of the fund (for a DC scheme). The benefits are transferred to the receiving spouse as a 'pension credit', which they can then transfer to their own occupational scheme or to a personal pension. The pension is taxable on the person who receives it. This could be more advantageous for Jackie.

For further information, including more detail on the potential advantages and disadvantages of each method, go to R04, Chapter 4, Section D.

4. What types of protection does Jackie need and what should be the term of each type of insurance policy?

- The benefit of any death-in-service payment from Chris's employment is likely to be lost, unless the lump sum payment is included in the pension attachment order.
- Life assurance will be needed to cover the possibility of Jackie's death during the period of the children's dependency. As the younger child is currently 10 and may finish university at around the age of 22, the life assurance should be arranged for at least 12 years.
- The policy should be a term assurance to keep the costs as low as possible. A family income benefit (FIB) would probably be the most inexpensive choice, because it is a decreasing term assurance. Some or all of the cover could be incorporated into the critical illness policy in order to reduce costs. To provide additional flexibility, the cover

could be renewable or possibly convertible, but this may be a luxury that she decides is not necessary.

- The benefits under the life policy should be written in trust for the children. It may be sensible for their absolute entitlement to the proceeds to be postponed until they are 25, in case they use the funds irresponsibly in their early 20s.
- Health insurance will be needed to cover her earnings if she became incapacitated. It will also be needed to cover the additional expenditure that might be incurred in the event of incapacity.
- The maximum income protection insurance should be arranged, but as this would only be about £12,000, it would almost certainly not be enough to provide adequate cover for her needs. The balance of her needs should be supplied through a critical illness policy.
- The health policies should be arranged to last for the rest of her projected working life, although the level of cover might need to be reviewed after the children have ceased to be financially dependent on her.

Reinforce

Family income benefit

Family income benefit is often used to protect young children. The sum assured can be targeted to the amount needed and is expressed as a tax-free income of £x payable each year from death until a fixed future point when the need for cover ends.

- Payments may be level or increasing (also called ‘escalating’), e.g. by 5% a year, but it is, in fact, another form of decreasing term assurance – the total of the instalments paid out if there’s a claim in the early years would be greater than the total payable on a claim in the later years. It is therefore a relatively inexpensive form of cover.
- The regular payments can usually be commuted into a lump sum once death has occurred. A rate of interest is used to reduce the amount that would have been paid over the remainder of the term due to the early payment.
- Premiums can be guaranteed or reviewable.
- Like other forms of term assurance, it can be placed under trust.
- The policy can be cancelled without penalty when it is no longer needed.

5. **Once their divorce has been finalised, Jackie wonders if she needs to worry about Chris’s insurance arrangements anymore. What are the main issues that make his insurance relevant for her?**

   - If Chris were to die or become seriously incapacitated, the maintenance payments for the children might stop.
   - His death might have an impact on payment to Jackie of his earmarked pension benefits.
   - If a pension attachment order is chosen for the pension provision, Chris’s life should be insured on a whole life basis, as his death at any time will result in a fall in Jackie’s income.
   - Alternatively, it may be possible to arrange a special form of contingent life assurance policy that provides a lump sum in the event of Chris dying before Jackie.

6. **State four benefits and four drawbacks for Jackie of incorporating her business.**

   Benefits

   - If a financial claim is made against Jackie’s business, her personal finances would be safe from creditors.
   - She could make company benefits available for herself, such as a pension, death-in-service and income protection.
   - Jackie could take some of her income in the form of dividends rather than salary, which should lead to reduced tax and NICs being payable.
   - Jackie would still build up her State Pension, but it would cost her less in NICs.

Drawbacks

- Jackie's accounts would be in the public domain, meaning a lack of privacy.
- She would incur accountancy costs.
- Her business would become more complex to run and there would be more administration, leading to higher costs in general.
- Her dividend income may not be taken into account if she applies for a mortgage in the future. It will not be included as relevant earnings for pension contribution purposes.

7. a. **What would be the IHT position if Jackie died shortly after the divorce was finalised? Assume she leaves her entire estate to the children.**

Jackie's estate at death would be as follows:

	£
Value of the home	275,000
Value of the portfolio of investments	250,000
Total estate	**525,000**
Nil rate band	325,000
Residence nil rate band	175,000
Taxable estate	**25,000**
Tax at 40%	10,000

b. **Is there any further action that she should take in order to mitigate the potential IHT liability on her death?**

It is difficult to see what action Jackie could take to reduce the IHT on her estate without reducing her income or the security of her capital.

If there are not enough assets after IHT to look after the children in the event of her death, she could take out a life assurance policy, which should be written in trust. The premiums should be exempt under the £3,000 annual exemption and the proceeds would be free of IHT.

She might be prepared to take advantage of the reduction in IHT rate to 36% by leaving at least 10% of her net estate to a registered charity.

8. **What areas should be covered by the investment statement prepared by her financial planner?**

- The purpose of the investments.
- The income or growth objectives.
- A statement about the client's risk profile, in detail or outline.
- A statement about asset allocation, in detail or outline.
- Other issues, such as ethical or socially responsible investments.

Reinforce

CGT on the transfer of investments

Because Jackie and Chris have been living together in the current tax year, the transfer of investments to Jackie will not give rise to a CGT liability, provided it is completed before the decree absolute (the legal document that ends their marriage). Jackie will acquire the investments at their original acquisition costs for CGT purposes.

Appendix 3

Appendix 4
Case study 3: Tony Gibbs

Tony Gibbs is 39 years old and runs his own company, a telecommunications business, which produces average annual taxable profits of about £100,000 after he has taken his usual salary of £65,000.

He is currently reinvesting these profits back into the business to provide it with more working capital. The profits are subject to fluctuation, falling last year (2021/22) to £70,000 before recovering to a likely £102,500 in 2022/23. His estimate of the value of the business, almost entirely based on goodwill, is £1 million.

Tony is married to Julia, aged 34, and they have two young sons aged seven and nine. They are all in good health. Julia looks after the home and their children.

The couple jointly own a house valued at £350,000, which is subject to an interest-only mortgage of £180,000. At present, they have made no arrangements for repayment of this loan. The interest on the mortgage is currently 5.5% fixed for the next two years. They believe that their cars and household possessions are together worth about £70,000.

Their other assets, totalling £162,000, include a UK equity investment portfolio of £100,000 that Tony enjoys managing, from which the gross yield is 4%.

Tony reports that half their equity investments are held in more or less equal amounts within personal equity plans (PEPs) and ISAs.

In addition, £50,000 is in his offshore deposit account, where the current interest rate is 2% and he understands that the interest is tax free. He is pleased with his £12,000 investment in gold coins, because he understands that they are tax free and have substantially increased in value.

Tony and Julia have been able to live in reasonable comfort on Tony's earnings from the company, but they are now finding that they need a higher income. So, this year, Tony is proposing that the company should employ Julia and pay her £25,000 a year.

They have made wills leaving all their assets to each other when the first of them dies, and then to their children in trust until they are 18. As an only child, Tony expects to receive the modest inheritance of his 72-year-old father's estate of £100,000. Tony thinks this may create an IHT problem, but says he will cross that bridge when he comes to it.

Tony has made no pension provision for himself. His attitude to retirement planning has always been that 'my business is my pension'. Tony considers pensions to be 'poor value for money', largely based on what he has read about annuity rates. His plan is to sell the business at age 55, but then to continue to work part-time on a consultancy basis, retiring gradually over the following five to seven years.

Tony has a decreasing term assurance mortgage protection policy on his life for the amount of the mortgage. The policy was taken out five years ago when they bought the house.

Questions

To gain maximum marks you MUST show ALL your workings and express your answers to two decimal places.

1. Identify mistakes and inconsistencies in the account you have been given of Tony and Julia's situation. **(10)**

2. Recommend and justify suitable plans for Tony and Julia's family protection needs in the event of:

a. either of their deaths; and **(7)**

b. long-term illness or accident. **(7)**

3. What additional questions should a financial planner ask Tony after receiving the completed fact-find? **(10)**

4.	Tony's current pension strategy is to rely on the sale proceeds from his company to provide his income in retirement. What are the disadvantages of this approach?	**(9)**
5.	What areas of concern should a financial planner bring to Tony's attention?	**(5)**
6.	What would be the main advantages and disadvantages of repaying the whole of the mortgage now from the investment portfolio?	**(9)**
7.	What issues should Tony take into account in deciding whether Julia should be paid a salary of £25,000 a year from the company?	**(10)**
8.	Tony dislikes the idea of investing in pensions. Explain why a self-invested personal pension (SIPP) would be suitable for him.	**(8)**

Total marks available for this question **(75)**

Model answer for case study 3

1. **Identify mistakes and inconsistencies in the account you have been given of Tony and Julia's situation.**
   - The valuation of the company looks very high for a business producing only £100,000 of profits, especially where there is little or no growth. Even at the height of a bull market, this would have been an ambitious valuation; now, it looks very unrealistic.
   - PEPs no longer exist. They would now be designated as ISAs.
   - Gold coins are not free of tax on either capital gains or, if applicable, the income from dealing profits.
   - Tony is very unlikely to have an IHT liability on his father's estate, because it is below the IHT nil rate band. Tony and Julia's own taxable estate is currently below the value of their joint nil rate bands after 100% business relief is taken into account.
   - Tony's view of pensions is largely based on current annuity rates. He may not understand annuities sufficiently to come to the conclusion that they are poor value. It is also not necessary for him to buy an annuity. He could opt to access his pension fund flexibly instead.
   - Tony and Julia have an interest-only mortgage that does not reduce in value with the monthly repayments, but the life cover on Tony's life is only suitable to stand alongside a repayment mortgage, where the capital outstanding reduces each month.
   - Tony seems to think that the company could pay Julia a £25,000 salary in the current year, although he says she spends her time looking after the children and the home.
   - Tony thinks that the interest on the offshore deposit account is tax free. It is only paid without deduction of tax. However, Tony does need to declare the interest each year in his tax return.
2. **Recommend and justify suitable plans for Tony and Julia's family protection needs in the event of:**

   a. **either of their deaths.**
      - Set up a family income benefit (FIB) plan. This should be written on a joint life, first death basis. This means that the survivor would have a tax-free regular income on the first death during the term of the policy to allow them to maintain their standard of living.
      - The sum assured should match the income needed for the survivor to maintain the required lifestyle the family needs so they do not suffer financially on the first death while the children are financially dependent.
      - The term should be for the time the children are expected to be financially dependent.
      - Waiver of premium should be included, which means that the premiums will continue to be credited in the case of the policyholder being unable to work due to sickness or accident.
      - An indexation option should be included, which means that the cover should maintain spending power.
      - The policy should be written in trust to ensure prompt payment to the beneficiaries and to avoid IHT.

- Tony and Julia should also consider their need for protecting the mortgage in the event of either death. Currently, they have a decreasing term assurance policy on Tony's life only. The mortgage balance is not decreasing, as it is interest-only. A level term assurance plan would be more suitable if the mortgage remains as interest-only, and they should have the policy in joint names, first death, with the sum assured and term to match the outstanding mortgage.

b. long-term illness or accident.

- Tony should have an income protection plan, as the family relies on his income. Own occupation will give the widest cover and provides the best claim potential.
- Julia could also have an income protection plan based on houseperson's terms – this would provide income to pay for substitute childcare if she were to fall ill.
- The maximum permitted benefit should be selected.
- An income protection plan will provide a tax-free regular payment if Tony were unable to work or if Julia were unable to perform a number of activities of daily living.
- Tony's policy term should be to his planned retirement age, whereas Julia's should be to the age at which the children will no longer require childcare if she were unable to provide it. This means that Tony and Julia would have regular income in the event of long-term illness or accident.
- Tony and Julia could also consider setting up critical illness cover to provide a tax-free lump sum in the event of either of them being diagnosed with a specific illness within the term of the policy. Depending on the sum assured selected, it could be used to repay the mortgage or any other liabilities or to pay for any specialist nursing/home alterations required.
- Two single life plans would be the best option, as it would mean that one policy would remain in force if either party made a successful claim. Budget permitting, they should select the term to be until retirement and include indexation option and waiver of premium. This means that the cover will stay in place and keep its spending power.

3. What additional questions should a financial planner ask Tony after receiving the completed fact-find?

- What is the strategy for your investments? Is the portfolio intended to generate income or capital growth?
- What level of risk are you prepared to take with your investments?
- What is the base value of the investments for CGT?
- What is the base value for the private company shares?
- Why have you not shared with Julia the ownership of your investments, your deposit account or the shares in your company?
- How much would you need to live on if you were to fall seriously ill and be unable to carry on working?
- How would the business survive if you were to die or fall seriously ill?
- Have you guaranteed any loans to the company or the lease for the premises?
- Why do you only have one small life assurance policy and no health insurance for either of you?
- Why have you valued the business at £1m? Have you received recent professional advice on the value?
- Is your father in good health?
- Do you expect the children to go on to university after school?
- Why have you not used your investments to pay off the mortgage?
- Why is the mortgage on an interest-only basis?
- Is there a penalty for repaying the mortgage early?
- Is the cash deposit on a term basis? If so, what is the term and what would the penalty be for early withdrawal?
- What do you expect the profits of the business to be next year?
- When do you think you will be able to start drawing more out of the company?

- What duties will Julia carry out for the company to justify her proposed £25,000 salary?
- What is your residence and domicile status for tax purposes?

4. Tony's current pension strategy is to rely on the sale proceeds from his company to provide his income in retirement. What are the disadvantages of this approach?

- The strategy is very high risk. It is extremely undiversified.
- Most small businesses have little or no capital value.
- It is a technology business and may be affected by sudden innovations that it cannot adapt to or keep up to date with, as well as fluctuations in the values of technology companies generally.
- Tony has probably overestimated the current value of the company. It is very hard to estimate its future value in 16 years' time, when he plans to sell it.
- When the time comes, there is a risk that Tony may be unable to sell the company at the price he hopes for or even at all.
- The company is likely to be very dependent on Tony personally. To make it saleable, he may need to find alternative management.
- As Tony gets older, he may no longer have the skills and energy to keep it running as a successful business.
- Tony may change his mind about the future of the business and want to pass it on to his sons or other family members. This might be difficult if he remains highly dependent on the company for his retirement income.
- Tony is neglecting to save for his future from the profits of the company either in a registered pension scheme or through another medium.

Reinforce

Business valuations

Valuing private companies is a complex issue and more of an art than a science, but a very rough idea of their values can be gathered from the prices being paid for listed companies. Price–earnings (PE) ratios are based on post-tax profits, which would be about £81,000 in the case of Tony's company, giving his company a PE ratio of approximately 12.3 on the basis of his £1m valuation.

Small companies are generally less valuable than larger companies. Slow or no growth companies are valued at less than fast-growing businesses. Tony's company is barely growing and is very small.

5. What areas of concern should a financial planner bring to Tony's attention?

- The provision of an adequate pension income that is not dependent on selling the company for a substantial sum. This could involve pension contributions for both Tony and Julia.
- A strategy for repayment of the mortgage immediately or by the time Tony and Julia are retired that does not depend on selling the company.
- A strategy for income and NIC planning that could involve sharing the ownership of assets with Julia and will not require her to be paid an unviable salary from the company. However, there may be legislation to counter 'income shifting' in future.
- The investment of the portfolio of investments in a way that will generate long-term capital growth.
- The arrangement of life and health protection to ensure that the family and business would survive the death or ill health/disability of either Tony or Julia.
- Topping up child trust funds or Junior ISAs for the children.

6. What would be the main advantages and disadvantages of repaying the whole of the mortgage now from the investment portfolio?

Advantages

- The interest saved would be currently 5.5% fixed for the next two years. For a higher-rate taxpayer, that is equivalent to a taxable return of over 9% a year. Tony is unlikely to find a return as high in such a safe home for the cash.
- The effective investment would be free of risk of losing money or fluctuating values.
- If money were needed at any time in the future, e.g. to inject into the company, it should be possible to raise the funds as a remortgage.
- If Tony needed to raise funds to lend to the company, the interest on the mortgage would usually be allowable and he could charge interest to the company.
- At present, they are making no provision to repay the mortgage, which they will need to do before the end of the mortgage term.
- At the very least, they should either earmark a regular savings plan to repay the mortgage or convert it into a repayment mortgage.

Disadvantages

- There would probably be an early redemption penalty on repaying the principal back to the lender before the end of the fixed term.
- The long-term performance of the equity investments might outperform the costs of the mortgage.
- Tony and Julia would be substantially reducing the liquid resources that they could draw on for temporary needs if their income were to drop suddenly.

7. What issues should Tony take into account in deciding whether Julia should be paid a salary of £25,000 a year from the company?

- Tony is a higher-rate taxpayer, so every extra pound he draws from the company as a salary or bonus will be taxed at 40% plus employer's NICs of 15.05% and employee's NICs of 3.25%.
- In contrast, Julia is taxed at nil income tax on the first £12,570 of income and nil NICs up to £9,880 (rising to £12,570 from 6 July 2022). Above £12,570, she pays 20% income tax on the next £37,700. The employee's NICs at 13.25% are charged up to the same threshold. The employer's NICs are charged at 15.05% over £9,100. So, paying Julia rather than Tony will result in substantial tax and NIC savings.
- If Tony has no other employees at present, he will be able to take advantage of the employment allowance by employing Julia, saving him up to £5,000 in employer's Class 1 NICs.
- If Julia were paid dividends as a shareholder, there would be no NIC charge.
- The most tax-efficient approach is to pay her a salary of just under £9,100 a year. This will be free of income tax and employee and employer NICs while still allowing Julia to be credited with NICs towards State benefits. This amount is above the lower earnings limit, but below the primary and secondary thresholds for employee and employer NICs, as well as being below the personal allowance for income tax. The balance could be paid as a dividend.
- However, in order to pay Julia a dividend, Tony would have to give her some of his shares absolutely or issue new shares from the company. Julia could receive £2,000 of dividend income tax free, with further dividend income charged to tax according to the tax bracket(s) it falls into.
- Salaries paid to employees (and also pension contributions paid for them) must be expenditure that is wholly and exclusively incurred for the purpose of the business.
- A workplace pension will need to be made available to Julia if her salary is in excess of the lower earnings limit (£6,240 in 2022/23).
- If expenditure by the company does not qualify, it will be disallowed. HMRC looks closely at situations where the recipient of a salary is a relative of the business owner and may disallow the payment. It will expect payments to be the open-market amount – i.e. what would be paid to a non-relative doing the same job.
- It is essential that Julia carries out real duties and is not paid an excessive amount in relation to those duties.

Reinforce

Remunerating spouses from companies and businesses

It is very tempting for a company to pay a non- or basic-rate taxpaying spouse instead of the higher-rate taxpaying shareholder director. The income ends up in the same bank account (usually) and the tax cost is significantly less.

However, the basic rule for deducting any expenditure in a business is that it should be incurred wholly and exclusively for the purpose of the business. If it does not meet that criterion, the expenditure is not allowed; and in the case of a company, it will be subject to corporation tax. Mostly, HMRC assumes that salaries will be allowable, but it looks at salaries paid to spouses very carefully. It needs to be reassured that the salary is the same as would have been paid to an unrelated person for carrying out the same duties. It seems unlikely that the £25,000 salary for Julia would be justifiable on this basis.

Pension contributions for such ‘employees’ are regarded by HMRC in much the same way.

If Julia were a shareholder, she could receive dividends as her income and without NICs. There is a small danger that Tony’s gift to her would be taxed under the special settlement rules and therefore taxed on him, but this is very remote, especially if she takes tax advice.

In the light of HMRC’s defeat in *Garnett v Jones* (2007) (also known as the *Arctic Systems* case), the Government has discussed the possibility of introducing ‘income shifting’ legislation. This case involved a husband and wife who jointly owned a company where he was the sole worker and director, but she received much of the annual profit in the form of dividends. They benefited from substantial tax savings as a result.

Legislation to outlaw income shifting would aim to stop these kinds of arrangements. The proposals were raised in 2008 and then abandoned, and have subsequently been postponed again. They may well be introduced at some point in the future.

8. **Tony dislikes the idea of investing in pensions. Explain why a SIPP would be suitable for him.**

   - Tony is interested in managing his own investments. A SIPP would allow him to do that with respect to his pension investments.
   - Tony would benefit from higher-rate tax relief on the pension contributions that he made, or indirectly if the company contributed. Higher-rate tax relief on Tony’s personal contributions would be subject to limits imposed by his relevant UK earnings and the annual allowance (£40,000 in the 2022/23 tax year).
   - If the company contributed to the pension scheme, the company would be able to deduct the contributions from its profit before tax as they would be a deductible business expense.
   - The funds would grow free of tax on both income and gains.
   - A 25% portion of Tony’s pension fund would be free of income tax, if paid as the tax-free lump sum (PCLS).
   - The balance of the fund could be taxable as income in whatever form (ongoing income or lump sum withdrawals) he decides to take it, which could be at the basic or higher rates depending on the tax rates at the time and the level of his income.
   - The pension income would not be subject to NICs.
   - If Tony died before the age of 75, the fund would be paid out tax free; if he died after age 75, it would be charged to tax as the recipient’s pension income under pay as you earn (PAYE).
   - The fund would be generally protected from creditors if Tony became bankrupt – a possibility to be considered as a business owner. The fund should be outside his estate for inheritance tax.

Appendix 5
Tax tables 2022/23

The 2022/23 tax tables can be found on the CII website:
www.cii.co.uk/qualifications/assessment-information/supporting-exam-documents.

They are also available on *ciigroup.org/login*.

Legislation

B

C

D

F

M

U

Index

D

E

M

N

O

P

S

T

U

V

W

Y

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