DRN-4311561

The complaint

Mr M has complained that Merlin Financial Services Limited (MFS) gave him unsuitable advice to transfer the value of benefits in a former employer's defined benefit (DB) pension scheme to a personal pension arrangement.

What happened

Very briefly, Mr M was a deferred member of a former employer's DB pension scheme. In addition to his main scheme benefits, he had Additional Voluntary Contributions (AVCs) with two different providers. In April 2018 he obtained a Cash Equivalent Transfer Value (CETV) and retirement estimates from his former employer's DB scheme. The CETV was for £180,161 plus non-guaranteed AVC values of £6,235 and £1,935. The benefits offered by the DB scheme at age 55, including AVCs, were a full pension of £6,195.93 pa or a tax-free cash lump sum of £32,690.42 and a reduced pension of £4,903.56 pa.

Mr M met with MFS in June 2018. A fact find was completed which recorded Mr M's personal and financial circumstances and his objectives. MFS issued a suitability report on 20 June 2018 recommending that Mr M transfer the value of his DB scheme benefits. Mr M later decided to retain one of his AVC funds but he went ahead with the transfer of his main scheme benefits and his other AVC fund. The transfer value paid in September 2018 was £240,399.94 plus AVCs of £6,261.90.

Mr M complained, via his representative, in November 2022 about the advice given by MFS. MFS didn't uphold the complaint and it was referred to us. One of our investigators looked into what had happened. She issued a detailed view on 15 July 2023. For the reasons she set out she upheld the complaint.

- Under COBS (Conduct of Business Sourcebook) 19.1.6G, when advising whether or not to transfer out of a DB pension scheme, an adviser should start by assuming a transfer won't be suitable unless it can clearly be demonstrated to be in the client's best interests.
- The critical yield was 18.1% based on retirement at age 60 which the suitability report said was unachievably high. The closest 'discount' rate published for the period before October 2017 was 3.9% for four years to retirement. The regulator's upper, middle and lower projection rates at the time were 8%, 5% and 2% respectively.
- Given his cautious attitude to risk (ATR) and the term to retirement, Mr M was likely to receive retirement benefits of materially lower value from the personal pension than the DB scheme would've provided. In referring to Mr M's ATR as cautious, the investigator said, although the risk profiler he'd completed categorised him as medium-high risk and a low-medium risk profile had been selected, he had no real capacity for loss, so a cautious approach would've been more appropriate.
- MFS had acknowledged, by transferring, Mr M would receive, over the long term, a lower income than that provided by the DB pension. The transfer was recommended because of more suitable death benefits and early and flexible access to his funds.
- The DB pension would've provided a 50% spouse's pension on Mr M's death. But he wasn't married. There was a 25% dependant's pension to eligible children under 18 or 23 if in further education. Mr M had three children aged between 15 and 18.

Whereas the remaining fund value of the personal pension could be left to Mr M's nominated beneficiaries.

- But the level of death benefits would depend on how much of the fund remained. That might not be much or the fund may have been completely depleted if Mr M lived a long life, made additional withdrawals or returns were less than expected. There was a risk that the transfer value wouldn't last through Mr M's retirement. That wasn't a risk if he retained his DB scheme benefits. He'd expressed some concerns about his health and longevity and so the lump sum death benefits would've been attractive to him. But any health issues hadn't been investigated further.
- The adviser had to make a recommendation that was in Mr M's best interests. A pension is primarily intended to provide an income in retirement, not act as a life assurance plan. That was discussed but, based on insuring a sum equivalent to the full transfer value. Mr M wanted to take 25% of that immediately. A whole of life or term insurance for a lower sum, based on what Mr M would've liked to leave to his children, would've been cheaper and could've been considered.
- The recommendation was made in part to allow Mr M to access a lump sum so he could gift his three children £10,000 each and have an emergency fund. The fact find indicated Mr M had surplus income of around £500 pm and credit card debt of £1,000. It was unclear if there'd been any discussion about how the £500 was spent and if there was scope to reduce his credit card debt and provide an emergency fund by building up savings.
- Giving up the guarantees associated with the DB pension to provide an emergency fund, when there appeared to be alternative means to address that, wasn't in Mr M's best interests. He may well have wanted to give his children cash gifts, but it was incumbent on the adviser to make clear the impact that would have on Mr M's long term pension security and whether, if fully informed, it remained a priority for Mr M.
- The DB scheme allowed both early retirement – and Mr M was already at an age when he could apply – but also the option of transferring just his AVCs separately, if a need to access capital arose. Doing that wouldn't jeopardise his valuable guaranteed income. The value of the AVCs wouldn't have been enough to make three gifts of £10,000 but that objective wasn't sufficiently explored with Mr M and appears to have been simply accepted by the adviser without further discussion.
- The flexibility requirement seemed to just relate to taking the initial lump sum without the associated income. It wasn't evidenced why Mr M wouldn't have accepted a regular income at the time. He was in receipt of two state benefits, but the recommendation didn't set out if or how a pension income would impact those and if Mr M would be better or worse off as a result.
- Mr M's anticipated retirement age was 67. It wasn't evident why he'd need to vary his income. If the guaranteed income from the DB scheme and his state pension had been in excess of £15,000 a year, the surplus could've been saved or invested. The DB scheme also offered a bridging pension up to state retirement age, which would then reduce once Mr M's state pension came into payment. So, if his requirement for flexibility related to reducing his income once his state pension became payable, the DB scheme offered a means to do that, without giving up the associated guaranteed and index linked income for life.
- Mr M's representative had said, at the time of the advice, Mr M was a vulnerable client due to his health and personal circumstances. MFS had said the adviser was unaware as Mr M hadn't wished to disclose details of his health or why he was in receipt of certain benefits. On the basis of the limited information the investigator thought it would've been reasonable for MFS to have considered whether Mr M was vulnerable. But her view didn't turn on that. She didn't think MFS had demonstrated that the transfer was clearly in Mr M's best interests. The advice was unsuitable, regardless of whether he'd been treated as a vulnerable client or not.

- The investigator concluded that MFS should've advised Mr M against transferring. And that Mr M would've accepted that advice and retained his DB pension. The investigator noted that, following correspondence about one of his AVC funds, Mr M was persuaded to retain these within the former employer's scheme. That didn't indicate he'd have insisted on transferring had he been suitably advised overall.
- The investigator set out what MFS needed to do to put things right for Mr M. She added that Mr M had started drawing a taxable income from his plan in March 2019, having taken all his tax-free cash immediately upon transfer. She said compensation should be based on Mr M taking his DB scheme benefits at age 55.

MFS disagreed with the investigator's view. MFS' main comments were:

- The DB scheme early retirement figures the investigator had quoted (a full scheme pension and AVC pension of £8,713 pa or tax-free cash of £43,990 and a reduced pension of £6,611 pa) were at age 60, not 55. But Mr M had said he didn't want any income. He couldn't just take tax-free cash from his DB scheme benefits – he'd have had to take income as well which he didn't want. And income would've potentially impacted on any means tested benefits.
- Mr M could've converted his flexible draw down plan to an annuity at any time. As of 7 August 2023 he could've bought an escalating single life annuity, guaranteed for five years, based on the transfer value (after tax-free cash and initial charges) of £182,639 of £7,629.84 pa with RPI (Retail Price Index) increases. That's £1,018.68 pa more than the reduced forecasted DB pension after taking tax-free cash. And the annuity would be higher, assuming growth on the transfer value.
- Mr M had completed a risk profile and came out as medium-high risk. After the adviser had discussed this with Mr M, it was agreed to reduce to low-medium. Despite that the investigator had said she didn't agree. She'd also said Mr M had no savings but he had two money purchase AVCs. She'd said he didn't have the means to withstand an immediate loss to this source of future income. But he wouldn't be suffering an immediate loss as he was only taking the tax-free cash lump sum and deferring taking his income until retirement.
- MFS' starting point when advising on DB transfers has always been to assume that transferring would be unsuitable unless it could be clearly demonstrated to be in the client's best interests. But the death benefits offered by the DB scheme were limited. Mr M wasn't married. Some death benefits for his children were offered but these were limited. Transferring gave a net initial investment of £182,639. Mr M could've left a third of whatever value was available to each child, either a tax-free lump sum or tax-free income payment. Mr M wanted his children to benefit. He had concerns about his own life expectancy so this was a legitimate area to look into.

After she'd issued her view the investigator asked how Mr M had spent his tax-free cash and other taxable income withdrawals he'd made. Mr M's representative told us that Mr M had made a number of charitable and other donations, evidence of some of which was provided. He'd also made payments to his children. His bank statements showed he'd made a lot of cash withdrawals to make cash goodwill payments.

The investigator responded to MFS. She accepted what MFS had said about the pension figures she'd quoted as being payable at age 60, not age 55. But that didn't alter her view that the advice was unsuitable. She added that she'd seen evidence that Mr M had made gifts and charitable donations which he wouldn't otherwise have done. This non-essential spending was a result of the availability of funds following the transfer and wouldn't have occurred, had he been suitably advised to retain his benefits. She said redress should be based on Mr M's DB scheme retirement age of 60.

MFS said Mr M had only wanted to access his tax-free cash initially and didn't want any income. He should take responsibility for the withdrawals and his spending habits, including gifts he'd made. He had an adviser in place who should've warned him about making too many withdrawals and depleting his funds. MFS' recommendation was based on Mr M wanting tax-free cash and no income. If he'd said he wanted income to spend that would've changed things and MFS almost certainly wouldn't have advised him to transfer.

As agreement couldn't be reached the complaint was referred to me to decide.

What I've decided – and why

I've considered all the available evidence and arguments to decide what's fair and reasonable in the circumstances of this complaint.

In reaching my decision I've taken into account relevant law and regulations, regulator's rules, guidance and standards and codes of practice, and what I consider to have been good industry practice at the time. This includes the Principles for Businesses (PRIN) and COBS. The below isn't a comprehensive list of the rules and regulations which applied at the time of the advice but provides useful context for my assessment of MFS' recommendation here.

- PRIN 6: A firm must pay due regard to the interests of its customers and treat them fairly;
- COBS 2.1.1R: A firm must act honestly, fairly and professionally in accordance with the best interests of its client;
- The provisions in COBS 9 which deal with the obligations when giving a personal recommendation and assessing suitability;
- COBS 19 which specifically relates to a DB pension transfer.

Where the evidence is incomplete, inconclusive or contradictory, I reach my conclusions on the balance of probabilities – that is, what I think is more likely than not to have happened based on the available evidence and the wider surrounding circumstances.

Against that background, I've decided to uphold the complaint. My reasons are the same as those given by the investigator and which I've set out above.

COBS 19.1.6G states that the starting assumption for a transfer from a DB scheme is that it is unsuitable. MFS should've only recommended a transfer if it could clearly demonstrate that the transfer was in Mr M's best interests.

MFS says it always starts from that premise. But the suitability report wasn't written in that way. It records, about Mr M's objectives, that he'd obtained a CETV from the DB scheme and he'd like to transfer to a personal pension with a view to having more suitable death benefits, early access and flexibility to take what he liked and when and he'd requested advice on how best to achieve that objective. And MFS' comments in response to the investigator's view also tend to suggest that MFS' onus was on meeting the client's requirements if possible. But it wasn't up to MFS to advise Mr M how he could facilitate what he thought he wanted to do. MFS' overriding responsibility was to give suitable advice. And, where a DB pension is concerned, only recommend a transfer if it can be demonstrated to be in the client's best interests.

I'm not satisfied that a recommendation that Mr M transfer was in his best interests. In reaching that conclusion I've considered financial viability and the specific factors pointed to by MFS – death benefits and flexibility, including Mr M's wish to access a lump sum.

The transfer wasn't financially viable. The critical yield showed how much Mr M's pension fund would need to grow by each year to provide equivalent benefits to those he'd be giving up in the DB scheme. Although MFS has pointed out that some of the income figures quoted by the investigator in her view were wrong, the critical yield required to match Mr M's DB scheme at 60 (on the basis he took a full pension) was 18.1%. As MFS itself noted, that wasn't achievable which meant that, over the longer term, Mr M would receive a lower income than the DB scheme would've provided.

I note what MFS has said about Mr M's assessed ATR (which was discussed with him and a lower risk approach agreed) and why MFS considers it should be entitled to rely on that. But I agree with what the investigator said about why, considering Mr M's overall financial position and that he didn't have any real capacity for loss, a cautious approach should've prevailed. Capacity for loss needs to be considered in conjunction with ATR. Mr M had no savings – I don't regard his two money purchase AVCs as such – and, as far as I'm aware, no other pension provision aside from his state entitlement. But, in any event, even taking a low-medium investment approach, Mr M was likely to receive benefits of a substantially lower overall value than the DB scheme would've provided.

MFS recognised that, based on financial viability alone, a transfer couldn't be recommended. I agree that financial viability isn't the only consideration. So I've gone on to consider the other factors MFS has pointed to as to why the recommendation to transfer was suitable.

Death benefits seemed to be an important driver for Mr M. It's natural for him to have wanted to ensure that his children would be provided for when he died. So the lump sum death benefits potentially available from a personal pension would've been attractive to him. Especially as he wasn't married and so the spouse's pension offered by the DB scheme wouldn't be required. I also accept what MFS has said about the limited value of any dependant's pension(s), given the ages of Mr M's children.

In addition, Mr M had some health issues and had expressed longevity concerns. In advising on a transfer out of a DB scheme, any health issues are an important consideration, especially if life expectancy might be impacted. But here it doesn't seem Mr M's state of health was further explored. Clients are sometimes understandably reluctant to discuss such matters. But they may be persuaded if it's explained why such information is relevant and could impact on the advice that's given. So I'd expect to see MFS made that point to Mr M. But it seems MFS may not have considered that necessary and took the view that the death benefits and other factors justified the recommendation anyway. But I'd have expected MFS to have at least tried to obtain further information (and it may have bolstered the case for transferring). Mr M may also have been entitled to take his benefits from the DB scheme early on ill health grounds which is another option I'd expect to see was considered.

As I've said I can understand why a lump sum death benefit may have appeared attractive to Mr M. But the main purpose of retirement savings is to provide an income in retirement. I don't think the fact that the personal pension offered different, and what might be regarded as more favourable death benefits, justified Mr M's retirement income being reduced. I don't see that it was in his best interests to prioritise potentially better death benefits over his financial security in retirement. I don't think MFS properly explored whether Mr M was really prepared and in a position to give up the guaranteed and escalating income that the DB scheme would've provided.

And any lump sum which might be available on Mr M's death would depend on how much, if any, of the fund remained after withdrawals and investment returns. Although Mr M's wishes to benefit his children were a relevant consideration and something Mr M was concerned about, I'm not persuaded transferring was justified because of the perceived superior death benefits the personal pension potentially offered.

MFS has also pointed to Mr M wanting early access to his pension benefits and flexibility to take 'what he liked when he liked'. I think MFS should've been particularly careful to ensure that Mr M understood that approach could result in his fund being depleted and not lasting throughout his retirement.

Mr M's requirement for flexibility seems to centre on wanting to access a lump sum so he could gift £10,000 to each of his three children. Again I can understand why Mr M may have wanted to help his children but it was up to MFS to make sure that the transfer was in Mr M's best interests. Instead of accepting what Mr M had said he wanted to do, MFS should've made sure Mr M understood the impact of transferring on his long term retirement provision. The money would no doubt have been appreciated by Mr M's children but there's nothing to suggest that any of them needed it urgently. I'd expect to see further discussions as to whether making such gifts really was a priority, given that Mr M would be making an irrevocable decision which would leave him financially worse off in the longer term.

And it seems that Mr M could've used his AVC fund to raise cash if he really needed it or wanted to give money to his children. The full £30,000 he had in mind for that wouldn't have been covered but Mr M may have been prepared to revise that figure in the interests of retaining his DB pension and the security and higher benefits it offered.

Mr M had also said he wanted to have an emergency fund. But I don't think that of itself or taken in conjunction with the other factors should've been a priority and at the expense of losing the guaranteed benefits offered by the DB scheme. And when it seems he did have surplus income anyway. MFS also seems to have accepted at face value what Mr M said about not wanting an income. But I'd expect there to have been some discussion and analysis as to whether it might benefit Mr M to take his DB scheme benefits and the income that would come with it. MFS says that taking income may well have affected any means tested benefits Mr M was receiving. That may or may not have been the case but the point is that MFS doesn't appear to have made any attempt to find out.

I note what MFS has said about Mr M being able to convert his flexible drawdown plan to an annuity at any time. And the calculations that MFS has undertaken to demonstrate that Mr M could buy an annuity using the remaining fund after the tax-free cash and get a higher income than he'd have got from the DB scheme. But I'm looking at the advice and its suitability at the time it was given. The transfer value actually paid increased substantially and since the transfer annuity rates have improved and Mr M is older, all of which will be reflected in any annuity Mr M could in theory now buy. Whereas it's for MFS to demonstrate – on contemporaneous evidence – that the advice was in Mr M's best interests at the time.

I further note all MFS has said about Mr M having approached MFS and that MFS had several meetings to discuss things with him, understand his requirements, explain the procedure and the potential risks. But even if MFS took a thorough approach and care to ensure Mr M understood the advice, that doesn't mean it was suitable. The transfer wasn't financially viable and represented more risk than Mr M should've been advised to take. I'm not persuaded the other reasons given justified the recommendation. I don't think Mr M's circumstances were such that he should've been advised to give up the valuable guaranteed benefits the DB scheme offered.

I'm not persuaded, if MFS had advised Mr M that he shouldn't transfer, that he'd have insisted on transferring anyway. I say that because I've not seen anything to indicate Mr M was an experienced investor who had the requisite skill, knowledge or confidence to go against professional financial advice he'd been given, especially in a complex pension matter. If MFS had given Mr M clear advice not to transfer out of his DB scheme and explained why it wasn't in his best interests, I think Mr M would've accepted that advice.

The upshot is that MFS must compensate Mr M for the unsuitable advice, using the regulator's defined benefits pension transfer redress methodology. I've previously clarified with MFS and Mr M's representative a couple of points as to the redress that would apply in the event that I upheld the complaint.

First, DISP App 4.3 sets out the steps a firm must take in carrying out a redress calculation for non compliant pension transfer advice. DISP App 4.3.15R requires a firm to determine when the consumer would've taken retirement benefits from the DB pension scheme. Under DISP App 4.3.16R there's a presumption that benefits would've been taken at the DB scheme's normal retirement age. DISP App 4.3.17G sets out examples of when that presumption will be rebutted. I explained that I didn't consider Mr M's situation fell within any of the examples given. So redress should be on the basis of the DB scheme retirement age which was 60.

Secondly, DISP App 4.4.2R sets out the redress calculation formula. It takes into account, as well as the current value of the defined contribution (DC) pension arrangement, the accumulated value of past benefits paid to the consumer from the DC pension arrangement from the retirement date to the valuation date. I said my understanding was that the withdrawals Mr M made will be taken into account and 'added back' into any redress calculation. The upshot is that MFS won't have to bear the cost of such withdrawals.

I added that I wasn't sure if Mr M's representative sought to argue differently. I went on to say why I didn't consider it would be fair to make an award which meant all or some of the withdrawals Mr M made shouldn't be taken into account. I noted what had been said about Mr M being vulnerable but, even so, I didn't think it would've been reasonably foreseeable that he'd act as he did. I added that, although some of the money appeared to have been given away to strangers or charities, Mr M did help his children which was presumably something he'd have done anyway.

MFS agreed with both points. Mr M's representative agreed that the DB scheme retirement age (60) should be used as per the presumption. On the second point, Mr M's representative said its understanding was that withdrawals would be taken into account. But some withdrawals, which weren't for family members, had only been made because Mr M was vulnerable and so shouldn't be taken into account – but for MFS' advice Mr M wouldn't have withdrawn those sums and so 'lost' that money, which wasn't used for him or his family.

I've considered that very carefully. My decision to uphold the complaint doesn't turn on any vulnerability on Mr M's part, but on the usual considerations as to suitability and whether the transfer could be said to be in Mr M's best interests, which, for the reasons I've explained, I don't think it was. But I've considered Mr M's vulnerability in the context of the withdrawals he made. I think that comes down to whether MFS knew Mr M was vulnerable or ought to have suspected he might be.

A vulnerable customer is someone who, due to their personal circumstances, is especially susceptible to harm, particularly when a firm isn't acting with appropriate levels of care. All customers are at risk of becoming vulnerable. There are four key drivers: health; life events; resilience; and low financial or other capability (such as literacy or digital skills). Mr M's representative points to Mr M's health and personal circumstances, including that he was in receipt of state benefits. I can see those were indicators which might suggest Mr M was or could be vulnerable.

On the other hand, there's no suggestion that Mr M self identified as vulnerable – that is, he didn't tell MFS he was or could be vulnerable. Nor have I seen anything to suggest how he presented to MFS should've led MFS to think about if he might be vulnerable. And Mr M didn't want to share certain information with MFS. I note the fact find records Mr M's health as 'fair' and that he had some health issues which he didn't want to discuss. He also told MFS that he was in receipt of Employment Support Allowance (ESA) and Personal Independence Payment (PIP).

ESA is paid to those under state pension age who are having difficulty in finding work because of a long term medical condition or disability. PIP is paid to help with the extra costs of living with a health condition or disability. So MFS would've known, from what he'd said and the benefits he was getting, that Mr M had a long term health condition which qualified him for state benefits. But not every customer in that situation will be vulnerable. On balance, and absent any other factors which might've pointed to him being vulnerable, I'm not persuaded that MFS should've treated Mr M on the basis he was or might be vulnerable. So I'm not going to say that any of the withdrawals that Mr M made should be discounted. And, as I've indicated, I don't think it would be reasonably foreseeable that Mr M would act as he did in terms of giving money away following the transfer.

Putting things right

A fair and reasonable outcome would be for Merlin Financial Services Limited to put Mr M, as far as possible, into the position he'd now be in but for the unsuitable advice. I consider he'd likely have remained in the DB scheme.

Merlin Financial Services Limited should therefore undertake a redress calculation in line with the rules for calculating redress for non-compliant pension transfer advice, as detailed in Policy Statement PS22/13 and set out in the regulator's handbook in DISP App 4.

For clarity, for the reasons discussed, compensation should be based on the DB scheme's normal retirement age of 60, as per the usual assumptions in the FCA's guidance.

This calculation should be carried out using the most recent financial assumptions in line with PS22/13 and DISP App 4. In accordance with the regulator's expectations, the calculation should be undertaken or submitted to an appropriate provider promptly following receipt of notification of Mr M's acceptance.

If the redress calculation demonstrates a loss, as explained in PS22/13 and set out in DISP App 4, Merlin Financial Services Limited should:

- calculate and offer Mr M redress as a cash lump sum payment,
- explain to Mr M before starting the redress calculation that:
  redress will be calculated on the basis that it will be invested prudently (in line with the cautious investment return assumption used in the calculation), and
  a straightforward way to invest the redress prudently is to use it to augment the current defined contribution pension
- offer to calculate how much of any redress Mr M receives could be used to augment the pension rather than receiving it all as a cash lump sum,
- if Mr M accepts Merlin Financial Services Limited's offer to calculate how much of the redress could be augmented, request the necessary information and not charge Mr M for the calculation, even if he ultimately decides not to have any of the redress augmented, and
- take a prudent approach when calculating how much redress could be augmented, given the inherent uncertainty around Mr M's end of year tax position.

Redress paid directly to Mr M as a cash lump sum includes compensation in respect of benefits that would otherwise have provided a taxable income. So, in line with DISP App 4, Merlin Financial Services Limited may make a notional deduction to allow for income tax that would otherwise have been paid. Mr M's likely income tax rate in retirement is presumed to be 20%. However, if Mr M would've been able to take 25% tax-free cash from the benefits the cash payment represents, then this notional reduction may only be applied to 75% of the compensation, resulting in an overall notional deduction of 15%.

My final decision

I uphold the complaint. Merlin Financial Services Limited must redress Mr M as I've set out above.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr M to accept or reject my decision before 11 January 2024.

Lesley Stead
Ombudsman