CISI
CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

Chartered Wealth Manager Qualification

Applied Wealth Management

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Welcome to the Chartered Institute for Securities & Investment's Applied Wealth Management study material.

This workbook has been written to prepare you for the Chartered Institute for Securities & Investment's Applied Wealth Management examination.

Candidates sitting the Chartered Wealth Manager titles will be provided with an Information Pack along with the question paper for the exam. This contains taxation rates and allowances for the relevant tax year and tables of gilt market prices.

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A learning map, which contains the full syllabus, appears at the end of this workbook. The syllabus can also be viewed on cisi.org and is also available by contacting the Customer Support Centre on +44 20 7645 0777. Please note that the examination is based upon the syllabus. Candidates are reminded to check the Candidate Update area details (cisi.org/candidateupdate) on a regular basis for updates as a result of industry change(s) that could affect their examination.

Workbook version: 13.1 (December 2025)

Candidate Further Reading

Examinations at level 6 and level 7 are intellectually demanding tests which differ from the CISI's offer at levels 3 to 5 in a number of ways.

The examination will be based on the content of the syllabus. The workbooks are designed to support your learning. At levels 3 to 5 no further reading is expected in respect of the technical content of the syllabus, although regular scrutiny of the financial press will be an advantage. You are expected to be able to apply principles outlined in the workbooks to situations which are not explicitly stated in the workbook, and may be expected to use information from more than one area of the workbook in answering a single question.

At levels 6 and 7, while the official workbook is essential reading, you are expected to read around the subject, and this reading is not prescribed, although for some subjects, there are suggestions at the end of the syllabus. Questions will be set on the whole syllabus, and topical issues may be tested, so candidates are expected to be aware of developments in the relevant area of financial services.

As part of your preparation for all level 6 and 7 examinations you should thoroughly scrutinise past papers for your exam, all of which are available free of charge via MyStudy, and refer to the Examiners' reports, which are also available. Together, these give a detailed insight into the type of questions asked, although they should not be relied upon to predict questions or syllabus areas likely to be tested in future papers.

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Changes in industry practice, economic conditions, legislation/regulations, technology and various other factors mean that practitioners must ensure that their knowledge is up to date.

At the time of publication, the content of this workbook is approved as suitable for examinations taken during the period specified. However, changes affecting the industry may either prompt or postpone the publication of an updated version.

It should be noted that the current version of a workbook will always supersede the content of those issued previously.

Keep informed on the publication of new workbooks and any changes to examination dates by regularly checking the CISI's website: cisi.org/candidateupdate

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The Chartered Institute for Securities & Investment is the leading professional body for those who work in, or aspire to work in, the investment sector, and we are passionately committed to enhancing knowledge, skills and integrity – the three pillars of professionalism at the heart of our Chartered body.

CISI examinations are used extensively by firms to meet the requirements of government regulators. Besides the regulators in the UK, where the CISI head office is based, CISI examinations are recognised by a wide range of governments and their regulators, from Singapore to Dubai and the US. Around 50,000 examinations are taken each year, and it is compulsory for candidates to use CISI workbooks to prepare for CISI examinations so that they have the best chance of success. Our workbooks are normally revised every year by experts who themselves work in the industry and also by our Accredited Training Partners, who offer training and elearning to help prepare candidates for the examinations. Information for candidates is also posted on a special area of our website: cisi.org/candidateupdate.

This workbook not only provides a thorough preparation for the examination it refers to, it is also a valuable desktop reference for practitioners, and studying from it counts towards your Continuing Professional Development (CPD).

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Completing a higher level examination enables you to progress even more quickly towards personal Chartered status, the pinnacle of professionalism in the CISI. You will find more information about the next steps for this at the end of this workbook.

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It is estimated that candidates will require approximately 200 hours of study time, including study of this workbook, any formal tuition and wider reading in order to be successful in the examination.

What next?

See the back of this book for details of CISI membership.

Need more support to pass your exam?

See our section on Accredited Training Partners.

Want to leave feedback?

Please email your comments to learningresources@cisi.org

Financial planning and wealth management play a significant role in helping individuals get the most out of their money. Careful planning helps individuals define their goals and objectives and work out how these may be achieved in the future, using available resources. Financial planning looks at all aspects of an individual's financial situation and may include tax planning (both during a person's lifetime and on death), asset management, cash flow planning, debt management, retirement planning and personal risk management.

The objective of this exam is to enable candidates to think critically, apply, and communicate clearly in the context of the following:

- The structure and conduct of UK financial services regulation.
- The integrity, standards, and professional values required of practitioners.
- The prevention, detection, and reporting of financial crime – clients need to be checked against the politically exposed persons (PEPs) list to ensure the source of wealth does not come from bribery or corruption. The checks on the sanction list are done at the same time as the checks for financial crime.
- Developing a picture of circumstances and preferences of clients from the information obtained, and the determination of appropriate financial and investment solutions.
- Communicating effectively the recommendations, advice, and action for the client.
- Managing liquidity to meet short- and long-term funding requirements.
- Matching clients to appropriate financial protection and retirement strategies, and communicating the recommendations and approaches.
- The structuring and managing of social investment and of philanthropic activity.
- The scope of taxation applicable to private clients.
- The appropriate application of trusts and intergenerational financial and investment planning.

Applied Wealth Management (AWM) is the final exam of the Chartered Wealth Manager Qualification, with the emphasis being on '*Applied*'. AWM builds on the content of the two previous units in the qualification – the first two papers cover relevant facts and theories, whereas AWM is intended to test candidates' application of fact and theory in the professional context. Candidates can be assessed on aspects of all three syllabuses in the AWM exam.

In this syllabus, the learning outcomes give an indication of the depth to which each topic should receive emphasis. The following provides an indication of what is expected.

Verb	CISI definition requires candidates to:	Other definition
Analyse	Review the information content in detail and draw conclusions	Study or determine the nature and relationship of the parts by analysis
Apply	Be able to use their knowledge in a given set of circumstances to present a clear and detailed explanation of a situation, rule or principle	
Assess/ consider/ appraise (critically)	Review the information content and to make an informed judgement (taking into account the strengths and weaknesses/advantages and disadvantages)	
Calculate	Be able to use formulae to perform calculations or determine by mathematical processes	
Distinguish	Be able to compare and contrast two or more issues, situations, rules or principles	Perceive a difference in; to separate into kinds, classes or categories
Evaluate	Judge the significance, worth, or quality of information given	
Interpret	Review the information content and extract meaning from it	To explain or tell the meaning of; to present in understandable terms
Know	Recall information such as facts, rules and principles	
Understand	Demonstrate comprehension of an issue, fact, rule or principle	

This syllabus and exam set a high bar for today's wealth manager, and a lot of material will be covered throughout this workbook.

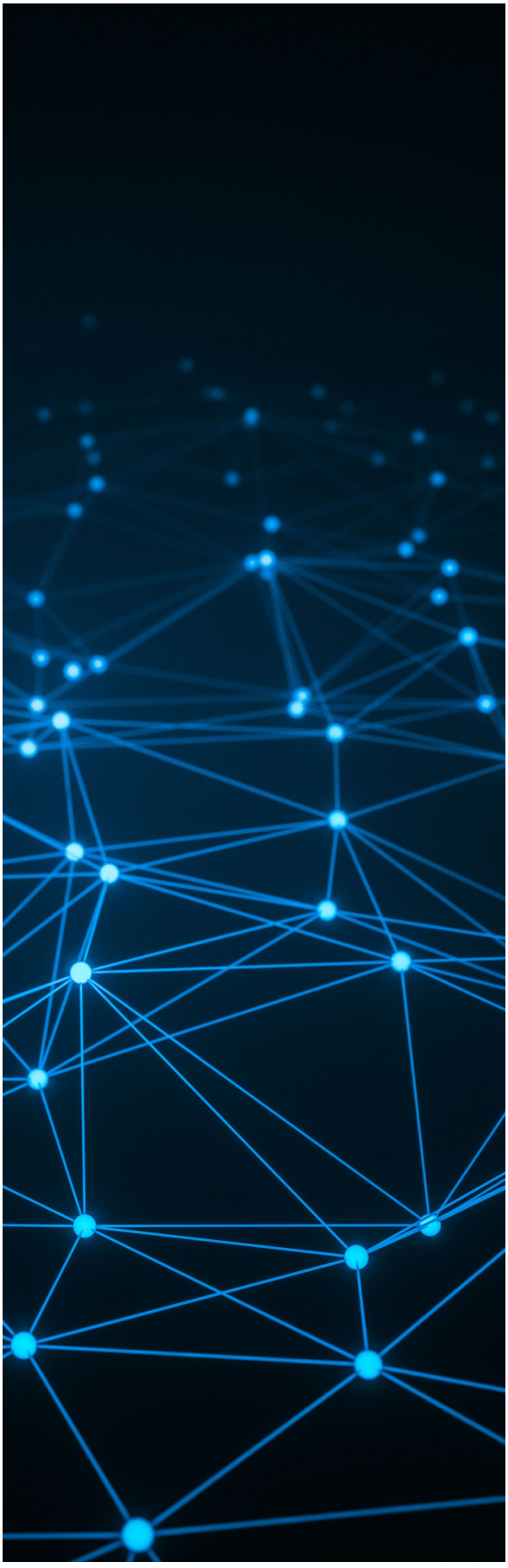
Please be aware that reading the workbook will not in itself enable a candidate to pass the exam, and further study and practical experience are essential.

Candidates should aim to acquire a good knowledge and understanding of a wide variety of wealth management topics and how to apply them in situations or scenarios as laid out in the exam questions. It is assumed that candidates at this level will have sufficient practical experience and fundamental understanding of risk, financial planning and investment, to be able to engage fully with theory, practice, or any client scenario, and to articulate and defend their views and advice.

Chapter One

The Regulatory Environment

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The Chartered Wealth Manager Qualification is a structured advanced programme of study. This part of the Applied Wealth Management exam requires candidates to demonstrate up-to-date knowledge of the regulatory environment surrounding the provision of wealth management services. The exam assumes that you will have already undertaken a regulatory qualification and, if necessary, you should refresh your knowledge in this area.

Wealth management typically caters to the needs of wealthy individuals and families, involving a comprehensive approach to managing and preserving wealth through personalised services.

Wealth managers are financial advisers who serve clients with complex requirements and focus on long-term, multi-generational wealth preservation and growth through sophisticated, customised solutions. They provide planning and management services covering finance, investment, retirement, life, protection and taxation. They also ensure regulatory compliance by staying current with financial regulations. (Financial planners offer similar services, but tend to serve a broader clientele with more basic investment advice.)

FinTech is transforming wealth management by making it more accessible and innovative. **RegTech**, a subset of FinTech, helps firms follow regulations through automation. Traditional firms are teaming up with FinTechs to meet changing client needs.

In this chapter, we will look at the regulatory framework governing financial markets, covering the regulatory structure, firm and individual authorisation, financial crime, business conduct and other rules, integrity and ethics principles, and the emerging area of RegTech. This chapter provides the understanding the wealth manager needs to ensure regulatory compliance.

Important Note

The regulatory environment is subject to significant change and candidates should ensure that their knowledge is up to date. Candidates should read the financial press and material published by the regulators and other agencies. You should identify how these affect the wealth management sector and be able to explain and evaluate the impact on the provision of wealth management services.

1. The Regulatory Structure

In this first section, we will review the regulatory structure within which wealth management operates.

1.1 The Development of the UK Regulatory System

The risk of monetary loss that can arise from dealing in all types of financial transactions has meant that financial markets have always been subject to the need for rules and codes of conduct to protect investors, market participants and the public.

As markets developed, a need grew for market participants to be able to set rules so that there were agreed standards of behaviour, and to provide a mechanism so that disputes could be settled readily. This need developed into what is known as self-regulation when, for example, a stock exchange, as well as providing a **secondary market** for shares, would also set rules for its members and police their implementation. The classic example of this is the **London Stock Exchange (LSE)** whose '*Dictum Meum Pactum*' – my word is my **bond** – which expresses and encourages adherence to the highest standards of integrity in financial markets.

Until the 1980s, there was a system of self-regulation within the industry, with standards being set by the industry itself. As markets, financial institutions and financial services developed, and the potential impact that they could have on both the economy and on society grew; self-regulation became increasingly untenable, and most countries moved to a statutory approach and established their own regulatory bodies.

The first major piece of UK legislation was the Financial Services Act 1986, which became known as self-regulation within a statutory framework as, once a firm was authorised, it was subsequently regulated by self-regulatory organisations such as the Securities and Futures Authority (SFA), the Investment Management Regulatory Organisation (IMRO) and the Personal Investment Authority (PIA).

This was, however, a period when retail investment was undergoing significant change. It saw UK banks copy the US model of bancassurer and move into retail financial services, setting up their own insurance companies and fund management divisions, developing their own product range and selling these to the mass market. They adopted the remuneration model of the insurance industry of low basic pay plus commission, along with aggressive selling techniques that resulted in a period of massive growth.

The system was fundamentally flawed, with clear conflicts of interest between firms and salespeople on one side and customers on the other, and it inevitably led to misselling scandals in personal pensions, endowment mortgages, structured capital at risk products and loan insurance. This was against a background of little or ineffective regulation. By the late 1990s, the model had started to unravel as growth became more difficult, misselling scandals created an environment in which consumers were told not to trust financial advisers, and being a financial adviser was not something you would want to admit to in a social setting.

Consider this...

Reflect on what happened at the time and compare it to the 2008 financial crisis and public reaction afterwards. Ask yourself whether, as an industry, lessons were learned. Once you have done this, consider the furore surrounding the British Steel pension transfer and whether there was another repeat of personal conflict of interest leading to misselling.

These combined crises led to demands for reform and, when the Labour Party gained power in 1997, it put in place significant changes to the regulatory landscape. The responsibility of the Bank of England (BoE) for banking supervision was transferred to the Financial Services Authority (FSA) and new legislation, the Financial Services and Markets Act 2000 (FSMA 2000), was passed completing the move to a basis of statutory regulation.

The reaction to those misselling scandals was the creation of the FSA as a single regulator, accompanied by many new rules and the start of a tougher regulator environment. A comment by the head of the FSA in 2005 spelt out the need for regulation quite succinctly:

> *'Regulation exists because of the potential economic and social effects of major financial instability, the desirability of maintaining markets which are efficient, orderly and fair and the need to protect retail consumers in their dealings with the financial services sector.'*

This, however, did not change the wider environment in which the UK financial services sector operates. The 2000s was a period of light touch regulatory regimes and saw new issues arise – payment protection insurance (PPI), fraudulent accounting malpractices at Enron and other companies, the Bernie Madoff Ponzi scheme, collateralised sub-prime mortgages, the collapse of Bear Stearns and Lehman Brothers, the dramatic failure of the Arch Cru funds and the London Interbank Offered Rate (LIBOR) fixing debacle, to name a few.

The financial crisis of 2008, including a bank run and the subsequent collapse of Northern Rock and the part-nationalisation of the Royal Bank of Scotland Group and Lloyds Banking Group, produced an update to FSMA 2000, a reversal in banking supervision back to the BoE and further changes to the regulatory landscape in the UK, the European Union (EU) and globally.

On 1 April 2013, the FSA was divided into two regulatory authorities popularly known at the time as the twin peaks regulators – the **Financial Conduct Authority (FCA)** and the **Prudential Regulation Authority (PRA)**. These changes were in response to what were purported to be systemic failings on the part of the FSA during the period up to and during the 2008 financial crisis. Errors were identified around the FSA's competence to maintain principles-based regulation of investment firms and rules-

based prudential regulation of UK banks simultaneously. Instead, the PRA took over the FSA's role as prudential regulator for UK banks, building societies, credit unions, insurance companies and a limited number of very large investment firms that are deemed sufficiently large to give rise to systemic risk for the UK economy; in popular terms, the issue of financial institutions being 'too big to fail'. The FCA was given responsibility for the prudential regulation of all other firms and of how all firms conduct their business, particularly the way products are marketed, distributed, sold and managed.

Although today's regulatory environment is the product of developments that have taken place since 1986, most recently it was the financial crisis of 2008 that irrevocably shook confidence in financial markets. This has led to an increased focus on cross-border regulation, awareness of systemic risk and intolerance of poor investment cultures.

The development of modern financial regulation can be thought of as being born out of changing political will, technological advancement, globalisation, improper business culture and a series of negative events, culminating with today's regulatory approach. All these events have shaped our regulatory environment, and continue to do so; no doubt, tomorrow's events will help shape the next phase of regulation.

1.2 The UK Regulatory Structure

FSMA 2000 established the current regulatory regime in the UK; it was subsequently amended by the Financial Services Act 2012 to pave the way for the present regulatory structure.

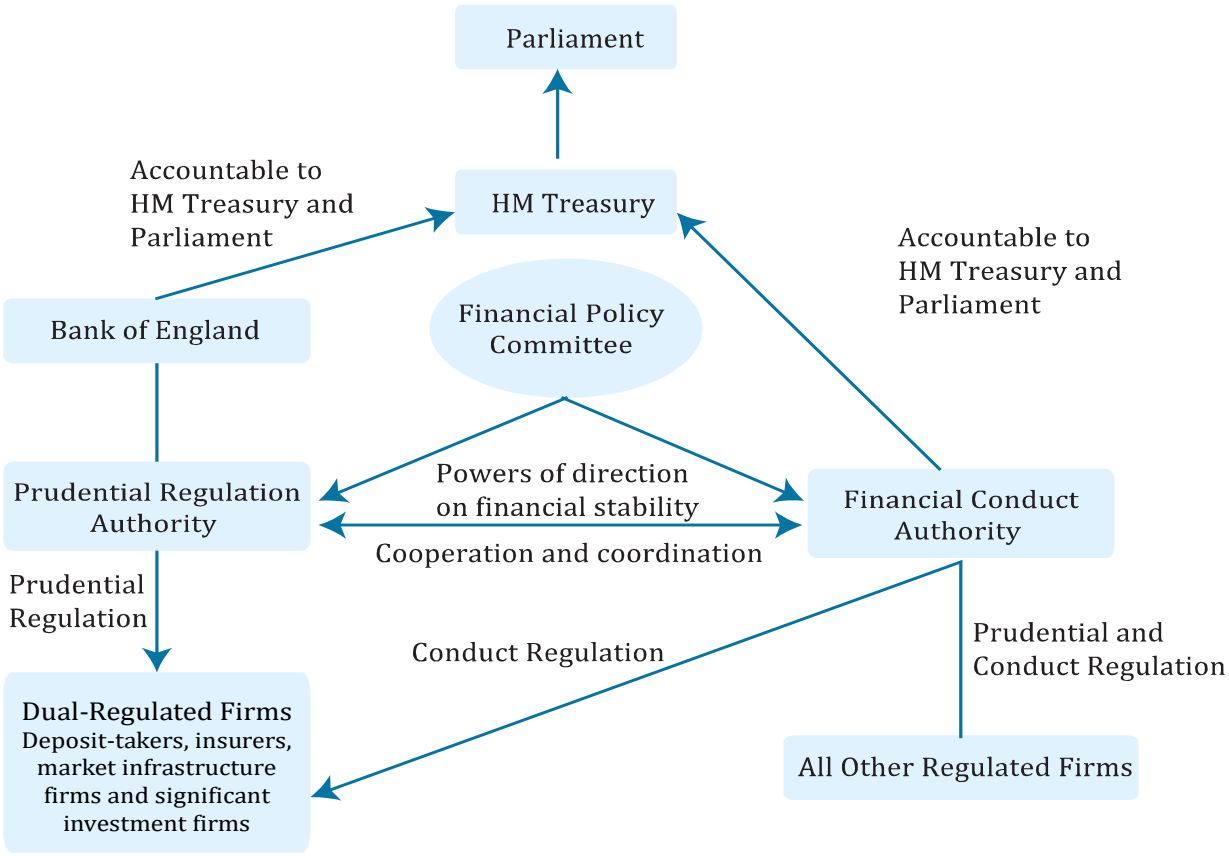
The diagram below summarises the current regulatory structure. It comprises the following:

- **The Financial Policy Committee (FPC)** – which has responsibility for identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.
- **The PRA** – which has responsibility for the prudential supervision of banks, insurers and systemically important investment firms. It supervises financial market infrastructures, such as clearing houses, but excludes trading platforms which are supervised by the FCA.
- **The FCA** – which is responsible for the prudential regulation of all other firms and for conduct issues across all authorised firms.

HM Treasury has overall responsibility for the UK's financial system, the institutional structure of financial regulation and the legislation that governs it, both domestic and international.

Note that, in the UK, all banks wishing to accept deposits must be authorised by the PRA for prudential regulation, which covers their financial soundness and stability. In addition, banks are regulated by the FCA for conduct matters, including how they treat customers and operate in the market. There are no banks in the UK that are authorised solely by the FCA. By contrast, some non-bank financial firms – such as electronic money institutions and payment institutions – may be authorised or registered solely by the FCA under separate regulatory frameworks, such as the Electronic Money Regulations 2011 or the Payment Services Regulations 2017. These firms are not permitted to accept deposits as defined under the Financial Services and Markets Act 2000 and, therefore, do not operate as banks.

The UK Regulatory Structure



The roles and objectives of the PRA and FCA are summarised as follows:

Roles and Objectives of the UK Regulators	
PRA	• The PRA's role is to contribute to the promotion of the stability of the UK financial system through the micro-prudential regulation of deposit-takers, insurers and major investment firms. • The PRA has an overall objective to promote the safety and soundness of regulated firms, and meets this objective primarily by seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system. • For insurance supervision, the PRA has two complementary objectives – to secure an appropriate degree of protection for policyholders and, as needed, to minimise the adverse impact that the failure of an insurer, or the way it carries out its business could have on the stability of the system. • The PRA supervises around 1,500 financial institutions including banks, building societies, credit unions and insurers, as well as major investment firms that have the potential to present significant risk to the stability of the financial system.

Roles and Objectives of the UK Regulators	
FCA	• The FCA has a single strategic objective, to ensure that the relevant markets are functioning well. It also has three operational objectives, which are to secure an appropriate degree of protection for consumers, protect and enhance the integrity of the financial system, and promote effective competition in the interests of consumers. • Underlining the operational objectives are the following three broad outcomes: ◦ Consumers obtain financial services and products that meet their needs from firms they can trust. ◦ Firms compete effectively with the interests of their customers and the integrity of the market at the heart of how they run their business. ◦ Markets and financial systems are sound, stable and resilient with transparent pricing information. • The FCA is responsible for the conduct regulation of all firms, the prudential supervision of firms not supervised by the PRA and the supervision of trading infrastructures including investment exchanges and **over-the-counter (OTC)** markets.

Wealth managers should be particularly concerned with the conduct of business rules and the supervisory approach of the FCA. Firstly, we will look at the FCA approach to supervision.

By supervision, the FCA means overseeing regulated firms to identify, prevent or reduce harm to consumers and markets. The FCA has identified that a firm's strategy and its culture are the root causes of major regulatory failings and so it will focus on business models and the drivers of behaviour in firms. For enforcement, their overriding principle is to provide substantive justice, aiming to achieve fair and just outcomes in response to misconduct and to ensure their rules and requirements are followed.

The FCA's operational objectives form the basis of their supervisory approach.

The FCA uses its judgement to supervise firms and individuals against its rules. However, if a firm fails to comply with the rules, or if the FCA has serious concerns about a firm, then the FCA has been given enforcement powers against that firm. For enforcement, the FCA's overriding principle is to provide substantive justice, aiming to achieve fair and just outcomes in response to misconduct and to ensure their rules and requirements are followed. Examples include prohibiting individuals from carrying on regulated activities, suspending firms and individuals from undertaking regulated activities, and issuing fines.

The FCA has developed some key supervisory principles which guide their work and help them prioritise their interventions in order to deliver their objectives. The supervisory principles are complementary to the Principles for Businesses which outline their expectations of firms and are summarised on the next page.

FCA Supervisory Principles	
Forward Looking	• Pre-empt or address poor conduct so that the risk of associated harm does not materialise or cause significant harm to consumers.
Strategy and Business Models	• Assess strategy and business models to identify emerging risks and poor alignment between a firm's profit incentive and the interests of consumers and markets functioning well.
Culture and Governance	• Identify what drives behaviour in firms and what is likely to cause harm. • Assess a firm's conduct risk framework, whether the firm has effective governance arrangements in place to identify the risk of harm to consumers and markets, and whether they have a strategy in place to manage and mitigate those risks.
Individual and Firm Accountability	• Approve and hold to account the most senior individuals whose decisions and personal conduct have a significant effect on the conduct of their firm. • Expect firms to take responsibility for the competence and integrity of their employees who have the potential to cause harm and all employees to be accountable for their conduct and competence.
Proportionate and Risk-Based	• Target those firms where misconduct would cause the most harm especially to vulnerable consumers or important markets, and those firms where misconduct is most likely to be significant.
Two-way Communication	• Engage with consumers to identify issues and target firms that may be causing harm. Engage with the industry to understand market-wide events.
Coordinated	• Work closely with other regulatory areas to reach robust decisions, share information and provide consistent messages.
Systematic Harm	• Put right systematic harm, move quickly to stop the harm occurring and make sure affected customers are redressed appropriately.

Source: FCA

To advance its objectives, the FCA prioritises a number of issues that are common across both retail and wholesale sectors, and it aims to ensure that firms and markets are stable and resilient, not used as conduits for financial crime, and do not fail in a disorderly way causing harm to markets or consumers.

Wealth managers need to be alert to areas of regulatory concern and essential reading includes the various thematic reviews that the FCA has undertaken, as well as their priorities for the coming year.

The FCA has published a range of material on the financial advice process that we will look at in the next chapter on the financial planning process. These are essential reading and include:

- guidance on the information needed from clients and on a number of issues on **suitability**, and, in particular, establishing the risk a customer is willing and able to take and making suitable investment selection **Markets in Financial Instruments Directive II (MiFID II)**
- factors to consider when making personal recommendations to clients, including when recommending **discretionary investment management**, and when making decisions to trade
- suitability failings where firms are failing to consider the impact and suitability of additional charges when conducting replacement business, and
- findings on the research and due diligence processes carried out by advisory firms on the products and services they recommend to retail clients.

The FCA sets out its priorities for the year ahead in an annual work programme (previously called the business plan). The FCA's Annual Work Programme 2025-26 is structured around four strategic priorities:

1. **A smarter regulator: more efficient and effective –** the FCA is focused on becoming a more efficient, effective and adaptive regulator by improving its use of technology, data and internal capabilities. It is removing unnecessary regulatory burdens, including the elimination of three regular data returns, and enhancing digital platforms, such as My FCA and RegData. The FCA is also automating parts of its **triage processes**, simplifying authorisations and investing in staff skills across multiple UK locations. These steps are designed to allow faster identification and response to risks, improve supervisory consistency and increase transparency.
2. **Supporting growth –** the FCA aims to support sustainable growth, encourage innovation and maintain the UK's position as a leading financial centre. In 2025-26, it will progress work on PISCES (a trading venue for privately held companies to launch in late 2025) and prepare for the new cryptoasset regulatory regime. The FCA is also investing in its AI Lab, which provides tools, case studies and collaborative spaces for firms to explore AI risks and opportunities responsibly. Additionally, it plans to regulate ESG ratings with a consultation once legislation is in place. The FCA seeks to ensure the UK remains an attractive place to do business and to invest.
3. **Helping consumers navigate their financial lives –** the FCA continues to focus on protecting consumers and ensuring firms deliver good outcomes under the Consumer Duty. It is reviewing how the Duty is embedded in firms' operations and intervening where practices fall short – such as in motor finance redress and fair value assessments. The regulator is also consulting on mortgage market reforms and bringing deferred payment credit within its regulatory perimeter. These efforts are designed to strengthen trust in financial services by ensuring consumers receive fair value, clear information, appropriate support and protection from harm and poor practice.
4. **Fighting financial crime –** tackling financial crime remains a central FCA priority. The regulator is investing in new data tools and intelligence capabilities to detect and disrupt fraud, scams, money laundering (ML) and market abuse more effectively. It continues to work with law enforcement and international partners and is supporting firms to improve anti-money laundering (AML) controls through better use of technology. Operational resilience remains a key area, with firms expected to prepare for and recover from significant disruptions. These efforts aim to protect consumers and strengthen the integrity of the UK's financial system.

The FCA is also working to enhance coordination with the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS) through updated Memoranda of Understanding and reforms to redress frameworks, aiming to modernise complaint handling and compensation arrangements. These efforts align with the UK government's wider pro-growth regulatory agenda, supporting innovation and improving outcomes for consumers and firms alike.

We cover the Consumer Duty in some detail later in this chapter.

1.3 European Financial Services Regulation

A major development in UK financial regulation this century has been the increasing powers of the European Commission (EC). The Treaty of Lisbon in 2010 gave increased powers to the EC and to cross-border regulators, such as the European Securities and Markets Authority (ESMA). Prior to Brexit, the UK financial system became increasingly interconnected with the EU. Much of UK financial services regulation originated from the EU; however, the UK, as the EU member leader in financial services, much influenced that regulation.

New policy standards in Europe are implemented through directives or directly applicable regulations. A whole series of EU directives has been passed over the years affecting many areas of the financial services sector. Two that particularly affect wealth management are the **Markets in Financial Instruments Directive (MiFID)** and **Packaged Retail and Insurance-Based Investment Products (PRIIPs)**.

As part of the UK's withdrawal from the EU, much of the previous European regulation was 'onshored' (ie, amended so that it works in a UK-only context). The UK is no longer bound by future changes to EU regulations. The government and regulators have begun to review and, where appropriate, diverge from these retained rules to better suit the UK market.

Key points for wealth managers to note in the post-Brexit environment include:

- **Onshored EU regulations –** regulations such as MiFID II and PRIIPs have been incorporated into UK law. The FCA and PRA supervise compliance with these 'onshored' rules, but the UK is now free to amend or replace them as needed.
- **Regulatory divergence –** the UK has started to diverge from EU rules in some areas, aiming to tailor regulation to the needs of UK markets while maintaining high standards of consumer protection and market integrity. Wealth managers should monitor FCA and HM Treasury updates for changes to onshored or new UK-specific rules.
- **Cross-border services –** UK firms no longer benefit from EU passporting rights. Firms wishing to serve EU clients must comply with local regulatory requirements in each member state, which may include obtaining additional authorisations or establishing partnerships with EU-based entities.
- **International cooperation –** the UK continues to seek regulatory equivalence with the EU in certain areas, though progress has been limited. At the same time, the UK is strengthening regulatory ties with other international partners to ensure continued access to global markets.

Wealth managers must remain vigilant to ongoing regulatory changes. It is essential to:

- Regularly review FCA, PRA, and HM Treasury updates on regulatory developments.
- Ensure cross-border services are compliant with relevant local regulations.
- Adapt internal policies and procedures to reflect the latest requirements, particularly in areas such as consumer protection, AML and market conduct.

The post-Brexit regulatory structure provides the UK with greater flexibility to shape its financial services regulation. Wealth managers must proactively manage regulatory risk and stay informed to maintain compliance and deliver high standards of service to clients.

1.3.1 Markets in Financial Instruments Directive (MiFID)

The original Markets in Financial Instruments Directive (MiFID) was a central pillar of the European regulation of financial markets. However, since MiFID came into force in 2007, financial markets have changed substantially. New factors, such as new types of trading venues and products, have come on to the scene and technological developments, such as high-frequency trading (HFT), have altered the landscape dramatically. All these have revealed shortcomings in MiFID, which is why the EC undertook a review of the Directive; it has now been replaced by the Markets in Financial Instruments Directive II (MiFID II) and the **Markets in Financial Instruments Regulation (MiFIR)**.

The MiFID II framework contains two separate pieces of European legislation:

- A revised directive (MiFID II) which covered a number of areas, including market structure, the scope of exemptions from financial regulation, organisational and conduct of business requirements for investment firms and trading venues, powers of national authorities, sanctions, and rules for third-country firms operating through a branch.
- MiFIR sets out requirements for trade transparency, the mandatory trading of **derivatives** on organised venues and the provision of services by third-country firms without a branch. It also confers a number of new powers on European regulators.

Not all authorised firms are directly subject to the requirements of MiFID: whether they are or not will depend on the nature of the regulated activities that they have within their Part 4A permission. If the activity is the same as a MiFID activity, the firm will be caught by the MiFID requirements.

Wealth managers normally fall into the category of MiFID investment firms as they provide an investment service in relation to financial instruments. MiFID has made a number of changes that affect wealth managers, and these are considered as part of the Conduct of Business Rules and the financial planning and investment services text within this workbook.

Under Article 3 of MiFID, however, some financial advisers may be exempt. **Article 3 firms** are now subject to a number of requirements derived from MiFID II, including a range of authorisations, conduct of business and organisational requirements – but not the whole range of requirements to which MiFID investment firms are subject.

1.3.2 Packaged Retail and Insurance-based Investment Products (PRIIPs)

Although there is no specific definition of PRIIPs, they typically provide exposure to multiple underlying assets, deliver capital accumulation over a medium- to long-term investment period, entail a degree of investment risk (although some may provide capital guarantees), and are normally marketed to retail investors. They can be categorised into four groups:

1. Investment fund
2. Insurance-based investment products
3. Retail structured securities
4. Structured term deposits.

The regulation brought in, among other things, the requirement for a standardised key information document (KID) for retail investors. A person who advises a retail investor on a PRIIP or sells a PRIIP to a retail investor, must provide the retail investor with a KID in good time before any transaction is concluded.

The PRIIPs Regulation requires that a KID is a standalone, standardised document prepared for each investment. A KID can be up to a maximum of three A4 pages. Each KID will need to contain the following information, presented in a predetermined sequence of sections:

- What is this product?
- What are the **risks** and what could I get in return?
- What happens if (name of the PRIIP manufacturer) is unable to pay out?
- What are the costs?
- How long should I hold it and can I take money out early?
- How can I complain?
- Other relevant information.

On 25 March 2022, the FCA published a policy statement (PS22/2) setting out new requirements for the UK PRIIPs regime. As a result of Brexit from 1 January 2021, UK policyholders of Dublin-based schemes will not be covered by the UK Financial Services Compensation Scheme (FSCS). This applies to offshore bonds based in Dublin and should be referenced as a further impact of leaving the EU. Changes include the replacement of performance scenarios in the KID with a requirement for 'narrative information' on performance and the introduction of criteria to determine if corporate bonds are PRIIPs. Firms had until the 31 December 2022 to implement the changes.

1.4 Role of Other Regulatory Bodies

In addition to the PRA and the FCA, a number of other bodies have responsibilities for the financial services sector.

Other Regulatory Bodies	
Financial Services Compensation Scheme (FSCS)	• The FSCS provides a safety net for customers of financial services firms when those firms become unable to repay them. • If an authorised financial services firm becomes insolvent, or appears likely to cease trading and fall insolvent, customers of that firm can make a claim to the FSCS for compensation for their loss – up to certain limits.
Financial Ombudsman Service (FOS)	• The FOS is an agency set up to deal with disputes between consumers and financial services firms. • The scheme provides an independent arbitration of disputes between eligible complainants and their product or service providers with a minimum of formality.
Competition and Markets Authority (CMA)	• The CMA took over the role and functions previously carried out by the Competition Commission and the Office of Fair Trading. • The FCA is responsible for regulating consumer credit transferred and the Unfair Terms in Consumer Contracts Regulations 1999. The FCA is responsible for considering the fairness of standard terms in financial services contracts issued by FCA-authorised firms or appointed representatives of firms that undertake any regulated activity. • If the FCA considers that the CMA is better placed to deal with a case, it will pass it to the CMA for it to take action. In 2017, for example, the FCA referred the entire investment consultancy and fiduciary management sector to the CMA following the Regulator's Asset Management Study.
The Pensions Regulator (TPR)	• TPR is the UK regulator of work-based pension schemes. • Its role is to ensure that people responsible for work-based pensions, including **trustees**, employers, pension specialists and business advisers, fulfil their obligations.
Information Commissioner's Office (ICO)	• The ICO is an independent official body for upholding information rights. This entails both promoting access to official information in appropriate circumstances and protecting people's personal data. • The ICO is responsible for administering the provisions of the data protection regulations, including the UK General Data Protection Regulation (GDPR) and the Freedom of Information Act 2000.
Payment Systems Regulator (PSR)	• The PSR aims to ensure payment systems work well for everyone by promoting competition and innovation, and protecting the interests of all the businesses and consumers that use them. • The PSR has a range of powers, including giving directions to take actions, imposing requirements on system rules and access, amending agreements, and investigating anti-competitive behaviour.

Other Regulatory Bodies	
His Majesty's Revenue & Customs (HMRC)	• HMRC is not itself a regulator but a government department responsible for tax collection and enforcing rules for products like ISAs and pensions.
Upper Tribunal	• The Upper Tribunal (Tax and Chancery Chamber) is not itself a regulatory body but an agency of the Ministry of Justice, which plays a crucial role in reviewing and hearing appeals against decisions made by regulators like the FCA, PRA and TPR, as well as first-tier tribunals – tax and charity cases.

2. Authorisation of Firms and Individuals

In the UK, undertaking regulated activities requires authorisation as it is a criminal offence to carry on regulated activities without it. FSMA 2000 makes it a criminal offence to carry on regulated activities in breach of the general prohibition; in other words, it is a criminal offence to carry on regulated activities without first being authorised, or being subject to one of the exemptions. The offence is punishable by a maximum sentence of two years in prison, and/or an unlimited fine.

The approach taken by the FCA and the PRA to authorising firms recognises that a firm is typically a collection of individuals. Some of these individuals occupy roles that are important to the control or operation of the firm and to its capacity to meet the requirements of authorisation and so require authorisation themselves.

2.1 Authorisation of Firms

For a firm to become authorised, these individuals must first apply to the regulator(s) (depending on whether the firm is single- or dual-regulated) for permission to perform particular regulated activities. If these people satisfy the threshold conditions, they will be granted permission. Authorisation is referred to as 'Part 4A' permission. In granting this, the FCA is required to ensure that the applicant satisfies five threshold conditions:

1. **Legal status** – the FCA broadly accepts individuals, companies, branches of companies, partnerships and unincorporated associations as authorised persons with some restrictions.
2. **Location of offices** – the FCA requires companies established under UK law to have their head and registered offices located in the UK if they are to be authorised.
3. **Close links** – the FCA requires that firms applying for authorisation must not have close links which might make it difficult for the FCA to supervise their activities.
4. **Adequate resources** – the FCA will only authorise firms which have adequate financial and non-financial resources.
5. **Suitability** – the firm is required to prove it is 'fit and proper' to be granted Part 4A permission for the range and nature of its proposed activities.

As an authorised person, the firm can carry on the regulated activities for which it is authorised without breaching the general prohibition and committing a criminal offence. However, permission is normally not granted for all regulated activities. Part 4A permission specifies which regulated activities the

firm can continue with, those investments to which the activities relate and any further requirements or special conditions. The regulated activities for which a firm is given permission to conduct can be limited; for example, it may be permitted to deal as principal, but only for a particular type of client.

2.2 Authorisation of Individuals

When a firm applies for authorisation – and when there are changes to key staffing roles – the Regulator will assess the calibre of the individuals who are responsible for the conduct of the business. Regulating the firm, and its key individuals, is essential to ensuring that firms act in an appropriate manner; equally, ensuring that each firm has well-trained and competent staff is a vital component in the quality of the investments and financial advice given to customers.

In response to the failings that became apparent during the financial crisis of 2008, the FCA introduced the **Senior Managers & Certification Regime (SMCR)** in 2016. Initially, the regime applied only to banks, building societies, credit unions and dual-regulated investment firms. Insurers became subject to the regime from December 2018, and the Approved Persons Regime (APR) was replaced in almost all financial services firms as of 9 December 2019.

2.2.1 The Senior Managers & Certification Regime (SMCR)

The SMCR consists of the following three key elements:

1. **Senior Managers Regime (SMR)** – arrangements for senior managers, including the identification of specific senior management responsibilities and their allocation to named individuals approved by the relevant regulator. Thus, the SMR applies only to the most senior staff in the firm.
2. **Certification Regime (CR)** – certification by the firm of other individuals who pose material risk or the risk of inflicting significant harm on the firm or to its clients. Examples include senior management functions, the CASS oversight function, proprietary traders and those functions that are subject to qualification requirements such as retail investment advisers. It also applies to investment managers, dealers and supervisors, among others.
3. **Conduct Rules and the Code of Conduct** – this applies to all employees.

A fundamental purpose of the SMCR is to enhance the accountability of individual senior managers. This is achieved by making a significant shift in the way in which senior management responsibilities are defined and assigned to individuals.

The rules identify a number of senior management functions. Individuals who will be performing any of these functions require approval by the relevant regulator, which requires the individuals to satisfy both the firm and the regulators that they are fit and proper to undertake their roles. For each of these roles, the regulators have defined a set of management responsibilities. When the firm applies for approval for an individual carrying out a senior management function, it must also provide a statement of responsibilities which details exactly what the individual will be responsible for. In addition, firms are required to produce and maintain an up-to-date management responsibilities map that includes details of reporting lines and lines of responsibility, reasonable details about the persons who are part of those arrangements, and the responsibilities of those persons. The intent behind these requirements is that it will now be much easier for the regulators to satisfy themselves as to who is responsible for what in the case of failures.

The SMR applies only to the most senior staff in the firm. One of the significant changes under the new regime is that the Regulator will not approve individuals carrying out other defined roles; instead, the firm will certify them. In general terms, these individuals pose a material risk to the firm or its clients. The firm is responsible for assessing the fitness and propriety of the individual; this assessment must be carried out not only at the outset of an individual taking on a role, but also on at least an annual basis.

Under the regime, a much wider group of individuals are subject to disciplinary action because of falling within the scope of the Conduct Rules. The Rules apply to senior managers, staff within the Certification Regime and all other employees (except ancillary staff). The Conduct Rules are divided into two tiers – a first tier applying to all individuals and a second tier only applying to senior managers.

Conduct Rules	
Individual Conduct Rules	• **Rule 1** – individuals must act with integrity. • **Rule 2** – individuals must act with due skill, care and diligence. • **Rule 3** – individuals must be open and cooperative with the FCA, the PRA and other regulators. • **Rule 4** – individuals must pay due regard to the interests of customers and treat them fairly. • **Rule 5** – individuals must observe proper standards of market conduct.
Senior Manager Conduct Rules	• **SM1** – senior managers must take reasonable steps to ensure that the business of the firm for which they are responsible is controlled effectively. • **SM2** – senior managers must take reasonable steps to ensure that the business of the firm for which they are responsible complies with the relevant requirements and standards of the regulatory system. • **SM3** – senior managers must take reasonable steps to ensure that any delegation of their responsibilities is to an appropriate person and that they oversee the discharge of the delegated responsibility effectively. • **SM4** – senior managers must disclose appropriately any information of which the FCA or the PRA would reasonably expect notice.

The Regime places three obligations on firms with regard to the Conduct Rules:

1. Make the individuals who are subject to the Rules aware that this is the case, and train them in how the Rules apply to them.
2. Notify the regulators when they are aware that or suspect that a person has breached the Conduct Rules.
3. Notify the regulators when they have taken formal disciplinary action against a person for any reason specified by the regulator.

3. Financial Crime

Financial crime can take many forms, including insider trading, money laundering, terrorist financing, bribery and corruption. For the most part, financial crime involves criminals obtaining money, services or property illegally or by deception, and benefiting from the proceeds.

3.1 Market Abuse

Market abuse may arise in circumstances where individuals or firms who behave unlawfully disadvantage financial investors directly or indirectly. Certain types of behaviour, such as **insider dealing** and market manipulation can amount to market abuse.

Market abuse is a civil offence and can be subject to fines and sanctions by the regulator. Insider dealing and market manipulation may also be criminal offences and prosecuted in the courts.

Market abuse was introduced by FSMA 2000, but concerns about market distortion led the EU to introduce the Market Abuse Regulations (MAR) in 2016 which applies unchanged across all EU countries. Regulations, known as UK MAR, have been passed, which are designed to ensure that UK markets and financial instruments continue to be subject to the same requirements and protections as under EU MAR.

MAR built on the existing regime but is wider in scope as it covers more financial instruments and more trading venues; it extends market manipulation to include attempted market manipulation, and it prohibits abusive behaviour in respect of benchmarks. UK MAR will still cover the same scope of financial instruments trading, or admitted to trade, on UK and EU trading platforms.

There are three market abuse behaviours specified in MAR – insider dealing, unlawful disclosure of inside information and market manipulation. These behaviours are specifically prohibited, subject to certain exemptions.

Market Abuse	
Insider Dealing	• Insider dealing arises when a person in possession of inside information uses it to deal, attempt to deal, recommend or induce another to do so. • Dealing includes acquiring or disposing of financial instruments to which the inside information relates, as well as cancelling or amending an order that was made before having inside information in relation to that instrument. • A person using the recommendation or inducement will also be insider dealing where they know, or ought to know, that the recommendation or inducement is based on inside information. • In the UK, the FCA judges what a 'reasonable person' knows, or ought to know, in such circumstances.

Market Abuse	
Unlawful Disclosure of Inside Information	• The general disclosure obligation requires issuers to inform the public as soon as possible about inside information which directly concerns them. Where their securities are admitted to trading on a regulated market, disclosure must also be made to the officially appointed central storage mechanism. • There is an obligation to prepare and maintain insider lists of any person with access to inside information. • Directors and senior executives (and their closely associated persons) who have regular access to inside information must notify both the issuer and the FCA of every account transaction relating to the issuer's shares, debt instruments, derivatives or other linked financial instruments.
Market Manipulation	• Market manipulation is committed if a person carries out any of the specified activities or behaviours in MAR. These include: ◦ giving false or misleading signals about the supply of, demand for or price of a financial instrument ◦ using fictitious devices or other deception or contrivance that is likely to affect the price of financial instruments ◦ disseminating information which gives, or is likely to give, false or misleading signals as to the supply, demand or price of financial instruments, or secures, or is likely to secure, their price at an abnormal or artificial level, including circulating rumours knowing the information was false or misleading, and ◦ certain other behaviours including collaborating to secure a dominant position over the supply or demand for a financial instrument or creating other unfair trading conditions including by algorithmic and HFT.

The regulations require firms to have procedures to both detect and report suspicious orders and transactions. This extends to both operators of trading venues and to investment firms and their staff who arrange or execute transactions.

Where a person has reasonable suspicion regarding an order or a transaction in any financial instrument whether placed or executed on or outside a trading venue, that it may constitute market manipulation or insider trading, they should notify the FCA immediately. The requirement extends to attempts to commit these offences.

3.2 Insider Dealing

As mentioned in section 3.1, insider dealing can also be a criminal offence.

When directors or employees of a listed company buy or sell shares in that company, there is a possibility that they may be committing a criminal act – that of insider dealing. For example, a director may be buying shares in the knowledge that the company's last six-month period of trade was better

than the market expected. The director has the benefit of this information because they are 'inside' the company. Under the Criminal Justice Act 1993, this would be a criminal offence, punishable by a fine and/or a jail term.

The instruments covered by the insider dealing legislation in the Criminal Justice Act are described as 'securities'. For the purposes of this piece of law, securities are:

- shares
- bonds (including government bonds and others issued by a company or a public sector body)
- warrants
- depositary receipts (DRs)
- **options** (to acquire or dispose of securities)
- **futures** (to acquire or dispose of securities), and
- contract for differences (CFDs).

Note that the definition of 'securities' does not embrace commodities or derivatives on commodities (such as options and futures on agricultural products, metals or energy products), or units/shares in open-ended collective investment schemes (such as open-ended investment companies (OEICs), unit trusts and société d'investissement à capital variables (SICAVs)).

To be found guilty of insider dealing, the Criminal Justice Act 1993 defines who is deemed to be an insider, what is deemed to be inside information, and the situations that give rise to the offence.

Inside information is information that relates to particular securities or a particular issuer of securities (and not to securities or securities issuers generally) and which:

- is specific or precise
- has not been made public, and
- if it were made public, would be likely to have a significant effect on the price of the securities.

This is generally referred to as unpublished price-sensitive information and the securities are referred to as price-affected securities.

Information becomes public when published, for example, a company publishing price-sensitive news through the LSE's Regulatory News Service (RNS). Information is also treated as public when acquired by persons exercising diligence or expertise, for example, by careful analysis of published accounts, or by scouring a library.

A person has this price-sensitive information as an insider if they know that it is inside information from an inside source. The person may have:

1. gained the information through being a director, employee or shareholder of an issuer of securities
2. gained access to the information by virtue of their employment, office or profession (for example, the auditors to the company), or
3. sourced the information from (1) or (2), either directly or indirectly.

The offence of insider dealing is committed when an insider acquires or disposes of price-affected securities while in possession of unpublished price-sensitive information. It is also an offence to encourage another person to deal in price-affected securities, or to disclose the information to another

person (other than in the proper performance of employment). The acquisition or disposal must occur on a regulated market or through a professional intermediary.

3.3 Money Laundering and Terrorist Financing

Money laundering is the process of turning 'dirty' money (ie, money derived from criminal activities) into 'clean' money (ie, money that appears to be from legitimate origins). Dirty money derived from criminal activities is typically difficult to invest or spend, and carries the risk of being used as evidence of the initial crime(s). It is easier to invest laundered money and spend it without risk of incrimination.

The current rules and regulations in relation to money laundering come from the following sources:

- **Proceeds of Crime Act (POCA) 2002**:
  - POCA 2002 specifies that money laundering relates to criminal property, that is any benefit (money or otherwise) that has arisen from criminal conduct. Property is only criminal property if the alleged offender knows, or suspects, it is criminal property.
  - The broad requirement is for firms to report their suspicions of money laundering to the authorities.
- **Serious Organised Crime and Police Act (SOCPA) 2005**:
  - SOCPA 2005 amended certain sections of POCA.
- **Criminal Finances Act 2017**:
  - The Criminal Finances Act 2017 amends the POCA 2002. It makes further provision for the forfeiture of assets and additional powers for the sharing of information in connection with terrorist property.
  - It creates corporate offences for cases where a person associated with a body corporate or partnership facilitates the commission by another person of a tax-evasion offence.
- **Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLR 2017)**:
  - The Money Laundering Regulations 2017 are relatively detailed. They deal predominantly with the administrative provisions that firms need to have to combat money laundering. For example, they deal with firms' requirements for systems and training to prevent money laundering and their obligations to check the identity of new customers.
- **Senior Management Arrangements, Systems and Controls (SYSC) Sourcebook**:
  - The FCA's SYSC Sourcebook provides rules and guidance on the way anti-money laundering (AML) provisions are implemented in the UK.
- **Joint Money Laundering Steering Group (JMLSG) Guidance**:
  - JMLSG guidance provides advice to firms on how they should interpret and implement the anti-money laundering (AML) provisions. They are not mandatory, but do highlight industry best practice.
  - HM Treasury has approved the guidance, which means that if a firm can show that it adhered to them, the courts will consider this as evidence of compliance with the legislation.

On 10 January 2020, changes to the Money Laundering Regulations came into force to update the UK's AML regime to incorporate international standards set by the Financial Action Task Force (FATF) and to transpose the EU's 5th Money Laundering Directive. Among other changes, businesses carrying out cryptoasset activities will need to comply with the rules and there are amendments to the high-risk factors to be considered for enhanced due diligence (EDD).

The UK opted out of the EU's 6th Money Laundering Directive (6AMLD), citing that its POCA 2022 and the UK's existing framework impose more stringent measures and higher levels of fines than those required by 6AMLD. However, by choosing not to implement the 6AMLD, the UK has begun to diverge from the EU regulatory environment, which may lead to differences in compliance obligations, enforcement and cross-border cooperation in anti-money laundering efforts.

3.3.1 The Stages of Money Laundering (ML)

The three stages of a money laundering operation are as follows:

1. **Placement** – the introduction of dirty money into the financial system. Typically, this involves placing the criminally derived cash into a bank or building society account, a bureau de change or any other type of enterprise which can accept cash, such as a casino.
2. **Layering** – this involves moving the money around the financial system in order to make it difficult for the authorities to link the placed funds with the ultimate beneficiary of the money. This might involve buying and selling foreign currencies, shares or bonds in rapid succession, investing in CISs, insurance-based investment products, or moving the money from one country to another.
3. **Integration** – the layering has been successful and the ultimate beneficiary appears to be holding legitimate funds (ie, clean money rather than dirty money). The money is regarded as integrated into the legitimate financial system.

Broadly, the AML provisions are aimed at identifying customers and reporting suspicions at the placement and layering stages, and keeping adequate records that should prevent the integration stage being reached.

3.3.2 Offences

POCA 2002 establishes five offences:

1. **Concealing** – it is an offence for a person to conceal or disguise criminal property.
2. **Arrangements** – that is, being concerned in an arrangement that a person knows, or suspects, facilitates the acquisition, retention, use or control of criminal property for another person. Being concerned in an arrangement may be widely interpreted, it could include advising on a transaction, for example.
3. **Acquisition, use and possession** – acquiring, using or having possession of criminal property.

These offences are punishable by a fine and a prison term of up to 14 years.

4. **Failure to disclose** – three conditions need to be satisfied for this offence:
   - A person knows or suspects (or has reasonable grounds to know or suspect) that another person is laundering money.
   - The information giving rise to the knowledge or suspicion came to them during the course of business in a regulated sector (such as the financial services sector).
   - The person does not make the required disclosure as soon as is practicable.

This offence is punishable by a fine and a prison term of up to five years.

5. **Tipping-off** – giving another person information, knowing or suspecting that a money laundering report has been made to the authorities, when that information is likely to prejudice the investigation.

This offence is punishable by a fine and a prison term of up to two years, and is only applicable to the regulated sector.

Prejudicing an investigation carries a jail term of up to five years. This applies differently within and outside the regulated sector.

A person has a defence against the first three offences (concealing; arrangements; and acquisition, use and possession) if they make the required disclosure to a firm's money laundering reporting officer (MLRO) or, if the person was the MLRO, to the National Crime Agency (NCA).

The offence of failure to disclose suspicions of money laundering may be committed not only when the person knows or suspects money laundering, but also when there are reasonable grounds to know or suspect money laundering (even if the person did not know or suspect it). The test as to whether there are reasonable grounds is called the objective test: whether a 'reasonable person' would have known or been suspicious, even though the offender protests their innocence.

3.3.3 Customer Due Diligence (CDD)

The purpose of customer due diligence (CDD) and monitoring obligations placed on firms is to make it more difficult to use the financial services sector for money laundering or terrorist financing. Firms also need to know who their customers are to guard against fraud, including impersonation fraud, and the risk of committing offences under POCA 2002 and the Terrorism Act 2000, relating to money laundering and terrorist financing.

Firms should hold sufficient information about the circumstances and business of their customers and, where applicable, their customers' beneficial owners, for two principal reasons:

1. To inform its risk assessment process and, therefore, manage its money laundering/terrorist financing risks effectively.
2. To provide a basis for monitoring customer activity and transactions, therefore increasing the likelihood that they will detect the use of their products and services for money laundering and terrorist financing.

Firms should apply different CDD requirements having regard to the risks associated with different types of their business relationship.

The Money Laundering Regulations 2017 specify the CDD measures needed and involve:

- identifying the customer and verifying their identity
- identifying the beneficial owner, where relevant, and verifying their identity
- assessing and, where appropriate, obtaining information on the purpose and intended nature of the business relationship or transaction
- undertaking verification of the source of wealth by, for example, obtaining copies of bank statements from where funds are held or a completion statement if the funds arise from a house sale, and
- checking the client against the politically exposed persons and sanctions lists.

(Note: AML requirements are considered further in chapter 2).

Where the beneficial owner is a legal person (other than a company listed on a regulated market), a trust, company, foundation or similar legal arrangement, firms must take additional measures to understand the ownership and control structure of that entity. Amendments to the regulations introduced by the Money Laundering and Terrorist Financing (Amendment) Regulations 2019:

- Introduced a new explicit requirement to understand the ownership and control structure of the customer as part of the CDD obligations.
- There is a new explicit requirement to determine the constitution and full names of the board of directors and the senior persons of a corporate body when the beneficial owner cannot be identified. Previously, firms only had to take reasonable measures to do so.
- Firms also need to understand the ownership and control structure of their corporate customers, and record any difficulties encountered in identifying beneficial ownership.
- Firms must also report any discrepancies they find between the information they hold on their customers and that in the Companies House Register, including differences in ownership structure, beneficial owners and directors.
- The new regulation requires firms to update their records relating to the beneficial ownership and ensure information on beneficial owners of corporate and other legal entities is stored in a central registry and is up to date.
- Firms are also required to disclose specific data about trusts and their beneficial owners to law enforcement agencies or the Gambling Commission on request.

A firm should obtain satisfactory identification evidence for the customer as soon as is reasonably practicable after first contact between the firm and the customer. If there is a delay between the forming of the business relationship and the verification of the customer's identity (eg, in the case of non-face-to-face business), firms' risk management procedures should limit the extent of the relationship. They could do this, for example, by placing restrictions on the transactions that the customer can enter into, or on the transfer of funds, until verification is complete.

If a firm cannot satisfactorily verify a customer's identity, it should not proceed with the business relationship and should consider whether this should cause it to make a report to the NCA. If it is simply the case that the customer cannot produce the correct documents or information, the firm may consider whether there is any other way it can satisfy itself as to their identity.

3.3.4 Simplified Due Diligence (SDD)

A firm may apply SDD measures in relation to a particular business relationship or transaction if it determines, taking into its risk assessment, that the business relationship or transaction presents a low degree of risk of money laundering/terrorist financing.

SDD means not having to conduct due diligence at all if the customer falls into one of the following types:

- Certain other regulated financial services firms
- Listed companies
- Beneficial owners of pooled accounts held by notaries or legal professionals
- UK public authorities
- Community institutions
- Certain products/arrangements when the risk of their use for money laundering is inherently low such as life assurance, e-money products, **pension funds** and junior ISAs.

Subject to an assessment of the risk, a firm may apply SDD measures to pensions or similar schemes where contributions are made by an employer or by way of deduction from an employee's wages and the scheme rules do not permit the assignment of a member's interest under the scheme.

3.3.5 Enhanced Due Diligence (EDD)

EDD is when the firm conducts more checks than for standard cases.

Firms must apply EDD measures on a risk-sensitive basis in any situation that by its nature can present a higher risk of money laundering or terrorist financing. For example, a firm may conclude that the information it has collected as part of the CDD process is insufficient in relation to the money laundering or terrorist financing risk, and that it must obtain additional information about a particular customer, the customer's beneficial owner, and the purpose and intended nature of the business relationship.

The Money Laundering Regulations 2017 brought in new specific circumstances in which EDD measures are mandatory:

- In any case identified by the firm under its risk assessment (or in information provided by the supervisory authorities) where there is a high risk of money laundering/terrorist financing.
- In any transaction with a person established in a high-risk third country.
- Where the client has not been physically present for identification purposes.
- In relation to correspondent banking relationships.
- In respect of a business relationship or occasional transaction with a politically exposed person (PEP) or a family member or known close associate of a PEP. (A PEP is defined as an individual – or a family member or a known close associate – who is, or has, at any time in the preceding year, been entrusted with prominent public functions, other than as a middle-ranking or more junior official.)
- In any case where a customer has provided false or stolen identification documents or information on establishing a relationship.
- In any case where a transaction is complex and unusually large or there is an unusual pattern of transactions.

Amendments to the regulations introduced by the Money Laundering and Terrorist Financing (Amendment) Regulations 2019 require firms to include new additional high-risk factors when assessing the need for EDD, and seek additional information and monitoring in certain cases.

These may occur where:

- there are relevant transactions between parties based in high-risk third countries
- the customer is the beneficiary of a life insurance policy
- the customer is a third-country national seeking residence rights or citizenship in exchange for transfers of capital, purchase of a property, governments bonds or investment in corporate entities
- non-face-to-face business relationships or transactions without certain safeguards, for example, as set out in regulation 28 (19) concerning electronic identification processes, or
- transactions related to oil, arms, precious metals, tobacco products, cultural artefacts, ivory or other items related to protected species, or archaeological, historical, cultural and religious significance, or of rare scientific value.

EDD measures include:

- increasing the quantity of information obtained for CDD purposes to be satisfied that the risk associated with the relationship is well known and legitimate
- increasing the quantity of information about the customer's source of wealth and funds, and
- increasing the frequency of reviews to ascertain whether the firm can continue to manage the risk associated with the relationship.

Politically Exposed Persons (PEPs)

Individuals entrusted with prominent public functions are defined as politically exposed persons (PEPs) and include:

- heads of state, heads of government, ministers and deputy or assistant ministers
- members of parliament or of similar legislative bodies
- members of the governing bodies of political parties
- members of supreme courts, of constitutional courts or of any judicial body the decisions of which are not subject to further appeal except in exceptional circumstances
- members of courts of auditors or of the boards of **central banks**
- ambassadors, charges d'affaires and high-ranking officers in the armed forces
- members of the administrative, management or supervisory bodies of state-owned enterprises, and
- directors, deputy directors and members of the board or equivalent function of an international organisation.

For comprehensive guidance on this, see the FCA paper FG 17/6 The treatment of politically exposed persons for AML, which includes FCA specific considerations.

3.3.6 Joint Money Laundering Steering Group (JMLSG) Guidance for the Wealth Management Sector

The JMLSG provides guidance that sets out how authorised firms should manage their risk in terms of money laundering and terrorist financing. The guidance was updated in June 2020 to reflect the changes introduced by the Money Laundering Regulations 2019. The guidance gives firms a degree of discretion in how they comply with anti-money laundering (AML)/combating terrorist financing (CTF) legislation and regulation, and on the procedures that they put in place for this purpose. The guidance provides recommendations specifically for the wealth management sector that are noted below.

Money launderers are attracted by the availability of specialised products and the provision of services that operate internationally, utilise detailed knowledge of clients, create a secure and reputable wealth management environment and are familiar with transactions for private investors. This generates a layer of respectability that 'covers' criminal activity and, it is felt, protects it from investigation.

Factors that contribute to the vulnerability of the wealth management sector include the following:

- **Wealthy and powerful clients** – such clients may be reluctant or unwilling to provide adequate documents, details and explanations. The situation with regard to them is exacerbated where the client enjoys a high public profile, and may fall into the category of a PEP, indicating that they wield or have recently wielded political or economic power or influence.

- **Multiple and complex accounts** – wealthy clients often have many accounts in more than one jurisdiction, either within the same firm or group of firms, or with different firms. In the latter situation, it may be more difficult for wealth managers to accurately assess the true purpose and business rationale for individual transactions.
- **Cultures of confidentiality** – better-off wealth management clients may seek extra reassurance that their need for confidential business that will be conducted discreetly will be met. However, requests for confidentiality should not lead to unwarranted levels of secrecy that suit those with criminal intentions.
- **Concealment** – the use of services, such as offshore trusts, and the availability of structures, such as shell companies, in some jurisdictions help to maintain an element of secrecy about beneficial ownership of funds and may give rise to significant misuse. Care is needed to ensure that use of banking and investment services in such countries does not facilitate the development of layers of obscurity that assist those with criminal intentions.
- **Banking secrecy** – there is a culture of secrecy in some jurisdictions, supported by local legislation, in which wealth management clients may hold accounts without being detected as doing so; it is very difficult, if not impossible, to investigate whether these accounts have been used for money laundering.
- **Corrupt jurisdictions** – there are jurisdictions where corruption is known, or perceived, to be a common method of acquiring personal wealth. Attempts may be made to launder assets gained from corrupt practices in these jurisdictions through wealth management firms.
- **Movement of funds** – the transmission of funds and other assets by private clients may involve high-value transactions, and rapid transfers of wealth across accounts in different countries and regions of the world; this can facilitate the concealment of illicit funds before the authorities can catch up with them.
- **Concentration accounts** – multi-client pooled/omnibus type accounts are used to collect together funds from a variety of sources for onward transmission and can hide laundered money in the pooling; they are seen as a potential major risk.
- **Credit** – the extension of credit to clients who use their assets as collateral also poses a money laundering risk unless the lender is satisfied that the origin and source of the underlying asset is legitimate.
- **Commercial activity** – commercial activity conducted through a personal account or personal activity conducted through a business account are methods that can be used to deceive the firm or its staff.

The role of the relationship manager is particularly important to a wealth management firm in managing and controlling and mitigating the money laundering or terrorist financing risks it faces. Relationship managers develop strong personal relationships with their clients, which facilitates the collection of the necessary information to know the client's business and financial affairs, including knowledge of the sources of a client's wealth.

However, wealthy clients can have business affairs and lifestyles that may make it difficult to establish what may constitute unusual behaviour. Equally, criminals seeking to gain advantage from using a firm's credibility are known to compromise, and sometimes threaten, the firm or its staff. Relationship managers must at all times be alert to the risk of undue influence.

Other recommendations from the JMLSG for the wealth management sector include the following:

- Relationship managers should neither accept cash nor deliver cash, nor other stores of value such as travellers' cheques, to anyone. A client should be required to deposit or withdraw cash at the counter of a recognised bank that is at least subject to local supervision.
- Using financial institutions, businesses or addresses in different jurisdictions should always be subject to scrutiny before undertaking a transaction.
- The level of diligence carried out in wealth management will be higher than that needed for other sectors. The use of sophisticated products and fiduciary services, sometimes involving more than one jurisdiction, including trusts, private investment vehicles and other company structures, require careful scrutiny. Where such legal vehicles and structures are used, it is important to establish that their use is genuine and to be able to check the sources of funds and follow any chain of title to know who the beneficial owner is.
- Due diligence on clients should go beyond the standard criteria and the firm should endeavour to understand the origins of a client's wealth, their business structures, the chain of title to the beneficial owner and the nature and level of business expected. Reputational searches should be undertaken as a normal part of CDD, which will include checks for negative information.
- Greater due diligence should be exercised for customers who live in high-risk countries or unstable regions. It is recommended that, in addition to the categories of client regarded as PEPs, clients connected with businesses, such as gambling, armaments or money service businesses should be considered for treatment as high risk.
- Where possible, relationship managers should visit their clients at their place of business in order to substantiate the type and volume of their business activity and income, or at their home if the business factor is not so relevant.
- All new wealth management clients should be subject to independent review, and appropriate management approval and sign off.
- The client information held should be reviewed periodically or when a material change occurs in the risk profile of a client. Wealth management firms should consider reviewing their business with higher-risk clients on at least an annual basis.
- In view of the risks associated with wealth management activities, there should be a heightened ongoing review of account activity and the use made of the firm's other products.

3.3.7 Suspicious Transaction Reporting

Under POCA 2002, it is an offence to fail to disclose a suspicion of money laundering. Obviously, this requires the staff at financial services firms to be aware of what constitutes a suspicion, and there is a requirement that staff must be trained to recognise and deal with what may be a money laundering transaction.

Persons in the regulated sector are required to make a report in respect of information that comes to them within the course of a business in the regulated sector where they:

- know
- suspect, or
- have reasonable grounds for knowing or suspecting that a person is engaged in, or attempting, money laundering or terrorist financing.

Any employee with any suspicion should disclose that suspicion to their firm's MLRO who reviews matters, and decides whether the suspicion should be passed on to the NCA. It is important to appreciate that, by reporting any suspicion to their MLRO, an employee has fulfilled their responsibilities under the law, and has disclosed their suspicions. Similarly, by reporting these suspicions to the NCA, an MLRO has also fulfilled their responsibilities under the law.

3.3.8 Terrorist Financing

Terrorism is the use or threat of action where it:

- involves serious violence against a person or serious damage to property
- endangers a person's life, other than the person committing the action
- creates serious risk to the health or safety of the public or a section of the public
- is designed to seriously interfere or disrupt an electronic system
- is designed to influence the government or intimidate the public, or
- is made for the purpose of advancing a political, religious or ideological cause.

In addition, if the threat or action involves the use of firearms or explosives, it is terrorism – regardless of whether it was designed to influence a government or to intimidate the public.

Many of the requirements of anti-terrorism legislation are similar to that of the anti-money laundering (AML) provisions encountered earlier. A person commits an offence if they enter into, or become concerned with, an arrangement which facilitates the retention or control of terrorist property by concealment, removal from the jurisdiction, transfer to nominees, or in any other way.

There is a duty to report suspicions and it is an offence to fail to report if there are reasonable grounds to do so. The Terrorism Act 2000 and the Anti-Terrorism Crime Security Act 2001 specify that a failure to report is liable to a term of up to five years in jail and a fine.

3.4 Bribery

The UK Bribery Act 2010 created a new offence that can be committed by commercial organisations, which fail to prevent persons associated with them from committing bribery on their behalf.

Bribery undermines democracy and the rule of law, and poses very serious threats to sustained economic progress in developing and emerging economies and to the proper operation of free markets more generally. The Bribery Act 2010 is intended to respond to these threats and to the extremely broad range of ways that bribery can be committed. It does this by providing robust offences, and enhanced sentencing powers for the courts, raising the maximum sentence for bribery committed by an individual from seven to ten years' imprisonment.

The Act contains two general offences covering the offering, promising or giving of a bribe (active bribery) and the requesting, agreeing to receive or accepting of a bribe (passive bribery). It also sets out two further offences that specifically address commercial bribery. Section 6 of the Act creates an offence relating to the bribery of a foreign public official in order to obtain or retain business or an advantage in the conduct of business. Section 7 creates a new form of corporate liability for failing to prevent bribery on behalf of a commercial organisation.

4. Conduct of Business

Firms are subject to the Conduct of Business rules if they carry out any of a range of activities including undertaking **designated investment business**. The activities that are covered are:

- accepting deposits (in part)
- designated investment business
- long-term insurance business in relation to life policies, and
- activities relating to the above.

As you will be aware, the Conduct of Business Sourcebook (COBS) rules are extensive, and so in this section, we will only consider some of the main obligations that affect wealth managers, and highlight the changes brought about by MiFID II. We will examine some of the topics in more detail in the next chapter on financial planning.

4.1 Conduct of Business Obligations

As well as the general fiduciary duties and standards that a firm and individual must comply with, COBS sets out further rules and principles in the following areas:

- Acting honestly, fairly and professionally
- Information disclosure
- Inducements
- Agent as client and reliance on others.

4.1.1 Acting Honestly, Fairly and Professionally

A firm must act honestly, fairly and professionally in accordance with the best interests of its client. This is the client's best interests rule.

This applies where a designated investment business is carried on for a retail client and in relation to MiFID business for any client. For eligible counterparty business, a firm must act honestly, fairly and professionally, taking into account the nature of the eligible counterparty and its business.

A firm must not seek to exclude or restrict any duty or liability it owes to a client unless it is honest, fair and professional for it to do so. This is in addition to the general law, including the Unfair Terms Regulations, which also limit the scope for a firm to exclude or restrict any duty or liability to a consumer.

4.1.2 Information Disclosure

Before providing services to a client, a firm must provide appropriate information in a comprehensible form about:

- the firm and its services
- the designated investments and investment strategies it will propose including appropriate
- guidance and warnings of the risks associated with the investments and investment strategies

- the execution venues that will be used, and
- costs and associated charges.

Firms may provide the information in a standardised format but it must be sufficiently clear so that the client is reasonably able to understand the nature and risks of the services and the types of investment offered and, consequently, is able to make investment decisions on an informed basis.

For MiFID business, the provisions extend the requirement for disclosure to all clients and introduce new provisions for disclosure of information about the firm and its charges (see section 4.3 below).

4.1.3 Inducements

A firm must not pay or accept any fee or commission, or provide or receive any non-monetary benefit, in connection with the provision of any investment or ancillary service to its clients. The rules apply to independent and restricted advice and to the provision of portfolio management services to retail and professional clients.

This prohibition does not apply to any fee, commission or non-monetary benefit that:

- does not impair compliance with a firm's duty to act honestly, fairly and professionally in the best interests of the client
- is disclosed to the client, or
- is designed to enhance the quality of the relevant service to the client and enables, or is necessary for, the provision of an investment service by the firm, such as custody costs, settlement and exchange fees, regulatory levies or legal fees.

MiFID II brought in new rules around how firms receive and pay for research. This meant that the FCA had to delete its previous rules on the 'use of dealing commission'. Firms which produce research must apply a separately identifiable charge to the research when providing it to another EU-regulated firm. The latter may only receive research if it pays for it directly from its own resources, or via payment from a research payment account controlled by the firm and funded by a specific charge to its clients.

4.1.4 Agent as Client and Reliance on Others

Situations arise where a firm that is acting for a client will need to use the services of another firm. The COBS rules set out the extent to which that other firm will owe a duty to act in the best interests of the client.

Where a firm is aware that the firm to which it is providing services is acting as agent for a client, then its client is the firm with which it is dealing, not the end client. The firm may rely on the information given to it about the client and is responsible only for the execution of the service or transaction. The introducing firm remains responsible for the completeness and accuracy of the information about the client, and for the appropriateness of any advice or recommendations provided to the client.

This applies unless it has agreed in writing to treat the underlying clients as its clients. If it does so, it can meet its obligations to notify, obtain consent from or enter into an agreement by issuing a single communication to the introducing firm but it must issue separate risk warnings, confirmations and periodic statements for each underlying client.

4.2 Client Categorisation

A firm is required to categorise its clients if it is carrying out designated investment business. It is very important that clients are categorised correctly, as permissions and protections vary between each classification. Key considerations include the following:

- MiFID lays down rules on categorising clients for MiFID business.
- For non-MiFID business, the FCA uses the same client categorisation terminology but modifies the rules on applying the categories in some cases.
- When a firm provides a mixture of MiFID and non-MiFID services, it must categorise clients in accordance with the MiFID requirements unless it conducts the MiFID business separately from the non-MiFID business. For example, where a firm may advise a client on investing in a unit trust and a life policy at the same time – the unit trust would fall within the scope of MiFID and the life policy would not – it should use the MiFID client categorisation.

The COBS rules categorise a client as a retail client, a professional client, or an eligible counterparty. Most clients of investment management firms fall into the retail client category, but firms also provide investment services to wealthier clients or corporate clients who are classified as professional clients. Professional clients may be either per se professional clients or elective professional clients (EPCs).

Per se professional clients are treated automatically as such, and are generally:

- another authorised firm, such as a credit institution, an investment firm, an insurance company, a collective investment scheme (CIS), a pension fund, or a commodity dealer
- 'large undertakings' that meet certain criteria for the size of their balance sheet, turnover or own funds
- national or regional governments, public bodies managing public debt, central banks, and international or supranational institutions, or
- institutional investors whose main business is investment in financial instruments.

Elective professional clients are retail clients who have chosen to 'opt up' to be treated as professional clients. To be able to do so, they must meet certain requirements through the following tests.

Qualitative Test

- The firm must take reasonable care to determine that the client has sufficient experience and understanding to be classified as a professional client.
- This involves an assessment of the client's expertise, experience, and knowledge to ensure they are capable of making their own investment decisions and understanding the risks involved.
- The client's experience, trading history, and financial standing are relevant factors in this assessment. If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf.
- Evidence should be obtained for each criterion – expertise, experience, and knowledge – and documented.

Quantitative Test

In assessing the client's expertise, experience, and knowledge, the client must satisfy at least two of the following quantitative criteria:

- The client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters.
- The size of the client's financial instrument portfolio, including cash deposits and financial instruments, exceeds €500,000.
- The client works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged.

The criteria that the client meets should be noted along with the type of evidence obtained.

Extra protections for local authorities are in place and you must now classify them as retail clients. Firms can classify them as an elective professional client where they meet or comply with the following criteria:

- The size of the authorities' financial instrument portfolio defined as including cash deposits and financial instruments, exceeds £10 million and either:
  - they have carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters (qualitative test)
  - the person authorised to carry out transactions on behalf of the authority works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged (quantitative test), or
  - the authority is an 'administering authority' of the local government pension scheme, and is acting in that capacity.
- The local public authority or municipality is established in a **European Economic Area (EEA)** state, and the EEA state has adopted alternative or additional criteria (quantitative test).

The FCA's approach for local authorities is to prevent smaller local authorities from being able to opt up to professional client status, particularly when exercising their treasury management functions, while allowing larger ones to be able to exercise this option.

Firms must notify clients of how they have classified them. Before providing services, they must also advise their rights to request recategorisation and of any limits in their protections that will arise from this.

Firms must allow professional clients and elective professional clients to request recategorisation, to retail client and professional client respectively, so that they can be afforded the benefit from the higher protections if they wish to be.

4.3 Disclosure Requirements

As we have seen already, COBS sets out the high-level disclosure requirements that firms must meet to enable the client to be able to understand the nature and risks of the service and of the specific type of designated investments offered and, therefore, enable the client to take investment decisions on an informed basis. Further rules expand on these in relation to information about the firm and in relation to information about products.

MiFID II included new disclosure provisions designed to increase client protections, in particular, for non-retail clients as the financial crisis demonstrated limits in the ability of certain types of such client to appreciate investment risks. The rules also strengthened the regulatory protections available to professional clients and elective professional clients; for professional clients, it applies disclosure requirements that previously only applied in relation to retail clients.

The disclosure rules require firms to:

- produce fair, clear and not misleading information
- produce information in a comprehensible format (which may be standardised)
- provide general and specific information about the investment firm, its services financial instruments, proposed investment strategies and execution venues
- provide general and specific information on all costs and associated charges, including timing and ongoing disclosure requirements
- provide information about safeguarding designated investments belonging to clients and client money, and
- provide post-sale and periodic reports, and keep records to show reports that have been sent.

4.3.1 Information about a Firm and its Services

Investment firms are to provide clients, or potential clients, with the following general information regarding the firm and its services:

- The name and address of the investment firm, and the contact details necessary to enable clients to communicate effectively with it.
- The language(s) in which the client may communicate with the investment firm, and receive documents and other information from the firm.
- The methods of communication to be used between the investment firm and the client including, where relevant, those for the sending and reception of orders.
- A statement of the fact that the investment firm is authorised, and the name and contact address of the competent authority that has authorised it.
- The nature, frequency and timing of the reports on the performance of the service to be provided by the investment firm to the client.
- A summary description of the steps which it takes to ensure the protection of a client's assets and details of any relevant investor compensation or deposit guarantee schemes.
- A summary of its conflicts of interest.

4.3.2 Information Relating to Managing Investments

If a firm proposes to manage investments for a client, it must provide the following information:

- Information on the method and frequency of valuation of the investments in the client's portfolio.
- Details of any delegation of the discretionary management of all, or part, of the investments or funds in the client's portfolio.
- Specification of any benchmark against which performance of the portfolio will be compared.
- The types of investment that may be included and the types of transaction that may be carried out, including any limits.
- Objectives, the level of risk to be reflected in the manager's exercise of discretion, and any specific constraints on that discretion.

When a firm manages investments for a client, it must establish an appropriate method of evaluation and comparison, such as a meaningful benchmark, based on the investment objectives of the client and the types of investment included in the client's portfolio, to enable the client to assess the firm's performance.

4.3.3 Information on Safeguarding Assets

Investment firms holding financial instruments or funds belonging to clients are required to provide them with the following information:

- Where the financial instruments or funds may be held by a third party on behalf of the investment firm, what the firm's responsibility is for any acts or omissions of that third party and what will happen if the third party becomes insolvent.
- Whether financial instruments will be held in an omnibus account including a prominent warning of the resulting risks.
- Details of situations where investments cannot be separately designated in the country in which they are held by a third party, what this means for the client and what the risks are.
- Details of where financial instruments held may be subject to the laws of a non-EEA jurisdiction and what this means for their rights over them.
- Details of any security interest or lien that the firm may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it should inform the client of the fact that a depository may have a security interest, lien, or right of set-off in relation to those instruments or funds.
- For securities financing transactions, what the firm's obligations and responsibilities are and what the risks might be.

4.3.4 Information about Costs and Charges

Firms must provide clients, including retail and professional clients as well as elective professional clients, with information on the costs and charges to which they will be subject in respect of both investment services and ancillary services. It should also include the cost of any investment advice, details of how the client may pay and details of any third-party arrangements.

MiFID II introduced new requirements for firms to provide aggregated and ongoing information on all costs and associated charges. A firm must aggregate costs and charges so that the client can understand the overall cost as well as the cumulative effect on the return of an investment. The following information must be provided at least annually during the life of the investment:

- All costs and associated charges charged by the investment firm or other parties for the services provided to the client.
- The aggregated costs and charges shown as both a cash amount and as a percentage.
- If the above are to be paid in a foreign currency, what currency is involved and the conversion rates and costs applicable.
- Where firms distribute units in a undertakings for the collective investment in transferable securities (UCITS) scheme or a PRIIPs, it will need to provide clients with additional information about other costs and charges related to the product purchase, which may not have been included in the UCITS key investor information document (KIID) or PRIIPs KID, including the costs and charges relating to their provision of investment services in relation to that product.

- Investment firms are to provide information at least annually and base the information provided on costs incurred on a personalised basis. Firms can choose to provide the information at the same time as periodic reports.
- Firms should provide an illustration that shows the effect of the overall costs and charges on the return when providing investment services.

Some income does not need to be included on a costs and charges schedule, such as commission from life and pension contracts, and income from offshore bonds set up pre-2012.

MiFID II also introduced a requirement that applies when a firm offers an investment service with another service or product as part of a package or as a condition for the same agreement or package. In such cases, the firms will be required to inform the client whether it is possible to buy the different components separately and must provide for a separate account of the costs and charges of each component. Where risks resulting from such an agreement or package offered to a retail client are likely to be different from the risks associated with the components taken separately, the investment firm must provide an adequate description of the different components of the agreement or package and the way in which their interaction modifies the risks.

It is important to recognise that there are new and more detailed cost disclosure requirements following the implementation of MiFID II and that, as well as the previous requirement to disclose costs before the client entered into a service or purchased a product, there is a requirement to disclose costs on an ongoing basis. The Retail Distribution Review (RDR) rules on **adviser charging** continue to apply alongside MiFID's costs and charges requirements.

Advisers need to disclose all costs and charges that relate to their retail recommendations. Indications of expected costs and charges need to be provided pre-sale, and details of the actual costs and charges need to be provided post-sale, where applicable on at least an annual basis. These need to be aggregated and expressed both as a cash amount and as a percentage.

The FCA has not mandated a standardised format setting out how firms should calculate and disclose point-of-sale or post-sale information, including information on costs and charges, so it is up to each firm to use a form of disclosure that will meet the needs of their clients and reflect their business proposition.

In broad terms, the following must be disclosed:

1. All one-off and ongoing charges and transaction costs associated with the financial instrument.
2. All one-off and ongoing charges and transaction costs associated with the investment service.
3. All third-party payments received and the total combined costs of these three categories.

These disclosures must also be accompanied by an illustration that shows the cumulative effect of the overall costs and charges on the return.

4.4 Client Agreements

The FCA updated the COBS rules on client agreements to match the MiFID II requirements from the beginning of 2018.

MiFID II brought in a minimum standard for client agreements across Europe that is similar to the rules that were in place in the UK prior to that. It requires an investment firm that provides investment services to a retail or professional client to enter into a basic written agreement with the client setting out the essential rights and obligations of both the firm and the client.

The agreement should set out the following:

- A description of the nature and extent of any investment advice services to be provided.
- The types of financial instruments that may be purchased and sold and the types of transactions that may be undertaken on behalf of the client.
- The main features of any custody services provided, including the role of the firm with respect to corporate actions and the terms of the securities financing transactions involved, will generate a return for the client.

It also changed the record-keeping requirements to at least the duration of the relationship with the client, so there is no obligation to keep records for at least five years, if that is longer than the relationship with the client. Firms will be able to keep records for less than five years if the relationship with the customer lasts less than five years, except for certain pensions business where firms must continue to hold these indefinitely. This means firms will be able to decide for themselves whether, and if so, for how long, they wish to keep records after the ending of the relationship with a client.

4.5 Suitability and Appropriateness

In this section, we will look at the FCA rules on suitability and appropriateness. Suitability is a major area of concern for the FCA, so we will look at this again in the next chapter in the context of financial advice and investment planning.

4.5.1 Suitability

The suitability rules are designed to ensure that authorised firms provide appropriate personal recommendations or manage investments that match their clients' needs. These rules apply when firms offer investment advice or investment management services. To determine suitability, firms must gather relevant information about their clients, including their knowledge and experience in investments, financial situation, and investment objectives and risk profile.

The firm should have a reasonable basis to believe that the recommended service or transaction aligns with the client's investment objectives, is financially bearable for them, and matches their understanding of the risks involved. Firms cannot discourage clients from providing this information, and they can rely on the information provided unless it is outdated, inaccurate, or incomplete.

If a client is classified as a professional client, the firm can assume they have the necessary experience and knowledge in that area and can bear the related investment risks.

The FCA is concerned about persistent failings in some firms to ensure that personal recommendations or decisions to trade are suitable for clients. The FCA requires firms to have a robust process for assessing a customer's **risk tolerance**, use appropriate investment tools, ensure fair and clear communication with customers, and engage in a suitability assessment process that prioritises customers' best interests.

Advisers are responsible for continuously ensuring the suitability of advice, considering the client's circumstances, risk attitude, and affordability. Additionally, advisers must clearly and properly explain the consequences of any recommended plan of action, including costs and risks, in a language understandable to the client.

4.5.2 Suitability Report

Firms that provide investment advice must give retail clients a suitability report explaining why the recommended transaction is suitable for the client based on their demands and needs. The report must also highlight any potential drawbacks of the transaction. This requirement applies to various financial products, including regulated CIS, investment trusts, life assurance policies, and pension-related schemes.

Following the implementation of MiFID II, firms must provide a suitability report for any investment advice on products like equities, derivatives, structured products, and unregulated collective investments. The report should address how the advice aligns with the client's preferences, objectives, investment term, knowledge, experience, risk attitude, and capacity for loss. The report should also set out the costs for the recommended products, including any initial and ongoing costs.

If the recommendations are likely to require periodic review, firms should inform the client and detail the review's frequency and extent. The report should contain an updated statement on how the client's investments meet their preferences and objectives. The frequency of assessments should be at least annual, with potential increases based on the client's risk profile and recommended financial instruments.

4.5.3 Churning and Switching

Churning is the activity of dealing overly frequently for a client, in order to generate additional fees or commissions for the firm. It is relevant when, for example, a firm manages a client's portfolio on a discretionary basis. Switching is the activity of selling one investment and replacing it with another.

The FCA's guidance on churning and switching is contained in the COBS rules on suitability which differentiates between MiFID and non-MiFID business.

For non-MiFID business, it states that, in the context of assessing suitability, a series of transactions that look suitable in isolation may not be suitable if the recommendations to make them are so frequent as to be detrimental to the client. It also states that firms should bear the client's investment strategy in mind when determining how frequently to deal for them. This would include, for example, the need to switch a client within, or between, packaged products.

For MiFID business, the suitability rules follow the MiFID directive. This requires that investment firms should collect the necessary information on the client's existing investments and the recommended new investments, and undertake an analysis of the costs and benefits of the switch so that they are reasonably able to demonstrate that the benefits of switching are greater than the costs.

4.5.4 Restrictions on Promotion of Investments to Retail Clients

There are a number of investments where there are restrictions and specific requirements on their distribution to retail clients, including non-mainstream pooled investments (NMPIs).

While some CISs are authorised, those that are unauthorised or unregulated funds cannot be marketed to the general public. These vehicles are perfectly legal, but their marketing must be carried out subject to certain rules and only to certain types of investor. The FCA refers to all unauthorised or unregulated CISs as a type of NMPI.

NMPIs are not subject to the same rules and restrictions as regulated schemes in terms of their investment powers and management. These rules govern, for example, investment and borrowing powers and a prudent spread of risk, and other investor safeguards. This gives the operator of the fund greater liberty to pursue new or unorthodox investment strategies, but it also means that NMPI investors generally place their capital at greater risk than would be the case for more mainstream investments.

Qualified investor schemes (QISs) are classed as a type of NMPI. Other examples of investments sometimes held in NMPI and similar products include:

- traded life policy investments
- fine wines
- crops
- unlisted shares, and
- timber.

The definition is, however, not specific or precise. The FCA expects firms and advisers to assess each investment on its merits.

The FCA has highlighted some of the specific risks of NMPIs, which include the following:

- A potential lack of **liquidity** or a high degree of **volatility**.
- Not subject to investment and borrowing restrictions aimed to ensure a prudent spread of risk.
- **Redemption** possibly being at the discretion of the fund manager.
- Unclear or high charges.
- Gearing of funds that may lead to risk of increased loss.
- In some cases, a lack of information on the fund and its past performance.
- No protection under FOS, and not covered by FSCS.

The rules mean that promotions will generally be restricted to sophisticated investors and high-net-worth individuals (HNWIs) for whom the products are more likely to be suitable. This would mean that such schemes could be marketed to professional investors, such as:

- certified HNWIs (essentially someone who has signed a certificate during the previous 12 months to confirm that they had an annual income of more than £100,000, or have investable net assets of more than £250,000)
- certified sophisticated investors, and
- self-certified sophisticated investors.

For those individuals, the certification has to meet certain regulatory requirements, appropriate warnings have to be given and the fund is limited in the types of investment that are permitted. As importantly, the fact that the investment is suitable to meet the client's needs and is within their **risk tolerance** has to be demonstrated.

We will cover suitability more in the next chapter.

4.5.5 Appropriateness

MiFID introduced a distinction between products considered either 'non-complex' or 'complex' for product sales that are not made through a personal recommendation or provided by a portfolio management service.

The appropriateness test applies to all complex products, and products deemed complex cannot be sold execution-only. An appropriateness test is a test by the firm to understand the knowledge and experience of the client. It enables a firm to assess whether a particular product or service is appropriate for that client.

When providing a service to which the appropriateness rules apply, a firm must ask the client to provide information regarding their knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded to enable the firm to assess whether the service or product envisaged is appropriate for them.

If a firm believes, based on the above assessment, that the product or service contemplated is not appropriate for them, it must warn them of that fact. It may do so in a standardised format. In addition, if the client declines to provide the information the firm needs to assess appropriateness, it must warn them that it is unable to assess the product's and/or service's appropriateness for them. If the client then asks the firm to proceed regardless, it is up to the firm to decide whether to do so.

Firms are not required to ask clients to provide information or assess appropriateness if:

- the service is execution-only or, for the receipt and transmission of client orders, in relation to particular financial instruments (see below) and at the client's initiative
- the client has been clearly informed that the firm is not required to do so in this particular case, and that they will, therefore, not get the benefit of the protection under the rules on assessing suitability, and
- the firm complies with its obligations regarding conflicts of interest.

The particular financial instruments are:

- shares listed on a regulated market or an equivalent third-country market
- money market instruments, bonds or other forms of securitised debt providing that they do not have embedded derivatives
- holdings in UCITS funds
- structured deposits, and
- other non-complex investments; a financial instrument is non-complex if:
    - it is not a derivative
    - there is sufficient liquidity in it

- it does not involve liability for the client that exceeds the cost of acquiring the investment, and
- it is publicly available and comprehensive information is available on it.

4.6 Dealing and Managing

In this section, we will look at the rules for **best execution** and how they have changed because of MiFID II. This includes the requirements on client order handling, record-keeping of client orders and decisions to deal, limit order display transactions and personal account dealing. We will also consider the telephone recording rules that are contained in SYSC.

4.6.1 Best Execution

The best execution rules under COBS require firms to execute orders on terms that are most favourable to their client taking into account the execution factors. Broadly, they apply if a firm owes contractual or agency obligations to its client and is acting on behalf of that client.

Portfolio managers have a corresponding duty to act in the client's best interest when placing orders with other entities for execution. The aims of the rules are threefold:

1. Ensure protection for investors.
2. Sustain the integrity of the price formation process, which itself underpins all trading activity.
3. Promote competition among trading venues in increasingly fragmented markets.

MiFID II

MiFID II did not materially change the previous regime; instead, it increased the compliance threshold to address information asymmetries and conflicts of interest and introduced rules that are more prescriptive. The changes seek to increase the transparency of order execution arrangements and order routing decisions to facilitate better scrutiny of performance by clients and their agents. It also addresses many of the areas that the FCA identified in its thematic review of best execution.

Order Execution Policies

Firms are required to establish an order execution policy to enable them to obtain the best possible results for their clients. This must include, for each class of financial instrument in which the firm deals, information about the different execution venues where the firm executes its client orders, and the factors that will affect the choice of venue used.

The policy must include those venues that enable the firm to obtain on a consistent basis the best possible result for their client. The obligation to take all sufficient steps to obtain the best possible result for the client does not mean a firm must include all available execution venues. However, a firm may only include a single venue when they are able to show that this allows them to obtain best execution for their clients on a consistent basis and is at least as good as the results that they could reasonably expect from using alternative execution venues.

Firms must give their clients appropriate information about their execution policies and obtain their clients' prior consent to their order execution policies. Where a firm may execute an order outside a trading venue, the client's express prior consent is required.

Information Needed in Execution Policies

- The process by which the firm determines how it will meet its obligation to take all sufficient steps to obtain the best possible result for their client taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
- A list of the execution venues on which the firm places significant reliance in meetings its obligation to obtain best execution and which execution venues are used for each class of financial instruments.
- Factors used in the selection of execution venues. These should be consistent with the controls used by the firm to demonstrate achievement of best execution.
- How the firm uses the execution factors and any other relevant factors to obtain the best possible result for the client.
- Information that a firm may execute a transaction outside a trading venue and the consequences of doing so such as counterparty risk.
- A clear and prominent warning that any specific instruction from the client may prevent the firm from taking the steps designed to obtain the best possible result.
- A summary of the selection process for execution venues, execution strategies employed, the procedures and process used to analyse the quality of execution obtained and how the firms monitor and verify that the best possible results were obtained for clients.

Best Execution Criteria

For each transaction, an investment firm must assess if the client is placing a legitimate reliance on the firm, or the firm is using its discretion. If so, the investment firm will owe that client a duty of best execution.

Firms must take all sufficient steps to obtain, when executing orders, the best possible result for their clients, taking into account the execution factors.

Execution Factors

These factors are price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order.

The relative importance of each factor will depend on the following criteria and characteristics:

- The client, including how they are categorised (retail or professional client, or EPC)
- The client order
- The financial instruments involved
- The execution venues to which that order could be directed.

Where an investment firm executes an order on behalf of a retail client, the best possible result is determined in terms of the total consideration, ie, the price and the costs relating to execution such as the execution venue fees, clearing and settlement fees, and any fees paid to third parties.

Ordinarily, the FCA would expect that price will merit a high importance in obtaining the best possible results for a professional client but, in some circumstances, it may determine that the other execution factors are more important.

When a firm could execute the client's order on more than one execution venue, the firm must take into account both its own costs and the costs of the relevant venues in assessing which will give the best outcome. Its own commissions should not allow it to discriminate unfairly between execution venues, and a firm should not charge a different commission or spread to clients for execution in different venues if that difference does not reflect actual differences in the cost to the firm of executing on those venues.

Best Execution Venues

Firms are required to monitor not only the execution quality obtained, but also the quality and appropriateness of their execution arrangements and policies. In addition, they must be able to demonstrate to their clients, on request, that they have executed their orders in accordance with their execution policy.

Where a firm owes best execution to a client, it will be required on an annual basis to provide a report on the top five execution venues where it has executed client orders. The concept of the report is for clients to assess and judge the quality of execution obtained on their behalf. (Note: the FCA is consulting on the removal of this requirement as research has shown it is little used.)

Specific Client Instructions

Whenever a firm receives a specific instruction from a client, it must execute the order as instructed. It satisfies its obligation to obtain the best possible result if it follows such specific instructions even if an alternative means of executing the order would have given a better result.

4.6.2 Client Order Handling

Client order handling rules provide an important consumer protection mechanism where a firm executes orders on their behalf by requiring firms to have processes and procedures in place to ensure that client orders are handled fairly, including where a firm aggregates orders. This rule is also consistent with the need for firms to avoid conflicts of interest, if possible.

MIFID II does not make any material changes to the client order handling and limit order rules. However, it does extend the client order handling provisions to investment firms when selling or advising clients in relation to structured deposits.

Client Order Handling

Firms must apply procedures and arrangements that provide for the prompt, fair and expeditious execution of client orders, relative to the other orders or trading interests of the firm. In particular, these should allow for the execution of comparable client orders in the order in which they are received.

Firms should ensure that:

- executed client orders are promptly and accurately recorded and allocated
- comparable orders are executed sequentially and promptly, unless this is impracticable or client interests require otherwise
- retail clients are informed of any material difficulty in the prompt execution of their order immediately on the firm becoming aware of this, and
- if the firm is responsible for overseeing or arranging settlement, the assets or money must be delivered promptly and correctly.

Firms must not misuse information relating to client orders and must take steps to prevent its abuse, eg, in order to profit by dealing on its own account.

Aggregation and Allocation

Firms may only aggregate their deals with those of a client, or aggregate two or more client deals, if:

- this is unlikely to disadvantage any of the aggregated clients
- the fact that aggregation may work to their disadvantage is disclosed to the clients, and
- an order allocation policy has been established which provides for the fair allocation of transactions.

The order allocation policy must cover how the volume and price of orders will affect allocation; it must also cover how it will deal with partial allocations. If there is part execution of an aggregated order, the firm must then allocate the various trades in order with this allocation policy.

If a firm deals on its own account, and its deals are included in an aggregated order along with those of its clients, it must not allocate them in a way that is detrimental to the clients. In particular, it must allocate the client orders in priority over its own, unless it can show that, without the inclusion of its own order, less favourable terms would have been obtained; in these circumstances, it may allocate the deals proportionately.

A firm must, as part of its order allocation policy, put in place procedures to prevent the reallocation, in a way that is detrimental to the client, of transactions for their own account that are executed in **combination** with client orders.

Client Limit Orders

Unless the client instructs otherwise, a firm that receives a client limit order that it cannot immediately execute under the prevailing market conditions must take measures to facilitate its earliest possible execution by making the limit order public. It may do this by transmitting the order to a trading venue that is easily accessible to other market participants. This applies in respect of shares admitted to trading on a regulated market or trading venue. However, the firm need not do so, however, for orders over **normal market size (NMS)**.

4.6.3 Record-Keeping

MiFID II amended the record-keeping requirements for client orders, decisions to deal and transactions to align them with the content of the transaction reporting regime under MiFIR.

The new measures require firms to record more details on different aspects of the trade; this includes the client instruction, the security traded, and the different parties involved in the execution of the order. Firms are also required to record all necessary order references that allow the matching of their records to the new transaction reporting requirements applicable to trading venues and the exact sequence of the order execution.

MiFID II also widens the scope of the record-keeping requirements to include transactions that are carried out on own account and order processing. It also brings structured deposits into scope for the enhanced record-keeping provisions.

4.6.4 Telephone Recording

Preventing, detecting and deterring market abuse is one of the FCA's key priorities. Good quality voice recordings and electronic communications help firms and the FCA detect and deter inappropriate behaviour and market abuse. This is the reason why the regulator developed rules requiring certain firms, to record and retain telephone conversations and other electronic communications linked to taking client orders and dealing in financial instruments for a period of six months.

Firms are required to take reasonable steps to record relevant telephone conversations and keep a copy of relevant electronic confirmations that use equipment provided, sanctioned or permitted by the firm. A firm must take reasonable steps to prevent relevant telephone conversations and electronic communications on privately owned equipment that the firm is unable to copy.

The rules apply to a firm that carries out any of the following activities:

- Receiving or executing client orders or arranging for client orders to be executed.
- Carrying out transactions on behalf of the firm, or another person in the firm's group, and which are part of the firm's trading activities or of another person in the firm's group.
- Executing orders that result from decisions by the firm to deal on behalf of its client.
- Placing orders with other entities for execution that result from decisions by the firm to deal on behalf of its client.
- Discretionary investment managers.

As part of implementing MiFID II, the FCA decided to implement slightly different arrangements for Article 3 firms as it considers that a full taping obligation is not proportionate. Instead, Article 3 firms can choose to tape or take a written note of all relevant conversations.

4.7 Reporting to Clients

As with some other areas of investment business, MiFID II made changes and brought in provisions relating to:

- reporting obligations in respect of portfolio management
- additional reporting obligations for portfolio management or contingent liability transactions, and
- statements of client financial instruments and client funds.

4.7.1 Occasional Reporting

If a firm (other than one managing investments) carries out an order for a client, it must:

- notify the client of the status of the order on request
- provide essential information about the execution of the order to the client promptly, and
- send a notice to the client confirming execution of the order as soon as possible and no later than the first business day following execution of the order.

Where a firm receives the confirmation from a third party, it must pass the details on no later than the business day following receipt.

The trade confirmation to the client should include:

- identification of the firm
- name and/or designation of the client
- trading day and time
- type of order (ie, limit order/market order/client-specific instructions)
- venue where the transaction was executed
- financial instrument
- buy/sell indicator
- nature of the order if other than buy/sell (ie, exercise of an option)
- unit price
- total consideration
- total of the commissions, expenses and any mark up/down applied to the transaction
- rate of exchange where the transaction involves the conversion of funds from one currency to another in order to settle the transaction in the client's **base currency**, and
- client's responsibility in respect of settlement of the transaction.

When calculating the unit price in trade confirmation information, particularly when the firm executes the order in tranches, firms may supply clients with the information about the price of each tranche or use the average price.

4.7.2 Periodic Reporting

Investment managers must provide retail and professional clients with periodic statements, which must contain prescribed periodic information. The reports should include a fair and balanced review of the activities undertaken and of the performance of the portfolio during the relevant period. The periodic information should include:

- the name of the firm
- the name and/or designation of the retail client's account
- the contents and valuation of the portfolio, including each investment and its value, cash balance at the beginning and end of the period, and its performance
- the total amount of charges, itemised to show management fees and execution costs, together with a note detailing that a more detailed breakdown can be provided on request
- a comparison of the firm's performance against the relevant benchmark(s)
- total amount of **dividends**, interest and other payments received, and
- information about corporate.

The periodic report should also contain details of executed trades unless the client elects to receive information on a trade-by-trade basis. A firm must issue periodic statements every quarter or monthly if the portfolio service is leveraged.

An investment firm may alternatively provide its clients with access to an online system containing up-to-date valuations. Where they do so, they do not need to provide clients with quarterly reports if it meets the requirements for a durable medium and the client can easily access the information. This is subject to the firm ensuring the client has accessed a valuation during the last quarter.

4.7.3 Statements of Client Financial Instruments and Funds

Investment firms that hold investments or client funds are required to issue quarterly statements to clients – firms that undertake portfolio management firms meet this obligation provided they include the statement in their periodic reporting pack. The statement of client financial instruments or client funds should be sent at least quarterly, or more frequently if requested by the client.

The statement of client assets shall include:

- details of all the financial instruments or funds held by the investment firm for the client at the end of the period covered by the statement
- the extent to which any client financial instruments or client funds have been the subject of securities financing transactions
- if it has been the subject of securities financing transactions and any benefit that has accrued
- a clear indication of the assets or funds which are subject to MiFID protections and those that are not, such as those that are subject to a title transfer collateral arrangement (TTCA)
- a clear indication of which assets are affected by some peculiarities in their ownership status, for instance, due to a security interest, and
- the market or estimated value of the financial instruments included in the statement with a clear indication of the fact that the absence of a market price is likely to be indicative of a lack of liquidity.

4.8 Client Assets and Money

Wealth management firms understandably focus on portfolio management and performance, but a firm also needs to safeguard client assets and money. Losing a client's money because of poor governance, inadequate systems, poor controls or misappropriation is unacceptable.

A string of firms has been fined over the years since the collapse of Lehman Brothers for numerous failures, such as not segregating client money from the firm's money, not having client money in trust, not keeping satisfactory records and not adequately carrying out internal or external reconciliations.

Principle 10 of the Principles for Businesses requires that *'a firm must arrange adequate protection for clients' assets when it is responsible for them*'. This Principle is expanded upon by the rules and guidance set out in the Client Assets Sourcebook (CASS). The intent behind the regime is to seek to ensure that when firms do leave the market they do so in an orderly manner and by holding client money and assets separately from their own and that they minimise any risk to clients in the event of their insolvency.

4.8.1 Client Money

The rules surrounding client money contained in CASS apply to all UK investment firms and to all types of clients, that is, retail clients, professional clients and eligible counterparties.

In CASS, 'client money' is defined as any money that a firm holds on behalf of its clients in the course of carrying on investment business. For these purposes, 'money' means any form of money including cash, electronic balances, cheques and any other form of payable order. However, money does not include coins that a firm holds for the intrinsic value of the metal rather than their face value, eg, gold sovereigns.

There are a number of exceptions where the client money rules do not apply and the two main ones where money is due to the firm and money held to settle a delivery versus payment (DvP) transaction.

The rules do not apply to money held in a bank account by a customer of the bank where the bank is acting as banker. In such circumstances, the bank must make it clear to any customer for whom it undertakes investment business that it is holding their money as banker rather than as trustee and that as a result it is not required to segregate customers' money as it would be if the client money rules applied.

To comply with CASS firms must open client money accounts that are separate from those of the firm and that the trust status of the account is established. When a client money account is opened, it is essential that the bank accepts that the client money is held in trust by the firm for its clients. In practice, the account opening process must ensure that:

- the title of the account clearly shows that it is client money and does not belong to the firm
- the bank provides written confirmation that it recognises the account is a client account and will not combine the account with any other account or exercise any right of set-off or counterclaim against money held in that account against money owed by the firm, and
- firms obtain the confirmation before any funds are deposited.

The CASS rules require firms to exercise due diligence in the choice of where they hold their client money and only deposit funds with one or more approved institutions, ensure proper account opening procedures are followed, regularly review their arrangements to ensure they continue to provide appropriate levels of protection, and maintain appropriate records.

Approved Institutions

In most instances, wealth managers must ensure that they deposit client money in an account at a third-party bank. The account should be identified as holding cash belonging to the wealth manager's clients and must be separate from any account at that bank which holds the wealth manager's own funds – this is referred to in the FCA's rules as a 'client bank account'. More specifically, the rules state that client money may only be deposited with the following approved institutions:

- a central bank
- a bank that is a credit institution under the Banking Consolidation Directive
- a bank authorised in another country, or
- a qualifying money market fund.

A qualifying money market fund is a UCITS scheme that meets certain conditions concerning the maintenance of its net asset value (NAV), the types of assets it invests in and its liquidity. Money market funds are held under the custody rules, rather than the client money rules and this must be disclosed to clients. The client must give explicit consent to the placement of their money in a qualifying money market fund.

Firms are required to undertake due diligence on the choice of bank or money market fund before opening the account and on a regular basis thereafter. This due diligence should extend to considering how many bank accounts it is appropriate to hold as well as assessing the bank's market reputation, its credit ratings and any legal requirements or market practices that could adversely affect clients' rights.

Firms are required to notify the FCA of where they hold client money, and the amounts held with each institution.

4.8.2 Client Assets

Investment firms hold client assets as part of the overall investment service provided to clients, and they will either hold the assets themselves or outsource some or all of this function to a custodian. To hold client assets, the firm or the custodian requires the necessary permissions from the FCA.

The custody rules in CASS apply to a firm that holds financial instruments in the course of its MiFID business or where it safeguards and administers investments for non-MiFID business. There are a limited number of exceptions to the rules.

As with client money, a firm must implement segregation to keep client assets separate from its own and to protect the assets of the client in the event of the firm going into liquidation. A firm must not use a safe custody investment for its own account without the client's prior written consent. Neither must the firm use, for the account of one client, the safe custody investment of any other client unless that other client has given prior written consent to the firm.

Investments held on behalf of clients must be registered in such a way that enables them to be segregated from those of the firm and suitably safeguarded. The rules now make it clear that a firm is restricted from registering its own assets in the name of the client or any nominee in whose name a custody asset is also registered. There are two main reasons for this:

1. To reduce the risk of custody assets being misappropriated or client's rights to their assets being affected. The latter could happen as there is an increased risk that the client's assets may not be separately identifiable from the firm's own assets, thereby delaying the return of custody assets and reducing client protection.
2. To increase the likelihood that the firm or an insolvency practitioner would be able to transfer client assets promptly before, or after, the failure of a firm to another entity.

Registration of Assets

Firms may only register legal title to their own assets in the same name as that in which the client's assets are recorded in two specific situations:

1. Where doing so is one of a specified number of exceptions, such as to resolve trading errors or reconciliation breaks providing that it is no longer than is reasonably necessary.
2. Where doing so arises only as a result of the law or market practice of a jurisdiction outside of the UK. This permits a firm, when operating in an overseas jurisdiction, to register its own assets in the same name as custody assets where it is not possible or highly impractical to avoid doing so.

Disclosure Requirements

Before a firm provides investment services to clients, it must make certain disclosures and where appropriate, enter into a client agreement.

A firm that holds safe custody investments or client money must provide the client with the following information:

- Whether the assets will be held by a third party and if so, the responsibility of the firm for any acts or omissions by that third party and the consequences to the client if that third party becomes insolvent.
- Whether assets will be held in an omnibus or designated account with a warning of the risks.
- Where assets are held abroad and cannot be separately identified from those of the firm or a third party a disclosure of that fact and a prominent warning of the risks.
- A summary of the arrangements made by the firm to protect the client's assets and money.

4.8.3 Custodians

Where a firm decides to use a custodian or other third party to hold the securities belonging to its clients, it must undertake due diligence and exercise due skill, care and attention in making the selection. This responsibility extends to the periodic review of the ongoing suitability of the custodian.

Due Diligence Checks

As part of this due diligence process, a firm should:

- consider the suitability of the arrangements that will be made for the holding and safekeeping of clients' assets
- ensure that any client assets deposited with a custodian are identifiable separately from assets belonging to the firm and from assets belonging to that custodian; this must be achieved by means of differently titled accounts or other equivalent measures that achieve the same level of protection
- take into account the expertise and market reputation of the custodian and any legal requirements or market practices related to the holding of those safe custody assets that could adversely affect clients' rights, and
- record the date and grounds upon which it selected the custodian and keep these records for five years after the firm ceases to use the custodian.

The firm should also assess the financial soundness of the custodian and the control environment it has in place to protect client assets by considering the external audit reports on the control environment that it has in place to control the safeguarding of client assets. These are known as 'assurance reports on internal controls of service organisations made available to third parties' or AAF106/06 reports.

A firm should only deposit safe custody assets with a custodian in a jurisdiction which specifically regulates and supervises the safekeeping of safe custody assets unless it, or the investment services connected with it, must be deposited with a third party in that third country.

When a firm appoints a custodian, the FCA now requires firms to enter into a written custody agreement.

4.8.4 Lending and Collateral

A firm must not lend money or extend credit to a retail client, or arrange for any other person to do so, unless:

- it has assessed the client's financial standing
- it is satisfied that the loan or credit is suitable for the client, and
- the client has given written consent specifying the maximum amount of the loan or credit and details of charges.

There are two exceptions where this rule does not apply and which allows a firm to take action because of failure by a retail client to meet their obligations:

1. Where the firm settles a securities transaction in the case of default or late payment by the client.
2. Where the firm pays an amount to cover a margin call on derivatives trading due from the client for a period of no longer than five business days. If the client has not repaid that loan within five business days, the firm is required to close out the position.

In terms of collateral, where a firm holds client assets and has a right to realise them, it must comply with the custody rules and the client money rules in respect of any collateral held as security. This is a 'bare security interest' – bare security interest in the client's assets gives a firm the right to realise the assets only on a client's default and without the right to use other than in default.

There are separate rules where the firm holds assets as collateral to secure any obligations the client owes to the firm and where the client has given the firm the right to treat the assets as its own subject only to an obligation to return equivalent assets at a later point. This is a 'right to use' arrangement or a title transfer collateral arrangement. Under this, the client transfers legal title to the firm with the intention that the firm can treat the asset as its own. When it does, it ceases to belong to the client and, in effect, becomes the firm's asset; if the firm fails, the client is generally an unsecured creditor for the value of their collateral. MiFID II contains a prohibition against entering into title transfer collateral arrangements with retail clients.

5. Other Rules

5.1 Complaints and Compensation

It is almost inevitable that some customers will raise complaints against a firm at some point; sometimes these complaints will be valid and sometimes, will not. The FCA requires authorised firms to deal with complaints from complainants promptly and fairly.

The FCA title for the complaint-handling rules is 'Treating Complainants Fairly (TCF)', which gives an immediate indication of the standards they expect. It is the firm's responsibility to ensure that they instil professional and ethical standards within their staff when dealing with customer complaints. Senior management are responsible for putting in place adequate systems and controls and assessing the appropriateness of those controls on an ongoing basis.

The rules fall into three areas:

1. **Consumer awareness** – in order to aid consumer awareness of the protections offered by the regulatory system, firms must:
   - publish appropriate summary details of their internal processes for resolving complaints and the right of eligible complainants to take unresolved complaints to the **Financial Ombudsman Service (FOS)**
   - refer eligible complainants in writing of the availability of these summary details at, or immediately after, the point of sale, and
   - provide the summary details in writing on request and when acknowledging a complaint.
2. **Complaint handling**
   - These require firms to have effective and transparent procedures in place for the reasonable and prompt handling of all complaints.
   - Firms must take steps to identify and remedy any recurring or systemic problems that lead to complaints. This includes examining the root causes of complaints and changing procedures to reduce the impact on future customers. It could also mean considering addressing any detriment to existing customers who may also have suffered.
   - Firms are required to appoint a senior manager to consider the root causes for complaints and to review FOS decisions.
3. **Complaint resolution**
   - Once a firm has received a complaint, it must investigate it competently, diligently and impartially.
   - It must assess fairly, consistently and promptly the subject matter of the complaint; whether to uphold the complaint and what remedial action or redress is appropriate.
   - The firm must provide an explanation to the complainant promptly and in a way that is fair, clear and not misleading. It should set out its assessment of the complaint, the reason for the firm's decision, and any offer of remedial action or redress. Finally, it should comply promptly with any offer of remedial action or redress accepted by the complainant.

By the end of eight weeks after their receipt of the complaint, a firm should issue a final response that accepts or rejects the complaint and gives reasons for doing so. In this case, they should enclose a copy of the FOS standard explanatory leaflet and inform the complainant that if they remain dissatisfied with the respondent's response, they may refer the complaint to the FOS within six months.

Not all complainants will have the right to take their grievance to the FOS. Access to the FOS depends on whether the circumstances fall within the FOS jurisdiction and whether the complainant is an eligible complainant. Eligible complainants include professional clients and eligible counterparties where the person is an individual acting for purposes outside their trade, business, craft or profession.

5.2 Financial Ombudsman Service (FOS)

The Financial Ombudsman Service (FOS) is an independent public body set up by Parliament to sort out complaints between financial businesses and their customers in a fair and impartial way. The FOS deals with complaints between a firm and a customer when they cannot resolve the complaint between themselves.

It was established as a statutory dispute resolution scheme under Part XVI and Schedule 17 of the Financial Services and Markets Act 2000 (as amended). The FCA appoints the board of directors and chairman with the approval of HM Treasury and sets the rules by which complaints are handled in Section Dispute Resolution: Complaints (DISP) of the Redress Section of the FCA Handbook.

The FOS is free to complainants and instead is funded by a general levy on all financial business covered by the service plus a fee for each case handled. The levy is set by and payable to the FCA and is based on the expected volume of cases that FOS is expected to receive and the size of the business.

5.2.1 FOS Jurisdiction

FSMA created both a compulsory and a voluntary jurisdiction for FOS.

Section 226 of FSMA created the compulsory jurisdiction and in very broad terms access to the compulsory jurisdiction depends upon four elements:

- The activity about which the complaint is being made must be included in the list contained within DISP which in summary is regulated activities or any ancillary activities, including advice.
- The activity must fall within the territorial scope of the jurisdiction; in general terms, activities carried on from an establishment in the UK which does not refer to the residence of the complainant.
- The complainant must meet the eligibility criteria to be considered an eligible complainant.
- The complaint must be referred to the FOS within the time limits set out in DISP.

In simple terms, therefore, was the activity regulated and carried out within the relevant territory, does the complainant fall into one of the four eligible categories, and was the complaint referred in time?

The voluntary jurisdiction applies to businesses that would not otherwise be covered but who can choose to be covered by the voluntary jurisdiction, meaning they agree to deal with complaints, and comply with FOS decisions in the same way. A number of businesses have chosen to be covered by the voluntary jurisdiction such as mortgage and insurance intermediaries who wanted to be covered before they were regulated by the FCA to other businesses who are based outside the UK but have a large number of UK customers.

5.2.2 Eligibility to Bring a Complaint

The FOS can deal with complaints from:

- a consumer
- a charity with an annual income of less than £6.5 million
- a trust with a net asset value of less than £5 million
- a micro-enterprise (ie, businesses employing fewer than ten people and with an annual turnover/ balance sheet of €2 million or less)
- a small business which is defined as companies with:
  - an annual turnover of less than £6.5 million, and
  - either (i) fewer than 50 employees or (ii) a balance sheet total of less than £5 million, and
- a guarantor that has given a guarantee or security in respect of an obligation or liability of a micro-enterprise or small business.

If a firm is in doubt about whether a business, charity or a trust is an eligible complainant, it should treat the complainant as if it were eligible. If the complaint is referred to the FOS, the Ombudsman will determine eligibility by reference to appropriate evidence, such as audited accounts or VAT returns.

However, before a complainant can apply to the FOS, it must first exhaust the internal complaints procedure offered by the business with which it is in dispute.

5.2.3 Timescales for Making Complaints

There are time restrictions for the making of complaints.

A complainant cannot refer a case to the FOS unless they have first obtained a final response from the firm or eight weeks have elapsed since the matter was raised with the firm. Once a final response has been received from the firm, the complainant has six months to submit a complaint to the FOS.

There is a further restriction which is that the matter cannot be referred to the FOS more than six years after the relevant events, or, if longer, three years after the complainant became aware or ought reasonably to have become aware that there was cause for complaint. In exceptional circumstances, the FOS may allow complainants to bring complaints after these time limits have expired.

Unlike the courts, the FOS does not apply the 15-year 'long-stop' limitation period because some financial services issues (eg, unsuitable pension advice, endowment mis-selling and structured products) may not come to light until decades later, and the FOS seeks to encourage higher compliance standards and long-term accountability.

5.2.4 FOS Process

FOS has a duty to make decisions based on what they think is fair and reasonable in all circumstances of the case.

When a complaint is first received, a case handler reviews it and shares their initial conclusions with both parties. Although it does not investigate complaints, the advice and guidance it offers may lead

to cases being resolved. The aim is to resolve the complaint quickly and most complaints are resolved informally at this stage.

If either party is not satisfied with the recommendation, they can request that an ombudsman carries out a formal review. If a case is formally referred to an Ombudsman and if there are no prospects of successful mediation or conciliation, the Ombudsman issues a 'final decision'.

The Ombudsman makes decisions on the basis of what it considers to be fair and reasonable. In handling complaints, the Ombudsman is required to take into account relevant legislation, the regulator's rules, guidance and standards, codes of practice and (where appropriate) good industry practice at the time.

Both the FSMA and DISP give powers to the Ombudsman rather than to the FOS. The final decision of the Ombudsman is binding on the business but not on the consumer. If the consumer decides to accept the Ombudsman's decision, it becomes binding on both parties and can be enforced through the courts. If the consumer decides not to accept the Ombudsman's final decision, they can seek redress in the courts.

5.2.5 FOS Awards

If the FOS upholds a complaint, they generally tell the business to put their customer in the position they would be in if they had been treated fairly or if a mistake had not taken place.

Where a consumer has lost out financially, the FOS can tell a firm to pay compensation for the financial loss incurred. There is a limit to how much they can tell a firm to pay; the award limit is the maximum amount that FOS can require a financial service firm to pay when they uphold complaints. This limit is now adjusted each year in line with **inflation**, as measured by the Consumer Prices Index (CPI).

The following are some of the complaints limits at the time the workbook was published:

- £445,000 for complaints about acts or omissions by firms on or after 1 April 2019, which are referred to FOS on or after 1 April 2025.
- £430,000 for complaints about acts or omissions by firms on or after 1 April 2019, which are referred to FOS on or after 1 April 2024.
- £415,000 for complaints about acts or omissions by firms on or after 1 April 2019, which are referred to FOS between 1 April 2023 and 31 March 2024.
- £195,000 for complaints about acts or omissions by firms before 1 April 2019, which are referred to FOS on or after 1 April 2024.
- £190,000 for complaints about acts or omissions by firms before 1 April 2019, which are referred to FOS between 1 April 2023 and 31 March 2024.

For the full list: *https://www.financial-ombudsman.org.uk/consumers/expect/compensation*

The rules also give the Ombudsman specific powers to make awards for pain and suffering, damage to reputation, and distress and inconvenience. The Ombudsman is also empowered to award costs 'reasonably incurred' by a complainant. This power is exercised sparingly. In general, the Ombudsman takes the view that a complainant does not need to be represented when bringing a complaint to the FOS.

5.2.6 Complaints Data

Since 2009, the FOS has published on its website the number of complaints received and the proportion upheld, with a breakdown of the products these relate to in each sector. The website also includes a database of decisions taken in individual cases.

The FOS is not formally a regulator in the strict sense. Its role is to resolve the individual cases which have been referred to it. Nor do its decisions form binding precedents. Strictly speaking, therefore, neither the FOS nor regulated firms are obliged to follow earlier decisions when dealing with similar cases. However, many firms take the view that they should align their practice with that of the FOS. Doing so is likely to protect a firm's reputation, build customer confidence and lead to easier relationships with the FOS and the FCA.

5.3 Financial Services Compensation Scheme (FSCS)

The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation scheme that provides protection for eligible customers, generally individuals and small businesses.

The FSCS protects consumers that incur financial losses when firms authorised under FSMA are unable, or likely to be unable, to pay claims against them relating to deposits, life and general insurance policies, investment business, advice and arranging of mortgage business and insurance broking. The aim of the FSCS is to enable consumers to participate in the financial markets with the confidence that they will be protected, at least in part, should the firm with whom they are dealing go into default and be unable to satisfy claims against it.

The FSCS is administered by Financial Services Compensation Scheme Limited and the FCA and PRA are jointly responsible, under FSMA, for ensuring that the FSCS is capable of discharging its functions. The FSCS is funded by levies on authorised firms.

5.3.1 Eligible Customers

In general terms, FSCS compensation is available to individuals, some charities, certain trustees and small businesses, limited companies and charities. Eligibility for small businesses and limited companies varies by different types of claims. Larger businesses are generally excluded, but there are exceptions for deposit and insurance claims.

Deposit claims	• Eligibility for deposit claims is assessed under the PRA's Depositor Protection Rules. • FSCS protection extends to nearly all types of depositors although this excludes most types of regulated financial services companies. • Limited companies' deposits are protected regardless of size but subject to the maximum compensation limit. • Where an individual has a personal account and a small business account with the same bank, eligibility depends on legal status. • If the business is a separate legal entity such as a limited company, then both accounts are covered. • If the individual is a sole trader, they can only claim up to the maximum compensation limit. • As an exception to the previous point, a business partnership is entitled to make one claim for the partnership and then individual claims for each partner for their personal accounts.
Investment claims	• Eligibility for investment claims is assessed under the FCA Compensation sourcebook. • To qualify as a small company, the firm must meet the criteria set in Section 392, Companies Act 2006 to be eligible. There are three criteria in the test – annual turnover, balance sheet and number of employees – and the firm must meet two of the three criteria to qualify as 'small'.
Insurance claims	• Eligibility for insurance claims is assessed under the PRA's Policyholder Protection Rules. • Generally, firms with an annual turnover of more than £1 million are not eligible for general insurance claims; this excludes most types of authorised financial services firms. • For compulsory general insurance, all firms are usually eligible, regardless of size or authorisation status. • All firms are generally eligible for long-term insurance contract claims although this is unlikely to apply in practice.

5.3.2 Compensation Limits

The FSCS operates separate sub-schemes for different types of financial products and the following apply:

Deposits	• Up to £85,000 per person per authorised deposit-taker. • Up to £170,000 for joint accounts. • Anyone who has deposits in more than one account under a single brand, or multiple accounts under different brands owned by a single firm, is only protected up to a total of £85,000 across all these accounts. • There is temporary deposit protection for up to £1 million for up to six months (eg, proceeds from a house sale).

Investments and home finance	• £85,000 per person per firm. • Certain qualifying conditions must be met.
General insurance advice and arranging claims	• 90% of the claim with no upper limit. • Insurance policyholders must have a protected insurance contract and be eligible to receive compensation. • Compensation for 100% of the claim is available for all long-term insurance claims and compulsory insurance.
Debt management	• £85,000 per person, per firm.

Note that the PRA has proposed raising the standard deposit protection limit from £85,000 to £110,000 from 1 December 2025 to reflect inflation and to maintain depositor confidence. This proposal is subject to public consultation and HM Treasury approval.

5.3.3 Deposit Compensation: Some Special Cases to Consider

Savings Platforms

Savings platforms work with a selected number of banks and savings institutions to help customers gain access to competitive interest rates. These platforms typically use a hub account where the money is held pending deposit in a savings product or between switches. If the platform fails, and the deposits are held in the client's name or on trust, then FSCS compensation should be payable, but it depends on the arrangements made by the platform.

International Banks in the UK

Overseas banks are able to operate in the UK. Since the end of the Brexit transition period, EEA banks can no longer rely on passporting rights and must be fully authorised by UK regulators to undertake business in the UK. Any EEA or non-EEA banks wishing to accept deposits in the UK must obtain authorisation from the Prudential Regulation Authority (PRA) or FCA. Only deposits with UK-authorised institutions are eligible for FSCS protection.

After the UK's departure from the EU, FSCS protection for UK-based customers of UK authorised firms did not change. The PRA and FCA published rules that apply since the end of the Brexit transition period, summarised in the table below.

Deposits with UK authorised banks held in an EEA branch	• Deposit protection previously provided by the FSCS for deposits held in EEA branches of UK firms ceased from 31 December 2020. • Protection should be provided by the depositor protection regime in each EEA country, but will depend on the rules in that country.
Deposits in Gibraltar	• Eligible deposits held in Gibraltarian branches of UK firms will continue to be protected by the FSCS.
Deposits with EEA branches of an EEA bank	• Protection should be provided by the depositor protection regime in each EEA country but will depend on the rules in that country.

Source: FSCS

The FSCS scheme does not cover deposits with institutions outside of the EEA or in the Channel Islands or the Isle of Man where separate compensation rules apply.

5.3.4 Investments

If an investment is held with a firm that has failed, then FSCS protection may be available provided that certain qualifying conditions are met:

- The person must be an eligible claimant.
- The provider is an authorised firm that has permission to carry out a regulated activity that the FSCS protects. The activity and product must have been regulated.
- The firm should no longer have enough funds to meet the compensation claim.
- The firm held client money or assets and there is a shortfall.
- If the claim is about negligent advice, then the advice must have been given after 28 August 1988, the firm must have been authorised at the time and money must have been lost after acting on the advice given. The person must be owed a civil liability, in other words, the firm is responsible for actions that damage or harm others. This does not include investment performance.

5.3.5 Insurance Contracts

To be protected by the FSCS, insurance policyholders must have a protected insurance contract and be eligible to receive compensation:

- For claims relating to general insurance, most private individuals and small businesses are eligible for protection.
- For long-term insurance, most claimants, including large businesses, are eligible for protection.
- Provided that the claim is a protected contract of insurance, there are no exclusions from eligibility for claims under insurance contracts that cover compulsory insurance.

Compensation for 100% of the claim is available for all long-term insurance claims and compulsory insurance. Included in this group are the following types of policies:

- Long-term insurance, such as whole of life assurance, term insurance, insured personal pensions, annuities and income protection insurance.
- Claims arising from the death or incapacity of the policyholder due to injury, sickness or infirmity.
- Compulsory insurance such as third-party motor insurance and employer's liability insurance.
- Professional indemnity insurance.

In all other cases, the limit is 90% of the claim. FSCS must calculate the value of the liability in accordance with set rules and this may mean that policyholders will lose some of the value.

5.3.6 Declaring a Firm in Default

Before the FSCS can pay compensation, it must be satisfied that a firm does not have sufficient assets to meet claims, described as being 'in default'. The FSCS will declare a firm in default if:

- it has received at least one claim, and
- it is satisfied that the firm is unable (or likely to be unable) to pay claims against it.

FSCS is required to do this before it can pay compensation to eligible claimants. Declaring a firm in default allows eligible claimants who believe they may have lost money as a result of their dealings with that firm to apply to the scheme.

5.4 Data Protection

The EU-wide General Data Protection Regulation (GDPR) came into effect on 25 May 2018 in the UK, when the Data Protection Act 2018 came into force, replacing the Data Protection Act 1988. The regulations lay down data protection principles that set out the main responsibilities of organisations.

Following Brexit, the GDPR has been kept in UK law as the 'UK GDPR'. With fines of up to 4% of the total annual turnover worldwide in the previous financial year or £17.5 million (whichever is higher), wealth managers cannot afford to ignore these far-reaching data protection regulations.

The GDPR applies to 'personal data', meaning any information relating to an identifiable person who can be identified by reference to an identifier. This definition provides for a wide range of personal identifiers to constitute personal data, including name, identification number, location data or online identifier, reflecting changes in technology and the way organisations collect information about people. The GDPR applies to both automated personal data and to manual filing systems where personal data is accessible according to specific criteria. One of the biggest issues for wealth managers is that most customer data currently lie in multiple unconnected systems and files that are a left over from earlier systems and initiatives.

In order to comply with the Act, firms have a number of legal responsibilities, including:

- notifying the ICO that they are processing information
- processing personal information in accordance with the data protection principles, and
- answering subject access requests received from individuals.

In summary, the data protection regulations require that personal data shall be:

- processed lawfully, fairly and in a transparent manner in relation to individuals
- collected for specified, explicit and legitimate purposes and not further processed in a manner that is incompatible with those purposes
- adequate, relevant and limited to what is necessary in relation to the purposes for which it is processed
- accurate and, where necessary, kept up to date; every reasonable step must be taken to ensure that personal data that is inaccurate, having regard to the purposes for which it is processed, is erased or rectified without delay
- kept in a form that permits identification of data subjects for no longer than is necessary for the purposes for which the personal data is processed, and
- processed in a manner that ensures appropriate security of the personal data, including protection against unauthorised or unlawful processing and against accidental loss, destruction or damage, using appropriate technical or organisational measures.

Any firm that is holding and processing personal data must register with the ICO and have a lawful basis for processing personal data. There are six available lawful bases for processing; at least one of these must apply whenever a firm processes personal data:

1. **Consent** – the individual has given clear consent for the firm to process their personal data for a specific purpose.
2. **Contract** – the processing is necessary for a contract the firm has with the individual, or because they have asked the firm to take specific steps before entering into a contract.
3. **Legal obligation** – the processing is necessary for the firm to comply with the law (not including contractual obligations).
4. **Vital interests** – the processing is necessary to protect someone's life.
5. **Public task** – the processing is necessary for the firm to perform a task in the public interest or for their official functions, and the task or function has a clear basis in law.
6. **Legitimate interests** – the processing is necessary for the firm's legitimate interests or the legitimate interests of a third party, unless there is a good reason to protect the individual's personal data which overrides those legitimate interests.

The principle of accountability requires firms to be able to demonstrate that they are complying with the data protection regulations, and have appropriate policies and processes. This means that a firm needs to be able to show that they have properly considered which lawful basis applies to each processing purpose and can justify their decision. They therefore need to keep a record of which basis they are relying on for each processing purpose, and a justification for why they believe it applies.

The GDPR requires the data controller (ie, the natural or legal person, public authority, agency or other body which, alone or jointly with others, determines the purposes and means of the processing of personal data) to be able to demonstrate that the consent is freely given, specific and informed, and that it is an 'unambiguous indication' of a data subject's wishes expressed by either a statement or a clear affirmative action. Consent is purpose-limited, ie, it will permit processing only for explicitly specified purposes. Consent contained in a written declaration must be distinguishable from other matters in the declaration and must be intelligible, easily accessible, and in clear and plain language.

Data controllers and data processors (ie, natural or legal persons, public authorities, agencies or other bodies which process personal data on behalf of the controller) are required to implement appropriate technical and organisational measures to ensure a level of security of personal data proportionate to the risk, eg, using pseudonyms and encryption, ensuring confidentiality of processing systems and having a process for regularly testing these measures.

Where there is a personal data breach (ie, a breach of security leading to the destruction, loss, alteration, unauthorised disclosure of, or access to, personal data), the following actions must be taken:

- A processor must notify the controller of data breaches without undue delay.
- The controller must then report to the ICO; where feasible, this report must take place not later than 72 hours after the controller having become aware of it.
- Where there is a high risk to a data subject, the controller must communicate the breach to the data subject without undue delay.

In considering whether to impose a fine and the level of such fine, the ICO must have regard to factors such as the nature, gravity and duration of the breach and its consequences, the measures taken to

ensure compliance with the GDPR and any action taken to prevent or mitigate the consequences of the breach.

6. Integrity and Ethics

Regulation really does underline the importance of how wealth managers conduct themselves. What is expected of us directly because of being authorised to conduct business can most easily be summed up as principles and standards. Some of these standards derive from regulation and others from the increasing emphasis on integrity and ethics in professional practice.

Principles are what guide us, check us and judge our actions. They can be personal, professional or, indeed, regulatory. Instilling principles into the wealth management industry is what separates us from the Wild West days following the Big Bang. In short, we need to set and enforce principles in order to maintain trust. Once, the London investment community adhered to just one simple principle, '*my word is my bond*', and it remains today as a cornerstone of the CISI.

6.1 Regulatory Standards

By only allowing 'fit and proper' firms to be involved in the financial services sector, the Regulator begins to satisfy the statutory objectives of enhancing financial stability and the integrity of the financial system, and protecting consumers. In addition to meeting the threshold conditions, there are regulatory principles and rules aimed at integrity and ethical standards within the industry.

6.1.1 PRA Rules and FCA Principles

The PRA's eight Fundamental Rules apply to all PRA-authorised firms. These are high-level rules that collectively act as an expression of the PRA's general objective of promoting the safety and soundness of regulated firms. As with the threshold conditions, it is vital that boards and senior management understand the Fundamental Rules, the more detailed rules in the PRA Rulebook and the directly applicable EU regulations, and establish within their firms a culture that supports adherence to the spirit and the letter of the requirements.

The Fundamental Rules are as follows:

- **Fundamental Rule 1** – a firm must conduct its business with integrity.
- **Fundamental Rule 2** – a firm must conduct its business with due skill, care and diligence.
- **Fundamental Rule 3** – a firm must act in a prudent manner.
- **Fundamental Rule 4** – a firm must at all times maintain adequate financial resources.
- **Fundamental Rule 5** – a firm must have effective risk strategies and risk management systems.
- **Fundamental Rule 6** – a firm must organise and control its affairs responsibly and effectively.
- **Fundamental Rule 7** – a firm must deal with its regulators in an open and cooperative way, and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice.
- **Fundamental Rule 8** – a firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

The FCA's 12 Principles for Businesses are a general statement of a firm's fundamental obligations under the regulatory system. As with the PRA's Fundamental Rules, it is vital that boards and senior management understand the Principles for Businesses and establish within their firms a culture that supports adherence to the spirit and the letter of these principles. If a firm breaches any of the Principles for Businesses, it will be liable to disciplinary sanctions as they are legally binding on all authorised firms.

The FCA's Principles for Businesses are as follows:

1. **Integrity** – a firm must conduct its business with integrity.
2. **Skill, care and diligence** – a firm must conduct its business with due skill, care and diligence.
3. **Management and control** – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. **Financial prudence** – a firm must maintain adequate financial resources.
5. **Market conduct** – a firm must observe proper standards of market conduct.
6. **Customers' interests** – a firm must pay due regard to the interests of its customers and treat them fairly.
7. **Communications with clients** – a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. **Conflicts of interest** – a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. **Customers: relationships of trust** – a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. **Clients' assets** – a firm must arrange adequate protection for clients' assets when it is responsible for them.
11. **Relations with regulators** – a firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.
12. **Consumer Duty** – a firm must act to deliver good outcomes for retail customers.

6.1.2 From Fair Treatment of Customers to Consumer Duty

It should be apparent from a reading of the Principles for Businesses that a general theme of overriding fair play runs through them; this is coupled with a recognition that there is often an information imbalance between the firm and its customers since the firm is usually more expert in its products and services than its customers.

The concept of fair treatment is at the heart of the regulatory system. It is expressed in Principle 6 as well as Principle 7 above, and also in an important conduct of business rule known as the client's best interests rule:

> *'A firm must act honestly, fairly and professionally in accordance with the best interests of its client.'*

An important part of the FCA's supervision of firms involves assessing how they are able to demonstrate fair treatment of clients – Treating Clients Fairly (TCF). The firm's management culture should be ethical and have the client's best interests at the heart of the firm.

A firm also needs to ensure it gathers sufficient management information to help it monitor how well it is adhering to these obligations, and to help it identify where it might be failing. The TCF Outcomes are as follows:

- **Outcome 1** – consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- **Outcome 2** – products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3** – consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4** – where consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5** – consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- **Outcome 6** – consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

TCF, with its focus on consumer outcomes, still underpins the delivery of the FCA's statutory consumer protection objective.

The FCA wants vulnerable consumers to experience outcomes as good as those for other consumers and receive consistently fair treatment. There is a risk that vulnerable consumers may not experience good outcomes due to their circumstances. They may have additional or different needs that affect their ability and willingness to engage with financial services, make decisions or represent their own interests. Firms should, therefore, take particular care when it comes to treating vulnerable consumers fairly. As a result, it has issued guidance for firms on the fair treatment of vulnerable consumers which is covered further in chapter 7.

In 2022, the FCA set out new rules and guidance: the Consumer Duty. It decided that Principles 6 and 7 above did not generate good enough outcomes for retail customers. Therefore, they will no longer apply to retail customers in the future. The Consumer Duty will come into force on a phased basis:

- **31 July 2023** – date to implement the new rules for open products or services (new or existing).
- **31 July 2024** – date to implement the new rules for closed products or services.

The regulator will continue to apply Principles 6 and 7 for non-retail customers.

The FCA now believes that to improve the outcomes for consumers of their rules and guidance (under their driving principles) it needs to specify what 'outcomes' it wants. The FCA sees the Consumer Duty as a step towards a better principle-based approach. Expect more rules and guidance in the future to come with outcomes attached.

Consumer Duty

The Consumer Duty is a set of new regulations that came into effect in 2023. It requires firms to prioritise their customers' needs and take actions to ensure positive outcomes for them. The Consumer Duty aims to enhance consumer protection and encourage competition in the financial services sector.

The Consumer Duty applies to all firms offering retail financial services to consumers in the UK, including those providing financial advice. It requires firms to consider the following four outcomes when designing, selling, and providing financial services:

- **Fairness** – Consumers should be treated fairly and should not be disadvantaged by the firm's products or services.
- **Understanding** – Consumers should be able to understand the firm's products, services, and associated risks.
- **Choice** – Consumers should have a choice of products and services and the ability to switch providers easily.
- **Protection** – Consumers should be protected from harm, including financial crime and market abuse.

The Consumer Duty represents a significant change in the way firms will be regulated in the UK. It will require firms to adopt a more customer-centric approach and prioritise their customers' needs. Additionally, the Consumer Duty aims to promote competition in the financial services sector, benefiting consumers with increased choice and lower prices.

To assist firms in understanding and complying with the Consumer Duty, the FCA has published various resources, including a guide, toolkit, and a series of webinars.

Firms need to undertake several key actions to comply with the Consumer Duty:

- **Understand customers' needs** – Firms must comprehend the needs, characteristics, and objectives of their customers, including those who may be vulnerable.
- **Design products and services that meet customers' needs** – Firms need to create products and services that are fair, understandable, and offer good value for money.
- **Communicate clearly and understandably with customers** – Firms must ensure their communications, including sales, customer support, and complaint handling, are clear and easily comprehensible.
- **Provide excellent customer support** – Firms should offer strong customer support, addressing any questions or issues customers may have with their products or services.
- **Monitor and review performance** – Firms need to monitor and review their performance against the Consumer Duty and take necessary steps to improve where needed.

The Consumer Duty introduces a new and complex set of rules. Firms providing retail financial services to consumers in the UK must make efforts to understand and comply with the Consumer Duty.

Price and Value Assessment

One of the most substantial areas of transformation, posing challenges for advisers, lies in the Consumer Duty's focus on price and value outcomes, encompassing a broader scope than the FCA's current value assessment rules for authorised fund managers (AFMs). This mandate applies to all firms involved in the (co-)manufacturing or distribution of products to retail customers, necessitating a demonstration of fair value provision for the first time.

For AFMs already conducting value assessments, this new regulation requires them to factor in value considerations when identifying suitable distribution channels for the product's target market. In this

assessment, firms are obligated to include not only their fees but also information from other entities in the distribution chain, substantiating the reasons behind their belief in the value offered by their products and services.

Moreover, the value assessment is expected to have a 'forward-looking aspect', demanding that manufacturers ensure their products maintain fair value for a reasonably foreseeable period. Manufacturers should responsibly include past performance disclaimers, recognising the importance of such disclosures. Firms should also think about probable customer journeys and other potential costs.

Beyond purely financial aspects, firms are urged to carefully consider non-financial factors impacting their products. Such factors encompass easy access to product information, transparent pricing, clear terms and conditions, exceptional customer support, and the flexibility of product switching.

The new value assessment requirements are likely to contribute to continued downward fee pressure, especially for distribution fees.

Guidance on Consumer Duty implementation

In February 2024, the FCA published guidance, identified in their initial supervisory work, on good practices and areas for improvement for firms implementing the Consumer Duty for open products and services, which came into force in July 2023. The regulator welcomed the improvements made by many firms to deliver better outcomes for customers but noted that some firms lagged behind.

Some of the improved practices seen include the following:

- The same level of support offered to new customers is available to existing customers.
- Additional engagement touchpoints with customers to prompt better decisions, such as notifying them about higher interest rate savings accounts.
- Clearer charges with examples of costs to improve customer understanding.
- Updated terms and conditions to include commitments to inform customers about better options.

Some of the areas where firms need to do more:

- Unclear with customers about charges and when they apply.
- Ineffective sharing of information across the distribution chain and poor effort in driving good outcomes.
- Inadequate processes to identify and support vulnerable customers across multiple products.
- Insufficient staff training to have complex conversations with customers in financial difficulty.

Now, the FCA emphasises the need for continuous improvement, urging firms to address existing gaps and prepare adequately to meet regulatory expectations. Ongoing assessments and guidance from the FCA will support these efforts.

To learn more about the consumer duty: https://www.fca.org.uk/firms/consumer-duty.

6.1.3 Outcomes-focused Regulation

The UK has a principles-based approach to the regulation of the financial services sector where the Principles for Businesses and the Conduct of Business rules provide the minimum standards that firms are expected to adhere to. Given the diverse nature of firms operating in the UK, the FCA's position is that it is neither possible nor desirable to specify exactly what they expect from every market participant against detailed rules. The FCA has a principles-based approach that is outcomes-focussed.

In the Strategy 2022 to 2025, the FCA announced a shift towards focusing on results rather than being driven by processes and that, for the first time, their strategy sets out the outcomes they expect all firms to deliver across the markets. In addition, they stated that they will be tougher on their own performance, collectively and individually, and are publishing measures that cover a multi-year period and against which they can be held accountable to support delivery of these outcomes.

The FCA explains that their outcomes-focused regulation translates to a model where they look at:

- **whole markets** – to see whether they are working in the interests of consumers and where market studies determine whether lack of competition is the driver of problems and the structural solutions needed
- **sectors** – where they use thematic work to look at specific problems where the right outcomes may not arise and the changes needed in firms' behaviours, and
- **individual firms** – where they are looking for key drivers of potentially poor conduct behaviour.

This means at the firm level, they are looking at how the interests of the customer and market integrity are at the heart of how they run their business – this means that their focus is on the firm's business model, culture and front-line activities, such as product governance. Fair treatment of customers is not a tick-box compliance approach and, instead, is a conduct question that is more a cultural and business model challenge.

6.1.4 Conduct Risk

Since the financial crisis of 2008, conduct risk has become a major area of attention by the FCA and the boards of financial services firms. There is no agreed definition for conduct risk but, in simple terms, it is how to place integrity and trust at the heart of how firms behave, and how customers and investors are treated. In essence, therefore, it refers to risks attached to the way in which a firm, and its staff, conduct themselves.

A good starting point is to consider conduct risk as the latest in a series of regulatory thinking that began with **treating customers fairly (TCF)**, which then progressed through principles-based regulation, and then on to outcomes-focused regulation, before becoming conduct risk. All of these expressions have at their heart the same basic idea, namely that regulation through the creation of rules alone is not enough to protect consumers or markets.

Existing conduct rules require firms to collect and assess client information in order to determine whether investment products are suitable and to review investments in the light of any relevant changes. Similarly, the way in which firms market their products and services is subject to specific

financial promotion rules. The rules expect firms to communicate in a way that is 'clear, fair and not misleading' – for example, giving clear risk warnings that past performance is not a guarantee of future performance.

Compliance with rules is generally a backward-looking philosophy. The question tends to be: 'Did the firm comply?' Certainly, this is how firms operated in the past, with compliance monitoring activity devoted to uncovering incidences of historic rule breaches. The conduct risk approach, on the other hand, has a forward-looking emphasis: *'Will the actions of the firm lead to poor outcomes for consumers or not?'*

6.2 Professional Ethics and Culture

Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the sector in recent history, causing harm to both consumers and markets. For markets to work and firms to be successful, it is critical that they are seen as trustworthy. Social expectations have changed, and public interest has raised questions of trust in firms, and in the industry as a whole. To increase confidence, firms need to demonstrate they are working in the interests of consumers and the market.

Professionals hold an important place in society. By virtue of their specialist skills and knowledge, they are in positions of power. Because of this privileged position, there is a social contract between professionals and the public. Professionals are afforded certain benefits (for example, the ability to perform specific tasks, pay that reflects their level of experience and membership of an exclusive group of individuals) and in return they are expected to act in the public interest and behave ethically and with integrity.

When this is not the case, ie, when professionals do not act ethically or with integrity, the public backlash is usually significant, as demonstrated during the financial crisis of 2008.

6.3 Codes of Ethics and Codes of Conduct

For any industry in which trust is a central feature, the need to have demonstrable standards of practice and the means to enforce them is a key requirement; hence the proliferation of professional bodies in the fields of health and wealth, areas in which consumers are more sensitive to performance and have higher expectations than in many other fields.

The terms 'code of ethics' and 'code of conduct' are often used synonymously. A code of ethics will also generally be aspirational, encouraging adherence to values that are above and beyond normal standards. A code of conduct will usually set out rules and guidance for individuals to adhere to.

Professional bodies operating in the field of financial services developed codes of conduct for their members. What is more, professional bodies have reinforced the importance of ethical behaviour, especially integrity, for their members and they provide guidance and training based around ethics and values. For example, the Chartered Institute for Securities & Investment (CISI) requires all members to complete and pass an ethics test called '*Integrity Matters*'. A practitioner working in the industry will, therefore, be exposed to both the rules issued by the Regulator and ethical standards expected of them by a professional body.

Balancing the requirements of the Regulator with the expectations of a professional body remains a major challenge for any professional working in the financial services sector. Thus, we should be considering how our ethical behaviour can be used to enhance the rather rigid structures of the legislative framework and produce enhanced outcomes for all stakeholders.

At this point, it is worth considering the principal features of what we can describe as the ethics versus compliance approach:

Ethics	Compliance
Prevention	Detection
Principles-based	Law/rules-based
Values-driven	Fear-driven
Implicit	Explicit
Spirit of the law	Letter of the law
Discretionary	Mandatory

Once again, it is back to the choice of doing things because you ought to and because it is the right thing to do (ethics) rather than because you have to (regulatory).

6.4 CISI Code of Conduct

As professionals within the securities and investment industry, we owe important duties to a range of stakeholders – including clients, the market participants, the profession, professional bodies, regulators, colleagues as well as to wider society.

The CISI Code of Conduct is stakeholder-based and each of the eight principles specifies the duties owed by members to one or more stakeholders who may be impacted by their actions. The eight principles and corresponding stakeholders are outlined in the following table:

Principles	Stakeholders
Personal Accountability – to strive to uphold the highest levels of personal and professional standards at all times, acting with integrity, honesty, due skill, care and diligence to avoid any acts, either in person, in a remote working environment or digitally which may damage the reputation of your organisation, your professional body or the financial services profession.	Self, Clients, Regulators, Colleagues, Market Participants, Firm, Profession, Society
Client Focus – to put the interests of clients and customers first by treating them fairly, being a good steward of their interests, never seeking personal advantage from confidential information received and utilising client data only for a defined purpose.	Clients

Principles	Stakeholders
Conflict of Interest – being alert to and actively managing fairly and effectively any personal or other conflicts of interest, obeying legislation and complying with regulations to the best of your ability, ensuring you are open and cooperative with all your regulators, challenging and reporting unlawful or unethical behaviour.	Clients, Market Participants, Regulators
Respect for Market Participants – to treat all counterparties and business partners with respect, to observe proper standards of market integrity, good practice, conduct and confidentiality required to maintain the highest level of mutual trust.	Clients, Market Participants
Professional Development – to strive continually for professional excellence, committing to continuous professional development (CPD) and promoting and supporting the development of others.	Profession, Clients, Colleagues
Aware of Capabilities – to decline to act on any matter about which you are not competent or qualified unless you have access to such advice or assistance to carry out the work in a professional manner, taking into account the nature of the individual mandates given by your customers and counterparties.	Clients, Profession, Market Participants
Respect Others and the Environment – to treat everyone fairly and with respect, supporting opportunity for all, embracing diversity and inclusion and ensuring that the environmental impact of your work is considered.	Society, Colleagues, Clients, Regulators, Market Participants, Profession, Professional Body
Speak Up & Listen Up – to be active in speaking up and encouraging others to do so by listening up, promoting a safe environment for all and recognising the responsibilities you have to the communities in which you operate.	Society, Colleagues

There may be situations where professionals are faced with making a decision where the correct course of action is not immediately obvious. In addition to referring to the Code, consideration of the following could help to decide the right course of action.

Clear & Honest	• Have I told no lies or 'half-truths' to any party involved in reaching my decision?
Impartial & Open	• Is everyone affected by my action or decision aware of the consequences?
Straightforward & Transparent	• Have I made sure that my action or decision will not result in any party being unknowingly disadvantaged or unduly advantaged?
Informed & Fair	• Have I considered the interests of my potential stakeholders and not been misleading when making my decision?

6.5 Professional Integrity

Professionals within the securities and investment industry owe important duties to their clients, the market, the industry and society at large. Where these duties are set out in law or regulation the professional must always comply with the requirements in an open and transparent manner.

Members of the CISI are also required to meet the standards set out within the CISI's eight principles, which impose an obligation on members to act at all times not only in compliance with the rules, but also to support the underlying values of the Institute.

These words from the introduction to the CISI Code of Conduct, together with the Principles themselves, which comprise the Code of Conduct, set out clearly the expectations upon members of the industry 'to act in a way beyond mere compliance'.

In other words, we must understand the obligation upon us to act with integrity in all aspects of our work and our professional relationships and not simply meet, but strive to exceed, the standards expected of us.

Similar sentiments were expressed by a former senior industry practitioner, who reminded members of the city of the order of priorities of the firm at which they started and of which they became a partner:

- Client first.
- Firm second.
- Self third.

At the corporate and institutional level, this means operating in accordance with the rules of market conduct, dealing fairly (honestly) with other market participants and not seeking to take unfair advantage of either. That does not mean that you cannot be competitive, but that rules and standards of behaviour are required to enable markets to function smoothly, on top of the actual regulations which provide direction for the technical elements of market operation.

At the individual client relationship level, the Principles remind us of our ethical responsibilities towards our clients, in addition to complying with the regulatory framework and our legal responsibilities. But, as we have seen, if you are guided by ethical principles, compliance with regulation is much easier.

6.6 Events in Ukraine – Regulatory Changes

The Russian invasion of Ukraine (as well as the financial sanctions imposed in response on Russia) are having a significant impact on financial markets and, therefore, regulators are responding to it.

On 6 July 2022, the FCA published a policy statement (PS22/8) title *'Protecting investors in authorised funds following the Russian invasion of Ukraine'* to address the potential harm caused by the exposure that UK authorised retail funds have to affected investments. So that these funds can operate fairly and efficiently in the interests of all investors, the rules allow these funds to use side pockets where their Russian, Belarusian and Ukrainian exposures are subject to financial sanctions, or cannot be valued or traded.

Affected investments include:

- equities and fixed-income securities issued by governments, public authorities and corporates in Russia, Belarus and Ukraine and securities listed, offered or placed in those countries
- assets listed and traded on other stock exchanges and backed by such securities, eg, depositary receipts (DRs)
- securities issued by companies whose operations are particularly severely affected by the current situation, or which are owned or controlled by individuals who are the subject of UK or international sanctions relating to Russia, and
- units in other collective investment schemes (CISs) that have suspended dealings because of exposure to such assets.

The new rules formally allow authorised fund managers (AFMs) to separate affected investments from the fund's other investments. This can be achieved through the creation of side pockets, ie, new classes of units, which allow:

- new investors to enter the fund without sharing in the exposure to the affected investments
- existing investors to sell the units which relate to assets that are not affected investments, and
- some funds to end their current suspension of dealing.

The FCA defines an authorised fund manager (AFM) as the fund operator of an authorised open-ended investment company (OEIC), an authorised contractual scheme (ACS) or authorised unit trust (types of funds authorised by the FCA).

The rules primarily apply to:

- managers of UK authorised retail funds with exposure to affected investments
- depositaries of these funds
- ancillary service providers to authorised fund managers and depositaries
- providers of investment services offering access to these funds, including **Self-Invested Personal Pension (SIPP)** providers, as well as Individual Savings Account (ISA) managers
- distributors of these funds
- investment intermediaries who advise on or invest in these funds
- insurers who offer unit-linked insurance contracts linked to these funds
- discretionary wealth managers, including those who offer **model portfolios**, and
- other professional or institutional investors.

The FCA encouraged those AFMs intending to implement side pockets to engage with the regulator before applying to modify scheme documents, so it can explain what specific information should be provided as part of the application. The FCA committed to undertaking reviews of authorisation applications as quickly as possible.

On 11 July 2022, the changes above came into force. On 18 July 2022, the FCA published them in the Handbook Notice 101.

Review of Sanctions Systems and Controls

Throughout 2022 and 2023, the FCA conducted assessments of over 90 financial services firms' sanctions systems and controls in response to the unprecedented sanctions imposed on Russia following its invasion of Ukraine. The assessments identified both good practices and areas for improvement.

Good practices seen include:

- conducting risk exposure assessments and scenario planning, which better-prepared firms to manage the resulting demands, and
- implementing effective screening systems to identify sanctioned individuals and entities.

Areas for improvement seen include:

- lack of sufficient management information provided to senior management to enable appropriate oversight of sanctions risks
- global policies not aligned with the UK sanctions regime in some multinational firms, and
- insufficient understanding of how third-party sanctions screening tools were calibrated and when lists were updated.

The FCA expects firms to continuously evaluate their approach to identifying and assessing the sanctions risks they face. In addition, they should actively enhance their measures to prevent sanctions breaches and evasion by adapting to the dynamic sanctions landscape and shifting risk exposures.

To learn more about sanctions systems and controls: https://www.fca.org.uk/publications/good-and-poor-practice/sanctions-systems-and-controls-firms-response-increased-sanctions-due-russias-invasion-ukraine.

7. RegTech (Regulatory Technology)

The term FinTech (a combination of the words 'financial' and 'technology') emerged after the financial crisis of 2008. It could be defined as a series of responses to the failings of the 'traditional' financial system. FinTech firms (also referred to as FinTechs) apply technology to improve financial activities; FinTech solutions designed for regulatory compliance and reporting are referred to as RegTech. (The Government Office for Science in the UK is attributed with coining the term 'RegTech' in its 2015 FinTech Futures Report.)

The RegTech solution providers make it much easier for financial services companies, including wealth managers, to comply with all the regulations that they may be subject to. Among other technologies, they leverage APIs and artificial intelligence (AI).

RegTech can help regulators too, by allowing them to track ownership of assets in real time, among other benefits.

It should be noted that although the term RegTech emerged only in recent years, digital solutions to help banks and other financial companies meet regulatory requirements had existed long before that. In particular, the more mature segments within RegTech – such as solutions related to financial crime

(eg, name screening, AML transaction monitoring and client onboarding) have been developed and implemented many years before the term RegTech came into circulation.

In 2018, Ascent RegTech announced that it had formalised an ongoing collaboration with the FCA with the purpose of componentising the FCA Handbook. Ascent RegTech improves the ability for individuals to search and analyse the FCA Handbook through the use of natural language processing (ie, software with the ability to read and understand a variety of written documents in a human way) and machine learning algorithms (software which, by trial and error, learns by mining information to discover patterns in data). These efforts will help financial firms (and other firms subject to the FCA Handbook) to more easily find and understand the FCA rules that apply to them, thereby increasing their ability to comply.

This came about in response to concerns from financial firms about the difficulty in trawling through voluminous regulatory text and extracting their specific obligations – a challenge faced by both businesses and regulators.

In 2016, the FCA introduced a regulatory sandbox which is a space for innovators to test new ideas with real customers open to regulated and non-regulated businesses and technology providers who meet the FCA's eligibility criteria, and where the FCA oversees trials using a customised regulatory environment for each pilot.

In 2018, Ascent RegTech formalised a collaboration with the FCA to componentise the FCA Handbook, using natural language processing and machine learning to help firms more easily find and understand relevant rules – addressing industry concerns about the complexity of regulatory texts. Later, Ascent enhanced its service by adding automated delivery of regulatory updates and actionable compliance tasks tailored to each firm. Meanwhile, IBM and Thomson Reuters launched a similar AI-powered service, helping firms manage regulatory alerts and assess business impact.

Since then, RegTech has advanced significantly in the UK and globally, driven by increased regulatory complexity and rapid adoption of AI and machine learning. UK regulators like the FCA have embraced data-driven supervision, including AI tools to detect misconduct and streamline compliance. RegTech firms have expanded AI-based services for AML, KYC and real-time fraud detection. Globally, RegTech has seen rising adoption of natural language processing, predictive analytics and blockchain for secure identity verification and audit trails. Regulatory sandboxes – now present in many jurisdictions following the FCA's model – and increased cross-border collaboration have further accelerated innovation across regions.

Law enforcement agencies, as well as financial regulators, are increasingly using RegTech tools. The rise of cryptocurrencies, which can obscure user identities, challenges traditional KYC methods. To address this, Chainalysis offers tools like 'Know Your Transaction' for real-time monitoring and 'Reactor' for linking crypto activity to real-world entities – used by exchanges and agencies such as the FBI, DEA and Europol.

7.1 RegTech Broad Categories

7.1.1 KYC and Client Onboarding

Perhaps the largest and most mature RegTech market is know your client (KYC) solutions. Traditionally, the KYC process involves face-to-face meetings and presentation of physical copies of documents. KYC RegTechs offer forms of electronic verification of identity, or eKYC. For example, Onfido, a UK-based RegTech, digitally proves people's real identities using photo IDs and facial biometrics. The COVID-19 pandemic saw not only social distancing policies being rolled out by governments, eKYC suddenly came into the public spotlight as it became obvious that faster technology adoption for onboarding was needed.

7.1.2 Surveillance

Perhaps the second RegTech segment with the largest user base – by virtue of the fact that it affects many employees at financial institutions – is surveillance tools that monitor employee communications for potential wrongdoing, such as insider trading, market abuse or theft of intellectual property. In the UK, some of the leading players in this segment are SteelEye, Behavox and Recordsure.

7.1.3 Transaction Monitoring and Risk Analytics

Transaction monitoring looks to identify suspicious transactions due, among other things, to possible fraud or money laundering. To do this, financial institutions create data models using various parameters, such as transaction patterns, transaction codes, country of origin, customer name and originating bank – out-of-pattern transactions are then examined. For example, IBM offers IBM Safer Payments, a fraud prevention solution that enables banks to intercept suspicious payment activities before they happen, while ensuring customers' genuine payments are processed.

7.1.4 Reporting

Reporting solutions are typically designed for a very specific regulatory requirement. For example, Delta Capita has a solution specifically designed for Securities Financing Transactions Regulation (SFTR) compliance in the EU. SFTR requires banks, investment firms, insurance companies, reinsurance undertakings and pension funds to report such transactions to approved trade repositories, with the aim of enhancing transparency on collateralised transactions. The solution won the 'Best Regulatory Reporting Solution' award at the RegTech Insight Awards.

These technologies will increasingly help wealth managers to digitalise. They are part of a broader trend where FinTech companies are helping wealth managers to make their administration processes more efficient and faster, so that they can focus more on the higher value activities.

7.2 Generative AI in RegTech

The increasing maturity and capabilities of generative AI technology, exemplified by the rapid growth of OpenAI's ChatGPT, has the potential to revolutionise the field of RegTech. Generative AI, a branch of artificial intelligence, can produce new outputs, such as text-based summaries and software programs, by leveraging large volumes of existing data it has been trained on, such as web pages and documents.

One promising application is using generative AI to automatically draft compliance policies, procedures, and control frameworks based on regulatory texts and requirements. By training large language models on legal documents, regulations, and industry best practices, these AI systems could rapidly produce tailored policies and controls that align with an organisation's specific compliance obligations. This could streamline policy management processes that are often manual and time-consuming.

Additionally, generative AI chatbots and virtual assistants have the potential to revolutionise how compliance professionals and business stakeholders interact with and understand regulatory information. Powered by natural language processing, these AI assistants could provide summarised explanations of complex regulations, answer queries about specific requirements, and guide users through compliance workflows – all through intuitive conversational interfaces. This could significantly improve regulatory knowledge dissemination and adherence across organisations.

However, the use of generative AI in RegTech also raises important considerations around transparency, bias, and accountability. As these systems become more prevalent in compliance processes, robust governance frameworks will be needed to ensure their outputs are accurate, auditable, and aligned with regulatory expectations.

The FCA recognises the transformative potential of AI and is actively assessing its regulatory implications. The FCA views itself as a 'technology-agnostic, principles-based and outcomes-focused regulator' focused on how firms safely and responsibly adopt AI technology, and understanding AI's impact on consumers and markets.

In April 2024, the FCA released its AI Update[1], detailing its approach to regulating AI in UK financial markets and outlining its future plans. Some of the FCA's priorities include:

- Re-running the machine learning (ML) survey with the Bank of England to monitoring the state of ML deployment.
- Considering if adaptations to the regulatory framework are needed for AI.
- Exploring an AI sandbox to test AI technologies in a controlled environment.
- Investing in AI for proactive market monitoring and surveillance.
- Researching deepfakes and simulated content.

The FCA asserts that AI could boost economic growth, enhance market efficiencies, improve consumer outcomes, and support regulation. But it underscores the need for a robust, adaptable framework to manage technological risks. The FCA believes that it has the foundations, collaboration, and supervision to ensure AI's safe deployment in UK financial markets, prioritising consumer and market interests.

1 Financial Conduct Authority, April 2024. AI Update. Retrieved from https://www.fca.org.uk/publication/corporate/ai-update.pdf (Accessed: June 2025)

In June 2025, the FCA announced a partnership with Nvidia[2], the advanced AI and cloud computing technology company, to supercharge the digital sandbox, which is a secure, cloud-based environment for early-stage experimentation using synthetic or anonymised data. It enables firms to develop, test and validate innovative technologies – especially AI-driven solutions – before live deployment, without risking consumer harm.

For wealth managers, these developments present both opportunities and responsibilities. RegTech and AI can streamline compliance, enhance risk management and improve client service, but firms must ensure that any adoption of AI tools is transparent, explainable and subject to strong governance and human oversight. Staying informed about FCA guidance, participating in industry initiatives and investing in staff training are essential to harnessing AI's benefits while maintaining trust, regulatory compliance and high standards of client protection.

2 Financial Conduct Authority (2025). FCA partners with Nvidia to supercharge the digital sandbox [Press release/ Speech]. Available at: https://www.fca.org.uk/news/speeches/supercharging-digital-sandbox-collaborating-nvidia-accelerate-ai-innovation (Accessed: June 2025)

Chapter Two

Financial Planning

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Financial planning and advice are inextricably linked with the subject of suitability. The Financial Conduct Authority (FCA) suitability requirements are intended to ensure that advisers take certain steps when they provide recommendations to clients. These steps include getting information on the client's knowledge and experience in relation to the relevant investment field, their financial situation and investment objectives. This is to enable advisers to make a recommendation, or make a decision, which is suitable for that client.

The subject of suitable advice has been a major focus for the FCA for some years and has seen a number of thematic reviews resulting in regulatory guidance. It is essential that advisers are very familiar with this guidance and so candidates for this exam are advised to ensure they study carefully the guidance which can be found on the FCA website.

The results of these reviews are referenced throughout this chapter.

In this chapter, we will look at each stage of the financial planning process and then focus on investment planning, retirement planning and protection planning in the chapters that follow.

1. Financial Planning

Experienced practitioners rarely stop to think about what steps are involved in undertaking financial planning for a client because experience and time has made the process automatic for them. It is useful, however, to see financial planning as a process because it allows new entrants to the industry to learn in a structured fashion but it is also a useful management process as it allows each step of the process to be analysed for the management controls needed and for potential improvements.

Before we proceed, it is useful to specify what is meant by financial planning. The CISI website explains it as follows:

'Financial planning is a professional service for individuals, their families, and businesses, who

need objective assistance in organising their financial affairs to achieve their financial and lifestyle objectives more readily.

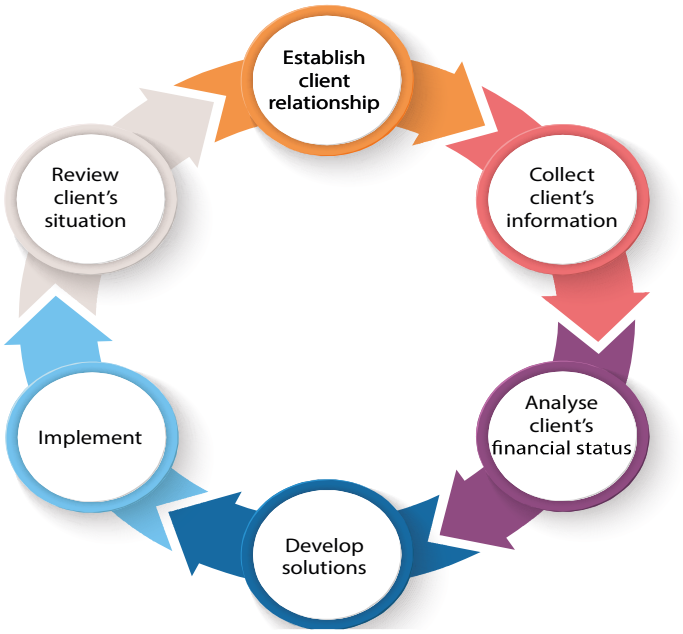
It might involve putting appropriate wills in place to protect your family, thinking about how your family will manage without your income should you fall ill or die prematurely, spending money differently, but it involves thinking about all of these things together, ie, your 'plan'. You can build a plan on your own, or if your needs are more complex you might want the help of a Financial Planner.

Start by working out your goals in life, in the short, medium and long term. Prioritise them and think about the likely cost of those goals and when you will need the money, so you can start to plan your finances to work out how to achieve them. Do not forget you also have to plan for some of the hurdles you may have to overcome too. It is about getting organised; being in control of your finances rather than letting your finances control you.'

From this we can immediately see that financial planning is an evolving plan of action as distinct from financial advice which is a one off recommendation at a single point in time. Financial planning will often involve financial advice, although it should be recognised that financial planning need not necessarily involve product recommendations. In some cases, a rearrangement of the client's affairs may be enough. Financial planning recognises the consequence or knock-on effect that one action can have upon other circumstances or objectives. It is comprehensive, in that it deals with a client's affairs in the round, unlike financial advice, which may be restricted to one or two areas of financial concern treated in isolation.

A financial plan may be very simple or very complex. However, the production of a plan will always result from following a financial planning process. A description of the steps involved in the financial planning process is defined by the Financial Planning Standards Board (FPSB) which describes the process as including at least six steps that form an ongoing cycle.

Financial Planning in Six Steps



Source: Financial Planning Standards Board

Trust is at a **premium** in the financial services sector, and being able to show clients that a firm has a rigorous process to understand their needs and control risks can go a long way to building trust and having a long-term profitable relationship with a client.

Having a structured investment advice process helps a firm to bring consistency to their advice process. Consistency means that each client should get the same service and outcome no matter which adviser they see. Inconsistency leads to regulatory and reputational risk, while consistency leads to trust and solid, long-term and profitable client relationships.

Many firms adopt a statement of principles as a way of embedding their values into the investment process. These set out the firm's beliefs and approach to investment management and covers areas such as:

- how a structured financial planning process aims to provide clear and suitable advice based on the client's circumstances
- the investment philosophy used and how risk is assessed, assets allocated and portfolios reviewed, and
- how these are used to prepare an investment plan that takes account of the client's unique circumstances.

A systematic investment approach requires a firm to have a strong organisational approach and controls. It also requires firms to be able to demonstrate to clients and regulators alike that they have a strong investment philosophy in place, based on research and knowledge, showing how they arrived at a given investment plan and populated it with certain investment products that were in the best interests of clients.

2. Establishing Client Relationships

We now look at the first phase of the financial planning process – how advisers establish a relationship with the client, the skills needed to establish a relationship and something that is increasingly important today, how they establish trust. This involves:

- identifying the needs of the client and determining whether these are within the range of services offered by the firm and whether the adviser has the necessary skills, competencies and authorisation
- explaining the services the firm can offer and an outline of the process as well as the required regulatory disclosures, and
- determining whether the firm can meet the needs of the client and, if so, whether advice from other professionals such as lawyers or tax experts is required.

2.1 Client Relationships

The role of the adviser is to build a relationship with a client that allows them, in a structured way, to identify the information needed to provide sound advice and guide the client through the choices that face them.

At the start of a client relationship, an adviser will be looking to establish rapport with a client so that the information needed to provide investment advice can be obtained and also to set the basis for their ongoing relationship where the goal of the adviser is to the deep trust of the client.

The adviser, therefore, requires three sets of skills:

1. An ability to earn trust.
2. A structured process to give sound and appropriate advice.
3. An ability to build a relationship with the client.

Key to this process is the communication skills of the adviser. Effective communication between client and adviser is fundamental to the financial advice process.

Effective communication skills are needed whether you are talking with a new client about their goals or with an established client about significant issues in their life. To be most effective, advisers need to learn a fundamental set of communication skills. Though excellent communication skills are an art, their component parts can be learned like any other. Drawing relevant factual and emotional information from the client and knowing how to handle it adeptly requires good communication skills in every interaction.

Communication and Listening

A 2022 study by Oxford Risk found that 68% of wealth managers are regularly surprised by their clients' investment decisions. Paradoxically, 80% of those same advisers believed they had a deep understanding of their clients' preferences and behaviours.

The lesson: experience and communication do not guarantee insight. Wealth managers need truly effective listening, which requires time, empathy and the discipline to test assumptions rather than rely on them.

Now reflect on how you and the people around you behave in real life. What good practice can you identify from how you and others act? People who listen pay attention to both the content of what is being said and to the emotional tone being communicated. They want to understand both. Their focus is entirely on wanting to fully comprehend the person with whom they are talking.

Many financial firms spend significant amounts of time and money on training their advisers in communication techniques. Techniques that need to be honed include:

- establishing a rapport with the client
- clarifying the purpose of the meeting early on
- explaining that the information collection exercise is to ensure the quality of the advice that will be given
- using a mixture of open and closed questions to establish the information needed
- using everyday terminology and explaining jargon when it has to be used
- checking understanding
- establishing priorities and getting the client to confirm their agreement, and
- guiding and controlling the pace of the interview.

It is also about listening – the most effective and successful financial advisers are the ones who listen to what the client wants, establish rapport with the client, build trust, interview effectively, make the client feel understood, manage the delicate issues that money can evoke, and mutually agree the course of action. Advisers who are keen to develop their skills might want to consider delving into material on active listening for the techniques that can be adopted.

Trust does not necessarily develop immediately or without reservations on the part of the client. At the outset of the relationship, clients may not be entirely certain whether to share what is to them very private information. If the adviser cannot earn that trust, the client may not reveal critical information, thus leading to unsuitable advice or they may simply walk away.

Regulatory Reminder

Where a firm provides investment advice or portfolio management services, it should not provide recommendations or make a decision to trade if it does not obtain sufficient information about the client to assess suitability.

2.2 Establishing Trust

Advisers need to gain the trust of clients if they are to provide suitable advice.

Unfortunately, trust in the financial services sector is in short supply today. Clients are generally somewhere between suspicious and cynical of financial advisers, which is unsurprising given the range of misselling scandals there have been over the last few decades. In today's market, restoring trust and acting ethically are at the forefront of the minds of regulators, industry bodies and firms.

Research in the UK as part of the FCA Financial Advice Market Review supports this position. The survey results drawn from the FCA's Financial Lives Survey showed the following:

- Just under half of the advised population has been using an adviser for more than five years and that figure rises to two-thirds for those over 65.
- Over nine in ten people who have used an adviser before generally use the same adviser, suggesting that they have built a relationship of trust with that individual adviser or firm.
- Those who had received advice in the last 12 months have high levels of trust in the adviser. Over half gave a score of nine or ten when asked to rate their levels of trust out of ten, and a further three in ten gave a score of seven or eight; however, there was a small minority, who felt less sure, including a very small number who said they do not trust their adviser at all.
- The over 65s have the highest level of trust in their adviser with 70% giving a high score of nine or ten, perhaps reflecting the long-standing relationship they have built with the adviser over time.

What comprises trust and what areas do advisers need to work on? Research by the Wharton Business School in the US suggests that trust in the client-adviser relationship is built on three components:

- **Trust in technical competence and know-how.**
  - Investors are looking for someone whose level of competence inspires trust. In other words, an investor generally seeks an adviser who is experienced and knowledgeable, one who can

help the investor make, or single-handedly make on the investor's behalf, difficult financial and personal decisions.
    - Clients value most the adviser who can tell them just enough about the subject without resorting to jargon or making things overly simplistic.
- **Trust in ethical conduct and character.**
    - Clients think of trustworthiness as a function of the personal ethics of an adviser and are also looking for firms who have a reputation they can rely on.
- **Trust in empathic skills and maturity.**
    - The final element focuses on interpersonal relationships which may be the most critical in a successful client-adviser relationship.
    - Wealth can bring unexpected stresses, and the client needs to know that they can trust the adviser to handle private information about themselves and their family with empathy and tact.
    - Clients are more comfortable and more likely to continue their relationship with advisers who are able to integrate the financial and the personal into their advice and service.
    - Clients are looking for advisers whom they trust enough – a trust grounded in the rapport established – to make difficult decisions for them.

In a world where investment solutions and services are becoming increasingly commoditised, the extent to which advisers can act as a trusted adviser to their clients will be the real differentiator or measure of value. The surest way to build trust, according to experts, is for the adviser to demonstrate competence through their actions and words in three critical areas: knowledge, ethics and, perhaps most importantly, interpersonal communications.

2.3 Regulatory Requirements

Although we have already looked at many of the regulatory requirements surrounding account opening, we will consider some of these again in more detail.

2.3.1 Client Categorisation

As we have seen in chapter 1, firms are required to classify their clients as a retail client, a professional client or an eligible counterparty. The regulations require this in order to determine the correct level of investor protection and transparency. From a practical perspective, it will also affect the types of products or investment strategies that the firm may use.

Advisers need to establish the appropriate client categorisation at the start of the relationship and keep it under review. It is possible to set a client category for all of the services offered by a firm or in relation to a specific trade, service or product.

Retail clients may request to be recategorised as professional clients if they meet the qualitative and quantitative requirements set under regulation. Documentary evidence as to how the firm has determined that the client meets the requirements is needed.

In order to be recategorised as a professional client:

- a retail client must state in writing that they wish to be treated as a professional client
- the investment firm must give the client a clear written warning of the protections and investor compensation rights that they could lose, and

- the client must state in writing in a separate document from the contract, that they are aware of the consequences of losing such protection.

Wealth managers should be able to explain to clients the implications of opting up. The table below provides an indication of some of the consequences when opting up to professional client status (note that the list is not intended to be exhaustive).

Consequences of Categorisation as a Professional Client	
Communications	• The way in which a firm communicates with professional clients may be different particularly in respect of the levels of detail and complexity. • Information about the firm, its services and remuneration will be provided but the granularity, medium and timing of such provision may be less specific.
Suitability and Appropriateness	• When assessing suitability for professional clients, a firm is entitled to assume that they have the necessary level of experience and knowledge to understand the risks involved in the management of their investments. • This is in relation to the products, transactions and services for which they have been assessed as a professional client.
Dealing	• Deals in listed shares for retail clients must be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for professional clients. • For execution-only transactions, the timeframe for providing confirmation that an order has been carried out is more rigorous for retail clients' orders than professional clients' orders.
Funds	• Unregulated collective investment schemes are deemed to be a high-risk investment, which are not generally suitable investments for retail clients. Firms are permitted to promote such funds to professional clients.
Reporting	• Firms that manage a retail portfolio that includes positions in leveraged financial instruments or contingent liability transactions must inform a retail client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for professional clients.
Client Assets	• The requirements under the client money rules are more prescriptive and provide more protection in respect of retail clients than in respect of professional clients. • For professional clients, a firm may conclude title transfer financial collateral arrangements for the purpose of securing or covering their present or future, actual or contingent or prospective obligations. This is not possible for retail clients.

A retail client who has opted up to elective professional client status is no longer able to 'opt up another step' to eligible counterparty status. Other types of professional clients can still opt up, but in order to do so they must comply with additional formalities. Retail clients that have been re-categorised as elective professional cannot be deemed to possess the same market knowledge and experience as per se professional clients.

Per se professional clients can request reclassification as a retail client in order to benefit from a higher degree of protection. A firm is required to notify a professional client or an eligible counterparty of its right to request a different categorisation and whether or not the firm will agree to such requests. However, a firm need only notify a client of a right to request a different categorisation involving a lower level of protection if it is prepared to consider such requests.

The rules place responsibility on professional clients to keep firms informed about any change that could affect their current categorisation. Nevertheless, if an investment firm becomes aware that the client no longer fulfils the conditions qualifying them for treatment as a professional, the investment firm is also required to take appropriate action.

2.3.2 Information Disclosure

The advice from a wealth manager can be independent or restricted.

In terms of independent advice, the wealth manager should be looking at the whole of the market for each product relevant to the client's circumstances and identify the one within that market which is most suitable to meet their objectives.

Restricted advice, on the other hand, is where the wealth manager is still providing a recommendation to a client, and is still required to have the same high level of qualifications as for independent advice, but they may only be offering advice based on a particular type of product or from a restricted range of providers.

The FCA offers these examples of restricted advice:

- the adviser works with one product provider and only considers products from that company
- the adviser considers products from a limited range of product providers, and
- the adviser is unable to review existing products that you may already have in place.

Most of these firms operate on an independent basis. They tend to be small. Larger firms are more likely to be restricted and focus on selling their own products and investment funds.

As we have seen, firms are required to make certain disclosures to clients at the start of the relationship. This includes information about the firm and the scope of the services that are offered, how it manages and safeguards investments, and the costs and charges that the client will incur.

Firms are also required to disclose to clients before providing investment advice whether its advice will be independent or restricted depending on:

- whether the advice will be based on a broad or more restricted analysis of different types of relevant products, or

- where the advice will be restricted, whether the range will be limited to relevant products from entities having close links with the firm, so as to present a risk of impairing the independent basis of the advice provided.

FCA Suitability Review

The FCA *Suitability Review*, published in May 2017, highlighted that acceptable disclosure was provided in only 52.9% of the cases it reviewed – by 'acceptable', they refer to meeting the FCA rules on disclosure. The main area where there is unacceptable disclosure is in initial disclosure and specifically around fee disclosure where insufficient information was provided to enable customers to estimate what costs would be incurred. A further review in 2019 found that wealth managers were aware of the rules and their responsibilities to disclose all costs and charges but that some firms interpreted the rules inconsistently, making like-for-like comparisons difficult for consumers. The FCA regards this as a persistent issue, and advisers therefore need to be aware of the need for compliance in this area.

Recall that the Conduct of Business Sourcebook (COBS) requires firms to provide information in a comprehensible form and in such a manner that clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instruments that are being offered. This applies to all clients.

Firms are also required to disclose the following:

- Why their advice qualifies as independent or non-independent and the type and nature of the restrictions that apply, including the prohibition to receive and retain inducements when providing independent investment advice.
- Explain the range of financial instruments that may be recommended, including the firm's relationship with the issuers or providers of the instruments.
- Provide a description of the types of financial instruments considered and the range of financial instruments and providers analysed per each type of instrument according to the scope of the service.
- When providing independent advice, how the service provided satisfies the conditions for the provision of investment advice on an independent basis and the factors taken into consideration in the selection process used by the firm to recommend financial instruments, such as risks, costs and complexity of the financial instruments.
- When providing investment advice, it should distinguish between financial instruments provided by other third parties and any offered by the firm itself or from entities having close links with the firm.

2.3.3 Client Agreements

Where the firm is managing investments for a client, it also needs to enter into a client agreement that sets out the essential rights and obligations of the firm and the client. A client agreement must meet the regulatory requirements, as well as provide the legal basis for provision of the service.

There is no standard form of client agreement as each firm prefers to draft its own. It may include some or all of the information that the FCA requires firms to disclose to clients or it may be a more focused document as those disclosures take place in another document. The client agreement must be signed by all parties – on behalf of the firm by an employee who is authorised to do so, and the client.

The FCA has issued a statement on the use of e-signatures in client agreements. The regulator does not explicitly require 'wet-ink' signatures, but says that firms must consider the 'risks and harms' of using e-signatures and ensure that the approach 'does not make it more difficult for the client to understand what they are agreeing to'.

It is important to keep in mind the legal requirements for who can enter into a contract for investment services. Legal persons and the capacity to enter into contracts is covered in chapter 7.

2.3.4 Money Laundering Checks

Firms must identify their customers and beneficial owners where applicable and then verify their identities. Firms must also understand the purpose and intended nature of the customer's relationship with the firm and collect information about the customer and, where relevant, beneficial owner. This should be sufficient to obtain a complete picture of the risk associated with the business relationship and provide a meaningful basis for subsequent monitoring.

FCA Examples of Good Practice

- A firm which uses electronic verification checks or politically exposed person (PEP) databases understands their capabilities and limitations.
- The firm can cater for customers who lack common forms of ID, such as the socially excluded and those in care.
- The firm understands and documents the ownership and control structures, including the reasons for any complex or opaque corporate structures, of customers and their beneficial owners.
- The firm obtains information about the purpose and nature of the business relationship sufficient to be satisfied that it understands the associated money laundering risk.
- Staff who approve new or ongoing business relationships satisfy themselves that the firm has obtained adequate customer due diligence (CDD) information before doing so.

Establishing the source of funds and source of wealth needs to be undertaken at each new business transaction, even for long-standing clients, to help ascertain if the level and type of transaction are consistent with the firm's knowledge of the customer.

- **Source of wealth –** describes how a customer or beneficial owner acquired their total wealth.
- **Source of funds** – refers to the origin of the funds involved in the business relationship or occasional transaction. It refers to the activity that generated the funds, for example salary payments or sale proceeds, as well as the means through which the customer's or beneficial owner's funds were transferred.

The Joint Money Laundering Steering Group (JMLSG) guidance provides that, in situations where the risk of money laundering or terrorist financing is very low and subject to certain conditions, firms may assume that a payment drawn on an account in the customer's name with a UK, EU or equivalent

regulated credit institution satisfies the standard CDD requirements. This is sometimes referred to as 'source of funds as evidence'.

In situations where the money laundering risk associated with the business relationship is increased, for example, where the customer is a PEP, firms must carry out enhanced due diligence (EDD). A politically exposed person (PEP) is someone in a high profile position where the role may be open to the risk that the proceeds of bribery and corruption may be laundered. Examples of PEPs include heads of state, government ministers, MPs, diplomats and a fuller list is included in Section 14 of the Money Laundering Regulations 2017. It should also be noted that PEPs also include the person's family members and close business associates.

Situations that present a higher money laundering risk might include, but are not restricted to: customers linked to higher-risk countries or business sectors; or who have unnecessarily complex or opaque beneficial ownership structures; and transactions which are unusual, lack an obvious economic or lawful purpose, are complex or large or might lend themselves to anonymity.

The Money Laundering Regulations also set out three scenarios in which specific enhanced due diligence measures have to be applied – non-face-to-face CDD, correspondent banking and politically exposed persons. The extent of enhanced due diligence measures that a firm undertakes can be determined on a risk-sensitive basis but the firm must be able to demonstrate that the extent of the enhanced due diligence measures it applies is commensurate with the money laundering and terrorist financing risks.

The following are some examples of enhanced due diligence (EDD):

- Obtaining more information about the customer's or beneficial owner's business.
- Obtaining more robust verification of the beneficial owner's identity based on information from a reliable and independent source.
- Gaining a better understanding of the customer's or beneficial owner's reputation, and/or role in public life and assessing how this affects the level of risk associated with the business relationship.
- Carrying out searches on a corporate customer's directors or other individuals exercising control to understand whether their business or integrity affects the level of risk associated with the business relationship.
- Establishing how the customer or beneficial owner acquired their wealth to be satisfied that it is legitimate.
- Establishing the source of the customer's or beneficial owner's funds to be satisfied that they do not constitute the proceeds from crime.

Where a firm cannot apply customer due diligence measures, including where a firm cannot be satisfied that it knows who the beneficial owner is, it must not enter into, or continue, the business relationship.

Firms are also required to comply with the UK's financial sanctions regime. The regime lists individuals and entities that are subject to financial sanctions; these can be based in the UK, elsewhere in the EU or the rest of the world. In general terms, the law prohibits firms from providing funds or financial services to those on the list, unless a licence is obtained from the Treasury's dedicated Asset Freezing Unit.

The Treasury maintains a consolidated list of financial sanctions targets designated by the United Nations, the European Union and the United Kingdom, which is available from its website. Firms should screen new customers and payments against the consolidated list and screen existing customers when new names are added to the list.

2.4 Fiduciary Relationships

The very notion of a fiduciary (*uburrimae fidei* or in utmost good faith) relationship was originally set down in UK insurance law for life and assurance contracts. It has gone on to be the mainstay for the relationship between advisers and clients, and the concept of the fiduciary perimeter has become increasingly topical. Who is covered and what it entails is very much under the spotlight.

A fiduciary relationship is one in which one person places special trust, confidence and reliance in, and is influenced by, another who has a fiduciary duty to act for the benefit of that person. In discharging their responsibilities, the fiduciary must be absolutely open and fair and act with loyalty, honesty and in a manner consistent with the best interests of the beneficiary of the fiduciary relationship.

Fiduciary relationships generally exist in all manner of relationships, including:

- agent and principal
- director and company
- lawyer and client
- banker and customer
- stockbroker and client, and
- trustee and **beneficiaries**.

As a result, a fiduciary relationship can be seen to exist between an adviser and a client whether it is acting as agent, banker, stockbroker, trustee or in any other capacity. The responsibilities that a financial adviser must follow, therefore, include the following:

- Act in the utmost good faith for their client.
- Not make a profit from the trust placed in them.
- Not place themselves in a position where their own interests conflict with their duty to the client.
- Refrain from misusing confidential information for their own advantage or the benefit of a third person without the fully informed consent of the principal.

This list is far from comprehensive, but it gives a good indication of the conduct expected of someone, such as a wealth management firm and its advisers.

The Law Commission considered the fiduciary duties of investment intermediaries involved in pensions and produced guidance on how these duties apply to investment intermediaries and **trustees**. This included guidance on how trustees should take account of ethical or **environmental, social or governance (ESG)** factors.

3. Collecting Client Information

This stage of the planning process involves fact finding. The adviser identifies the client's personal information and financial objectives, needs and priorities so that they can subsequently analyse the client's financial position and identify suitable solutions. It also potentially involves helping the client to clarify and prioritise their short- and long-term objectives, including discussing with the client the feasibility of any objectives that appear to be unrealistic.

This phase encompasses three main areas:

1. Agreeing the client's investment and financial objectives and identifying any constraints.
2. Establishing the client's risk profile.
3. Collecting the quantitative and qualitative data needed.

Although this is in a logical sequence, in practice, an adviser often ends up moving between the phases and returning to previous ones as new information becomes available.

3.1 Goals and Expectations

Understanding the client's goals and expectations is vital to the investment advice process.

Finding out what clients want to achieve with their finances can be one of the longest and most difficult aspects of the investment advice process. Some clients have a good understanding of their general aims and objectives, but many have not thought them through, so it may be important to help them to consider these issues. In many cases, these are defined during and as a result of the process.

An experienced adviser often sets out to determine a client's goals and expectations at the outset, rather than embarking on a detailed fact-find. The financial planning experience may well be the first time that a client has thought seriously about their long-term future or tested their aspirations and assumptions against financial realities.

A fact-find process is essential, but clients often see it as having nothing to do with what they want to achieve. A more successful strategy is usually to determine their goals and expectations, and then explain that a detailed fact-find will be necessary in order to be able to make recommendations.

Understanding a client's background is important, as a person's history always plays a dominant role in shaping individual attitudes. Most individual's attitudes and beliefs about money are shaped by their experiences and the challenges they have faced in achieving a sense of financial well-being. Understanding this helps with clarifying their attitudes to money and managing it and contributes to establishing their tolerance to risk.

Equally, questioning a client about how satisfied they are with their life and financial position can be illuminating and can add further to the background picture of the client. Satisfaction is personal and dependent on an individual's beliefs, and so the results may indicate key priorities that need to be addressed or the degree to which investments need to be targeted at income production, wealth preservation or wealth creation.

An adviser should also try to elicit what principles matter to a client. They may have strong views about where their money should or should not be invested, or the level of risk they are prepared to take to achieve objectives. Their attitude to money, and principles and values which matter to them, will help the adviser understand what influences them, and this can be factored into recommendations.

It is also important to understand the stage of life that a client has reached. This may seem as obvious as finding out someone's age and making assumptions from that. Open questions about the client's intentions are likely to bring out useful information about their plans and the challenges they face.

Understanding a client's family situation is useful in developing a long-term plan. Issues to consider include:

- Does the client have previous partners they need to pay maintenance to?
- Do they have children or grandchildren they want to benefit longer term from any investments?
- Do they have a will in place which sets out how they want their money to be split?

Understanding this can help form the suitability report in identifying a client's longer-term objectives and how your recommended structure can help meet these goals.

Finally, these conversations lead nicely on to the client's goals and aspirations. Questions designed to find out what their plans are, what they hope to achieve and the lifestyle they want will all help ensure that any recommendations are aligned with these.

Establishing goals and expectations in this way will help the adviser with the fact-find process, which must follow if investment recommendations are to be made.

3.2 Behavioural Finance

The subject of **behavioural finance** is covered in the Portfolio Construction Theory exam, but we will return to it in this section and look at aspects that are relevant to the client relationship.

Traditional finance theory assumes that people make rational investment decisions as they choose between different asset classes in the light of prospective risk and return and think rationally about their overall objectives. In practice, however, emotion and psychology influence our decisions causing us to act in unpredictable or irrational ways. Behavioural finance tries to combine what psychologists call cognitive behaviour with conventional financial theory to better understand how we make decisions.

An understanding of the concepts of behavioural finance is important for wealth managers as they can help us better understand clients' needs and design and deliver services that take into account how we act in practice.

3.2.1 Heuristics and Decision-Making

Behavioural finance suggests that our decision-making processes are rarely rational where all relevant information is collected and objectively evaluated. Rather, we will often take mental shortcuts or use our intuition and gut feelings in the process.

Heuristics refers to the rules of thumb, educated guesses or gut feelings which humans use to make decisions in complex, uncertain environments. Limited time and cognitive capacity mean people have problems inferring relevant facts when making decisions, even when they may have all the relevant information. Behavioural finance refers to this as bounded rationality.

Some key decision attributes have been identified which include the following:

- Individual preferences tend to be multidimensional, open to change, and often formed only during the decision process itself.

- Individuals appear to be adaptive. The nature of the decision and the environment in which the decision is made contribute to the selection of a decision process or technique.
- Individuals seek satisfactory, rather than optimal solutions.

Some results of research into decision-making from behavioural finance are as follows:

Heuristic	Description
Use of information	Individuals may not take into account all the relevant information. This may help to explain why investors rely on past performance and fail to take full account of risk and expected return.
Investment inertia	Once people have made **asset allocation** decisions, they tend to leave them unchanged. The status quo then becomes people's default position. Status quo bias is the tendency for people to stick with their prior choices, especially in circumstances of too much complexity.
Representativeness	When faced with having to make decisions under conditions of uncertainty and inadequate information, an individual will tend to see patterns and similarities to previous contexts where perhaps none exist. This is used to explain a behaviour known as 'herding'. Herding occurs when investors follow each other, somewhat irrationally, and are led by an ebullient and upward-trending market into speculative bubbles.
Overconfidence	Overconfidence leads many investors to overestimate their predictive ability. People can be slow to revise their previous assessment of a company's likely future performance, even when there is notable evidence that their existing assessment is incorrect.
Anchoring	People tend to base their decisions on reference points that are often arbitrarily chosen. People are concerned not only with what they have, but with how it compares to what they used to have and with what they might have had; for example, whether people choose to sell shares is influenced by what they paid for them.
Gambler's Fallacy	This is the belief that there are discernible sequences or patterns observable in repeated independent trials of some random process, such as the repeated spinning of a roulette wheel.
Availability	This is the notion that if something readily comes to mind when asked to consider a question or make a judgement, then what has come to mind must be relevant and important.

Research finds that individuals tend to rely more heavily on heuristics as decisions become more complex, or when time is short, or emotions run high. People also tend to reduce the amount of information considered when they are under stress.

From these, a number of useful conclusions can be sought that can help when explaining investment choices and risk:

- Offering more choice to consumers is not always helpful as it can increase procrastination, reduce satisfaction, and incline people to invest less or invest in low risk/return funds and drive individuals to simple options.
- Behavioural economists refer to the concept of choice overload to describe the situation where complex investment menus may discourage participation.
- Well-designed and managed investment solutions may be a better option for most people than too much choice.
- Wealth managers need to counsel their clients to avoid the risk of herd behaviour by using examples of previous asset price bubbles.
- When dealing with overconfidence, wealth managers need to exercise even greater care in establishing a client's risk profile with careful framing of questions and explanations of the risk of loss.
- Anchoring shows that people are very much influenced by the manner in which a question is posed or if any background information and context is provided. Questions and information need to take account of the cognitive ability of the client and any tendency to overconfidence or risk aversion.

3.2.2 Prospect Theory

Traditional financial theory suggests that we aim to maximise our investment decisions by making an overall evaluation of whether an investment choice is desirable. According to prospect theory, developed by Daniel Kahneman and Amos Tversky, however, people value gains and losses differently and so will base decisions on perceived gains rather than perceived losses.

If a person is given two equal choices, one expressed in terms of possible gains and the other in minimising possible losses, they will choose the former, even when they achieve the same economic end result.

Some of the key concepts addressed by prospect theory are as follows:

- **Loss aversion** – research in behavioural finance finds that investors are inconsistent in their attitude to risk. Individuals play safe when protecting gains but are reluctant to realise losses.
- **Regret aversion** – this arises from the desire to avoid feeling the pain of regret resulting from a poor investment decision. Regret aversion can encourage investors to hold poorly performing shares, since avoiding their sale also avoids having to acknowledge the fact that a poor investment decision has been made. The wish to avoid regret can also bias new investment decisions, as people will often be less willing to invest new sums in investments or markets that have performed poorly in the recent past.
- **Mental accounting** – behavioural finance has challenged the standard economic assumption that individuals treat types of income and wealth equally. It could mean, for example, that individuals prefer to invest their own pension contribution as safely as possible, while there may be more appetite to seek higher returns with the employer contribution.
- **Information and noise traders** – according to portfolio theory, the correct procedure to adopt for success as an investor is to become an information trader, as being in possession of high-quality information is the key to a profitable investment strategy. Since noise is the opposite of information,

people who trade on noise make trading decisions without the use of fundamental data, relying instead on trends, sentiment, anomalies and momentum. As noise traders, by definition, do not trade on fundamentals, they are allegedly more likely to buy high and sell low.

Research suggests that it is easier for an individual to forgo a gain than to accept a loss. This leads to anomalies in investment decisions:

- **Disposition effect** – investors tend to sell winning investments too early and hold on to losing ones too long.
- **Break-even effect** – when facing a loss, many investors take on additional risk in an attempt to recover their investment and break even. This behaviour is particularly evident in falling stock markets, where investors may take on additional risk in an attempt to recover their investments.

It is also important to recognise that certain groups of people may have higher levels of loss aversion due to a:

- lack of financial capacity to bear a loss
- lack of financial capability to understand the meaning of investment loss, or
- psychological reluctance or unwillingness to bear a loss.

Loss aversion with loss avoidance behaviour is a potential problem as it may lead investors to apply loss aversion strategies that are inappropriate or prevent investing altogether. A wealth manager should focus on communication strategies in order to help clients better understand this area.

3.2.3 Applying Behavioural Finance to Client Relationships

Possibly the most challenging aspect of behavioural finance is to apply it to real life client situations. Identifying behavioural biases can be challenging in itself but deciding whether to try and moderate client behaviour to counteract behavioural biases so that the asset allocation is optimal for the client can involve the adviser treading into difficult areas.

The main objective of the financial planning process is to guide investors to make decisions that serve their best interests. With that in mind, which of the following is better?

- Recommending an asset allocation that suits the client's natural psychological preferences but does not maximise expected return for a given level of risk. In other words, an underperforming investment portfolio.
- Recommending an asset allocation that goes against the client's natural psychological preferences and accepting greater risk in order to maximise return for a given level of risk. In other words, a portfolio that meets their objectives but where they may be uncomfortable with the level of risk taken.

There is no simple answer to the question, and it will instead depend on the client's circumstances. Sometimes, it will be right to accept the behavioural biases and, on other occasions, the adviser should try to moderate those behaviours and persuade the client of the merits of a more appropriate strategy.

The behavioural biases discussed above and in Portfolio Construction Theory are thought to be deep seated aspects of human decision-making which may be unhelpful when thinking about long-term financial decisions. Some factors worth considering are noted below:

- **Overconfidence** – advisers need to be aware of the potential for overconfidence in themselves as well as clients. They should consider carefully the outcomes of past investment decisions, making an honest assessment of what went well and what did not.
- **Loss Aversion** – advisers have a key role in helping clients deal with loss aversion and contain their desire to sell winners and hold losing investments. They should help the client evaluate the future prospects of the investment and whether it is still suitable for the client's circumstances.
- **Avoiding Regret** – inertia means that clients fail to get around to taking action, often even on things they want or have agreed to do. Advisers should explain how factors such as automatic portfolio rebalancing can be used to overcome inertia and meet their financial goals.
- **Mental Accounting** – finance theory recommends that we see all of our investments as a single portfolio rather than focusing on individual investments. Advisers should use framing to widen what the client looks at and counsel them to avoid focusing on individual investments.
- **Rule of Thumb** – clients often struggle with how to apply the concept of **diversification** in practice and instead opt for a simple approach and risk ending up with overly aggressive or overly cautious results. Advisers should caution clients that familiarity is not a substitute for a good spread of investments.
- **Anchoring** – a number of biases can result in the incorrect use or misuse of information. Decisions or viewpoints can be based on factors such as an index level, recent events or the short-term record of a fund. Advisers should ask whether they or the client are being anchored by an irrelevant factor or the way an issue is framed, responding based on available memory or judging based on superficial similarity, or being too conservative based on recent changes in information.

Advisers should attempt to understand the biases and think about how to reduce any potential adverse effect. A clear understanding of why particular investment decisions have been taken can help mitigate the effects of behavioural biases. Framing can be a valuable tool for this. Framing portfolio discussions in terms of the investment policy statement, long-term goals and the client's overall wealth can form a type of commitment device which allows rational decisions to be made rather than judgements based on biases.

3.3 Client Data

There is no simple way of establishing all of the information needed about a client quickly. The adviser will need to undertake a detailed, and potentially lengthy, interview with the client in order to understand what existing assets and liabilities they have before turning to developing a true understanding of what their needs are.

There is also no single way of collecting all of the required information. Most firms use a Know Your Customer (KYC) questionnaire or fact-find that the adviser completes during their interview with the client so that the information can be collected in a logical and straightforward manner and can be available for later use. The advantages of this approach are its consistency, the factual record it creates and the opportunity for quality-checking that it provides. Its disadvantage is the customer's reaction to what they may perceive as a lengthy form-filling exercise – hence the need for good communication skills on the part of the adviser.

The information that needs to be collected will depend on the service and products under consideration but will generally include:

- personal details
- health status
- details of family and dependants
- details of occupation, earnings and other income, and sources of wealth
- estimates of present and anticipated outgoings
- assets and liabilities
- any pension arrangements and any life or insurance arrangements, and
- potential inheritances and any estate planning arrangements.

We will now look at each of these in more detail and identify what information is needed and why it is required when undertaking investment planning.

3.3.1 Personal Details

An adviser will seek to establish extensive personal details about the client including their:

- full name
- address
- date of birth
- place of birth
- tax residency status
- domicile
- tax identification numbers, and
- tax-paying status.

Details of the client's name and address will need to be verified to comply with AML requirements by inspecting photo ID and original documents that prove their address, such as a utility bill.

The client's date of birth will clearly establish their age, and this should immediately start to indicate the stage of life they have reached, which may have implications for any asset allocation strategy. It will also give an indication of their potential viewpoint on long-term investments.

The client's age may also be relevant when looking at their assets. For example, an elderly client who has had a portfolio for many years may well be sitting on significant gains and, if these were sold, a liability to capital gains tax (CGT) might arise. It may, therefore, be worth considering whether these should be retained until the client dies, when they can be passed on to their beneficiaries without any CGT being incurred. This should, however, be viewed alongside other issues, such as inheritance tax (IHT) planning and the inherent investment risk, eg, the potential loss from not undertaking diversification or following a prescribed model portfolio. In practice, a wealth manager would recommend paying the tax from the gains realised but even so, the timing of such a sale is a significant issue.

The client's place of birth may have a bearing on their residency and domicile. The adviser needs to establish whether the client is resident or not for UK tax purposes and their domicile. If the client maintains that they are not UK resident or domiciled, what evidence is available to substantiate this if challenged by the tax authorities.

These factors could have a significant bearing on how the returns from any recommended investments are taxed and therefore on which are selected, and the net returns that are generated for the client. It may also impact their eligibility for certain products, such as ISAs.

Tax ID numbers will also be needed, as they may be required for any tax wrappers that may be selected and for any tax reporting requirements that may have to be met.

3.3.2 Health Status

There are many subjective factors that can influence a client's attitude to risk, and so it should be no surprise that the same set of events might be seen differently by different people. Understanding a client's health status and life expectancy, however, can help towards an understanding of their risk tolerance and planning an appropriate cash flow forecast.

Firstly, a client's health status will need to be established; that is, whether they are in good health or have any serious medical conditions that may influence their investment objectives and attitude to risk.

An individual in good health who comes from a family with members who traditionally live until a very old age will want to plan for the long term, and planning for income well into retirement may well be very high on their list of priorities. This may influence the investment strategy selected as there may be a need to generate a growing level of income for many years, implying the need for a higher exposure to equities and the growing dividend stream these can provide.

At the other end of the spectrum, a client may be in poor health, and this may drive an investment strategy to produce a more immediate income. This will then influence the asset allocation strategy adopted and sway weightings away from equities to cash and fixed-income instruments. It is important that a client in ill health is assessed as to whether they are vulnerable and whether their near-term cash flow requirements are in line with any long-term financial aspirations. An adviser needs to discuss the implications with a client who is in poor health yet is opting for a high-risk strategy in the hope of leaving an inheritance. Additionally, an adviser should explore whether an impaired or enhanced **annuity** may be more suitable to obtain higher levels of income from retirement funds, rather than investing.

A client's health may also influence their attitude to risk. A client in good health, who expects to live well into old age, may take the view that they need to be cautious in their approach or, alternatively, that they have the time horizon that enables an adventurous approach. A client in poor health may take the view that ensuring they have the funds to care for themselves is their overriding priority and so may not be prepared to take undue risks. Equally, a client might take the view that they are going to spend and enjoy life while they can, so being adventurous is right for them. In that example, shorter-term goals demand quite different advice to long-term needs. An adviser may need to determine and document if their client is insistent on pursuing a short-term, high-risk strategy.

Wealth managers may consider introducing vulnerable customer review statements, taking into account the age, faculties, health and overall vulnerability of the client. A wealth manager must be comfortable so that the client fully understands the advice and actions being taken on their behalf.

Vulnerable Customers

Vulnerability can come in a range of guises, and can be temporary, sporadic or permanent in nature. Wealth management firms frequently encounter this with older clients or with the problems that old age brings to name just two. Consumer protection legislation focusses on a typical customer, but vulnerable ones are at greater risk and more likely to suffer harm than the average consumer. The FCA believes this is an area where firms can take action and have the power and capacity to create good outcomes for the customer if they develop effective strategies and manage interactions well. The subject is covered further in chapter 7.

3.3.3 Details of Family and Dependants

Details of the client's family and dependants will normally be established as part of the fact-finding exercise. The information that will be collected will include the name and date of birth of the client's spouse or civil partner, as well as their health status, as this may equally impact the client's investment objectives and attitude to risk.

Although not essential, it is wise for the adviser to try and establish the attitude to risk of the spouse/civil partner, as well and whether that might influence the client. The client might well have an adventurous attitude to investment and be prepared to accept the associated risks, but their spouse/civil partner may have alternative views which could lead to tensions that could affect the service provided by the firm and adviser.

Where the client has been married/in a civil partnership previously, the adviser should determine the extent of any ongoing divorce/dissolution payments that might be relevant to the investment strategy.

Details of children or other dependants should also be established. Where the client has young children there may be a need to provide funds for school fees or university education. These may need to be planned for separately and give rise to not just multiple investment objectives but also potentially different attitudes to risk. This is especially the case when an adviser follows goal-based planning.

3.3.4 Details of Occupation, Earnings and Other Income, and Sources of Wealth

The fact-find will seek to establish details of the client's business and occupation, the income that they earn from this and other sources, and the source of their wealth.

The client's occupation or business will give a good indication of their experience in business matters, which may be relevant when judging the suitability of a particular type of investment that carries greater risk. However, an adviser cannot simply assume experience or reduce their fiduciary responsibilities as a consequence. For example, customers of execution-only companies may need to complete an appropriateness form to determine what types of securities they can invest in.

Establishing the client's occupation may lead the adviser to realise that there may be issues with dealing in certain stocks if the client holds a senior position in a company. In such a position, the client and firm face the risk of dealing on inside information. They will need to ensure that arrangements are put in

place to request permission to trade, avoid closed dealing periods and ensure that any trading takes place in a manner that places neither the firm nor the client at risk.

A client may also potentially be a politically exposed person (PEP). Where that is the case, they often need to distance themselves from any investment decision-making so that there can be no accusation of them exploiting their position or knowledge. In such cases, it is often common to establish a blind trust where all investment decisions are taken on a totally discretionary basis and where the client is deliberately kept unaware of trading decisions or their rationale. It is not unusual for there to be extra due diligence required by firms (often overseen by the compliance department) when deciding whether to on-board a PEP, including referring to the country sanctions list.

Where the client is in business, the adviser will want to understand the client's plans for the business and any funds that may be forthcoming immediately or in the future that might affect the investment plans that the adviser will draw up.

Clearly, it will be necessary to establish a client's income and the sources it arises from.

3.3.5 Estimates of Present and Anticipated Outgoings

An understanding of the client's outgoings will be needed in conjunction with their income, where it is necessary to look at budgeting, planning to meet certain liabilities or generating a specific income return.

Depending upon the client's priorities, both their present and anticipated future outgoings may be needed, for example where the investment plan involves generating a certain income in retirement.

The FCA is keen for customers to have some sort of reserve funds in case of volatility soon after investing. The general rule of thumb is that advisers should consider six months' worth of expenses held by the client in reserves to avoid any short-term calls on the portfolio. The adviser should satisfy themselves that, whatever amount is agreed with the client, it is suitable and commensurate with their personal circumstances.

3.3.6 Assets and Liabilities

Full details of the client's existing assets and liabilities will need to be ascertained.

As part of the anti-money laundering checks that an adviser will need to undertake, the source of the client's wealth will need to be established. When investigating the source of the client's wealth, it is possible that the adviser will become aware that the client has undertaken some dubious activity such as deliberately avoiding paying tax. The adviser needs to exercise extreme care over this as deliberately avoiding paying tax and similar exercises are classed as financial crime.

The Criminal Finances Act 2017 makes companies and partnerships criminally liable if they fail to prevent tax evasion by either a member of their staff or an external agent, even where the business was not involved in the act or was unaware of it (see chapter 6 for further details).

As well as obtaining details of the client's assets, the adviser should also look to establish:

- the location of the assets and whether any investments are held in a nominee account
- the tax treatment of each of the assets
- whether any investments are held in a tax wrapper
- CGT acquisition costs for any quoted investments held and any present year gains or losses incurred
- if the client's spouse/civil partner has any remaining CGT allowance that could be utilised (whether the client will allow CGT to be incurred on an ongoing basis should also be established), and
- details of any early encashment penalties.

The information needed will vary by type of asset; the following table gives an indication of some information that may be needed.

Assets and Liabilities	
Asset	**Information Needed**
Bank and savings accounts	• Account type and details. • Balance. • Branch where account is held if needed. • Interest rate on the account. • When interest is paid and whether there are any bonuses payable. • Any early encashment penalties or lock-in periods.
Quoted investments	• Full title of each instrument. • Nominal amount of stock or shares held. • Dates of purchase. • Acquisition costs. • Where the stock is held and, where known, the SEDOL or ISIN identification. • Details of any pending corporate actions. • Whether the asset currently qualifies for Business Property Relief.
Investment funds	• Full title of each fund. • Number of units or shares held. • Dates of purchase. • Acquisition costs. • Share class – to make sure it is the RDR share class. • Investment structure, fund type, tax status. • Whether the holding is certificated or uncertificated and in what name it is registered. • Any exit fees. • Frequency of valuation points if fund redemptions are infrequent. • Dealing and notice periods, eg, some illiquid assets, such as hedge funds and private equity funds, have quarterly or yearly dealing.
Tax-exempt accounts	• Account type and details. • Eligibility criteria for tax exemption. • Assets and cash held. • Whether further additions can be made in the current tax year. • Whether account can be transferred without loss of tax-exempt status. • Tax ID reference.

Assets and Liabilities	
Structured products	• Type of product and features. • Details of sum payable and any guarantees. • Conditions to be met for payment. • When purchased and cost. • Term and repayment date. • Cost structure. • Any early encashment penalties. • Whether quoted or unquoted.
Life assurance bonds	• Policy type and details to include if written in trust or not. • Policy conditions. • Whether it is with-profits or unit-linked. • Details of unit-linked funds and number of units held. • When purchased and costs. • Any encashment penalties.

Details of any liabilities that the client has should be established, and whether these are covered by any protection products.

Any cash funding requirements, such as the need to fund school fees or university education, will particularly need to be understood so that the requirement to provide the necessary cash at the appropriate time can be factored into the investment strategy.

3.3.7 Pension Arrangements

The pension arrangements that the client has made will need to be closely linked to the investment strategy that is adopted both for retirement and other financial objectives.

The availability of tax exemptions for pension contributions may be an influencing factor on the choice of investments and so clearly needs to be factored in at this stage.

Where the client has some influence over where the funds are invested, the adviser will want to discuss with the client how the funds will be managed and whether they will be incorporated into any overall asset allocation.

The firm may be able to manage the investments held within the client's pension plan, and in so doing will need to decide whether that portfolio will be managed as a discrete entity or whether a holistic view will be taken. This could involve the pension plan portfolio being treated as a sub-portfolio for investment management purposes, with the investment manager looking at the combined picture of a taxable portfolio, tax-free accounts and pension portfolios and allocating investments between the accounts.

3.3.8 Potential Inheritances and Estate Planning Arrangements

Finally, the client should be asked to provide details of any potential inheritances they may receive and of any trusts where they are beneficiaries. This will be relevant where the amounts due to be inherited might influence the investment strategy adopted. For example, a client may be due to inherit a substantial sum from elderly parents and so may be able to take a view that their investments should be directed to outright growth.

The adviser should also check whether the client has left any specific gifts of shares in their will and, if so, whether this would prevent any sale of such a holding. It is also prudent to check the main terms of the will and if any existing **estate** planning is in place to ensure financial recommendations do not negatively impact on these.

3.4 Risk Profile

Investment always involves a trade-off between risk and return. However, different people are prepared to tolerate different levels of investment risk. It is also important to note that investment risk means different things to different investors – to some, it may mean volatility in security prices; while for others, it may mean permanent loss of capital, to give an example. Variations in attitude to risk arise because of individual differences in circumstances, experiences and psychological make-up.

A client's risk profile is made up of three components – risk tolerance, risk perception and **risk capacity**, which are explained in more detail in the sections below.

Taken together, these three elements along with relevant additional fact-find information should allow a risk classification or profile to be determined that can be agreed with the client.

The risk assessment process usually starts with an investigation of attitudes; consideration of risk capacity usually follows later since it requires knowledge of the client's objectives and the particular investments that are being considered.

Essential Reading

The FCA website contains guidance on establishing the risk a customer is willing and able to take and making a suitable investment selection. The guide and an on-demand webcast is available at https://www.fca.org.uk/firms/assessing-suitability

3.4.1 Risk Tolerance

Risk tolerance is defined as the degree of uncertainty that an investor can handle, with regard to a negative change in the value of their portfolio.

It reflects the extent to which an investor is comfortable with the risk of losing money on an investment. If they are unwilling to take the chance that an investment might drop in price, they have little or no risk tolerance. On the other hand, if they are willing to take some risk by making investments that fluctuate in value, they have greater risk tolerance. The probable consequence of limiting investment risk is that they are vulnerable to inflation risk, or loss of buying power.

There are a number of objective and subjective factors which can be established that will help define risk tolerance.

Objective Factors

- The timescale over which a client may be able to invest will determine both what products are suitable and what risk can be adopted.
- Family commitments are likely to have a significant impact on a client's risk profile as they will want to meet their obligations which may make higher-risk investments less suitable.
- Wealth will clearly be an important influence on the risk that can be assumed. A client with few assets can little afford to lose them, while ones whose immediate financial priorities are covered may be able to accept greater risk.
- Stage of life is equally important as it will impact the level of risk that can be adopted and the time horizon over which they consider investments.
- The age of the client will often be used in conjunction with the above factors to determine acceptable levels of risk.

Subjective Factors

- Investors who are more knowledgeable about financial matters are typically more willing to accept investment risk.
- Some individuals have a psychological make-up that enables them to take risks more freely than others, and see such risks as an opportunity.
- A client's preferred investment choice such as a client's normal preferences for the relative safety of a bank account versus the potential risk of stocks and shares.
- A client's approach to bad decisions. Some clients can take the view that they assessed the opportunity fully and therefore any loss is just a cost of investing. Others regret their wrong decisions and therefore avoid similar scenarios in the future.

Establishing objective factors is a preferable and more accurate way to help define a client's risk tolerance, but subjective factors also have a part to play.

Subjective factors enable an adviser to try and establish a client's attitude to taking risks. A client's attitudes and experiences must also play a large part in the decision-making process. A client may well be able financially to invest in higher-risk products and these may well suit their needs, but if they are cautious by nature, they may well find the uncertainties of holding volatile investments unsettling. In these cases, both the adviser and the client may have to accept that lower-risk investments and returns must be selected.

3.4.2 Risk Perception

Risk perception refers to people's subjective judgements about the likelihood of negative occurrences such as injury, illness, disease and death. In investment terms, risk perception is a subjective view that clients take on the risks involved in making a particular investment, when compared to the alternatives available, based on their own knowledge and experience.

Individuals evaluate risks mostly according to subjective perceptions, intuitive judgements, and inferences made from media coverage and limited information. By contrast, experts try to base their

risk perceptions more on research findings and statistical evidence. Risk perception is a highly personal process of decision making, based on an individual's frame of reference developed over a lifetime, among many other factors.

The concept of framing seen in section 3.2 (Behavioural Finance), therefore, plays a significant part, and the adviser needs to consider how to manage the client's perception. Effective risk communication depends on acknowledging the many factors that contribute to individual risk perception and should aim to clients combine instinct with evidence to make the best choices possible.

For some clients, taking on risk is acceptable whilst for others, risk is something to avoid. A client may perceive that placing funds in a cash deposit account does not present any risk to the value of their capital. However, this ignores the impact of inflation and, once this has been explained and understood, the client may appreciate that the real value of their capital will diminish over time if the rate of interest they receive on their savings does not exceed the current rate of inflation.

As the client's practical experience of investing increases, this is likely to shape their perception of risk when considering future investment opportunities. Advisers need to be aware that this will happen and, without being patronising, help the client deepen their understanding to whatever extent they wish.

3.4.3 Risk Capacity

Risk capacity is the client's ability to absorb any losses that may arise from making a particular investment.

Risk tolerance and risk perception are partly subjective, but risk capacity is largely a matter of fact. While subjective factors largely determine risk perception and attitude, the key question in assessing risk capacity is more what the consequences will be for the client if losses are incurred.

The ability to bear loss will vary significantly from investor to investor, and will depend on their goals.

In some cases, risk capacity will play the most important role in determining the client's overall risk profile. The client's capacity for risk will also be affected by the level of investment being considered. If the amount at risk represents a significant portion of the overall portfolio, risk capacity may be diminished. Risk capacity will be greater when the amount at risk is a small fraction of available capital. The FCA highlight the necessity for advisers to assess investors' capacity for loss, and provide investment advice adjusted to the individual's risk capacity.

3.4.4 Risk Descriptions

Establishing an investor's risk profile is not straightforward. Attitude to risk and its definition are themes that financial services companies constantly revisit. The reason for this is simple; namely, that they want to be able to categorise a client into a risk category and then be able to say which of their products are suitable for clients with that risk profile. However, definitions of risk profiles are imprecise.

The output of risk profiling is a description of investor risk appetites.

Investor Risk Appetites	
Low Risk	• Prefer knowing that their capital is safe. They would rather keep their money in the bank and are unlikely to have much experience of other investments. • They will usually suffer from severe regret if their decisions turn out badly. • Clients need to understand that their caution can mean that their investments may not keep pace with inflation or that they may fall short of their investment goal. • Clients with time horizons of ten years or more typically have portfolios with a majority of bonds and cash, with little exposure to equities or other higher risk investments.
Low-Mid Risk	• Prefer not to take risk with their investments, but they can be prepared to do so to a limited extent. They would prefer to keep their money in the bank, but they may realise that other investments have the potential to generate higher returns over a longer term. • They can often experience regret when decisions turn out badly. • Investors with time horizons of ten or more years typically have portfolios with a majority of bonds and cash, but with some exposure to equities and other higher risk investments.
Mid Risk	• Understand that they have to take investment risk to meet their long-term goals. Clients are often more willing to take risks with at least part of their available assets and may have some experience of investment, including investing in products containing higher-risk assets. • They can usually make up their minds on financial matters relatively quickly, but they still suffer from some feelings of regret when their decisions turn out badly. • Clients with time horizons of ten years or more typically have portfolios with a mix of higher risk investments such as equities and lower risk investments, such as bonds and cash.
Mid-High Risk	• Willing to take on investment risk and understand the nature of the long-term risk/return trade-off. Clients are willing to take risk with most of their available assets, are typically experienced investors and have used a range of investment products in the past. • They will usually be able to make up their minds on financial matters quite quickly. While they can suffer from regret when their decisions turn out badly, they can accept that occasional poor outcomes are a necessary part of long-term investment. • Clients with time horizons of ten years or more typically have portfolios with a majority of higher risk investments such as equities, but also bonds and cash.

Investor Risk Appetites	
High Risk	• Want the highest possible return on their capital and are willing to take considerable amounts of risk to achieve this. • Clients are usually willing to take risk with all of their available assets, and have substantial amounts of investment experience. • They have firm investment views and will make up their minds on financial matters quickly. They do not suffer from regret to any great extent and can accept occasional poor outcomes without much difficulty. • Clients with time horizons of ten years or more typically have portfolios made up primarily of higher-risk investments such as equities, with little in bonds and cash (if at all).

These descriptions are intended to be only illustrative and bring out common traits, but every individual is different.

The results of risk profiling should support the KYC process and form a basis for discussion between the adviser and client as to the types of investments that such a risk profile would suggest are suitable. In those discussions, it is important that advisers consider the knowledge and experience of clients and properly discuss the nature of the risk they are willing and able to take. They should guard against situations where the client commits to an investment selection on the basis of a misunderstanding of the level of risk involved.

The descriptions can be a helpful way of reflecting the level of risk inherent in any subsequent investment selection. However, firms should ensure that care is taken that the risk categories they use are not too wide, so that situations where the FCA have expressed concerns are avoided, for example:

- where the risk a client is willing to take is at the low end of such a category, but the investment selection is reflective of the high end of the category; this is likely to lead to unsuitable advice, or
- where there is a significant difference in the proportion that can be invested in equities for consecutive risk categories, this may create large jumps in the risk taken.

FCA Guidance

Engaging with the customer to check that the risk a customer is willing and able to take was correctly assessed is a reasonable step firms can take to ensure that the outcome is suitable as long as:

- the descriptions and illustrations used in the process are drafted and presented in a way that explains the investment risk in a way that is fair, clear and not misleading, and
- the explanations clearly differentiate the level of risk between categories.

3.4.5 Risk-Profiling Tools

Risk attitude is a complex area and as a result risk profiling is not an exact science. There are a number of approaches that can be taken to establish the client's attitude to risk.

Risk Descriptions

A much-used approach to establishing a client's risk profile is to describe different types of investment attitudes to find out which is closest to the client's view. This has the advantage of simplicity.

Its drawback is that statements such as medium risk or on a scale of one to ten mean different things to different people.

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. It uses a questionnaire to generate a risk score that can be compared to other clients. Its advantage is that it allows clients to consider their attitude to investment decisions very carefully and to articulate them to the adviser, who can ask further questions and discuss the relationship of risk to the behaviour of different asset classes.

It is important to remember though, that the psychological profile is only one of the inputs into the investment decision-making process. But it is a good starting point to a discussion that could include the impact of the profile on potential outcomes for the client's different goals.

Stochastic Modelling

Stochastic modelling software usually incorporates a risk profiling questionnaire to help assess a client's attitude to risk. The answer to each question is given a score, which helps identify the client's risk category and is an excellent tool to aid further understanding of an individual's willingness to take financial risk. The stochastic model can then be used to forecast a range of possible returns from different portfolios of investments.

This model helps clients choose the appropriate portfolio by showing the range of possible outcomes from each portfolio and the probability of achieving them. Its advantage is that it helps to explain investment risk to the client, compare alternative strategies and recommend a portfolio of suitable investments.

It is important to understand that the model is making predictions about the future and is therefore reliant on its assumptions. A further drawback is that some clients may think these projections are set in stone.

Computer-based assessments and psychometric-profiling tools are widely available from a number of different sources, both as stand-alone software packages and online. These offer a more scientific approach to establishing risk and often incorporate some or all of the elements listed above, including graphical representations, numerical scales, direct statements and closed questions.

Assessing Risk-Profiling Models

Where advisers are reliant on risk-profiling models, they need to understand the nature of the assumptions underlying the model, and 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 it is not possible to predict. Furthermore, different models may well come up with a range of predictions.

Although there is increasing use of computer-based risk-profiling tools, the most important part of the process is usually the discussion between the adviser and the client. Tools can usefully aid discussions with clients by helping to provide structure and promote consistency, but they often have limitations which mean there are circumstances in which they may produce flawed results.

FCA Guidance

If a firm relies on the automated output from a tool, it is important that:

- the tool is fit for purpose
- it is used only in the circumstances, and for the target market for which it was designed
- users understand how the tool works and any limitations of the outputs it generates, including the extent to which the tool will help them meet their regulatory requirements, and
- the customer is able to understand and engage with the process as designed.

Where firms rely on tools they need to ensure they are actively mitigating any limitations through ensuring suitability and the KYC process. It is important to stress that a risk-profiling tool cannot negate an adviser's obligation to carry out a thorough amount of fact finding and confirm suitability.

3.4.6 FCA Guidance

In its 2011 report on assessing suitability, the then UK regulator (the FSA) highlighted a high number of unsuitable investment selections both in terms of recommendations and discretionary wealth manager decisions. The FCA does not prescribe how firms establish the risk a customer is willing and able to take, or how they make investment selections, but require that firms have robust procedures, tools and risk category descriptions (where used) to establish and check the level of risk a customer is willing and able to take, as well as assessing the suitability of investment selections.

The following sets out the regulator's requirements.

FCA Guidance

Firms should ensure that, in particular:

- they have a robust process for assessing the risk a customer is willing and able to take, including:
  - assessing a customer's capacity for loss
  - identifying customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital
  - appropriately interpreting customer responses to questions and not attributing inappropriate weight to certain answers.
- tools, where used, are fit for purpose and any limitations recognised and mitigated
- any questions and answers that are used to establish the risk a customer is willing and able to take, and descriptions used to check this, are fair, clear and not misleading
- they have a robust and flexible process for ensuring investment selections are suitable given a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience
- they understand the nature and risks of products or assets selected for customers, and
- they engage customers in a suitability assessment process (including risk-profiling) which acts in the best interests of those customers.

A May 2017 review[1] by the FCA identified that there were still issues with risk profiling. They identified that some firms were not considering or mitigating the limitations of the risk profiling tool they used or where the recommended solution did not match the risk the customer was willing or able to take.

This concern has persisted. In its March 2024 Retirement Income Advice review (TR24/1)[2] , the FCA again found widespread issues, particularly in evidencing risk profiling, distinguishing between clients' risk attitudes and their capacity for loss, and ensuring that recommendations – especially in decumulation – were properly aligned with client profiles. The FCA continues to stress that robust and tailored risk profiling, clear documentation, and regular review of advice processes are essential, especially under the Consumer Duty, which requires firms to deliver and evidence good client outcomes.

3.5 Investment Objectives and Constraints

Having collected all of the core information needed about the client, the adviser can then turn to agreeing with their investment objectives.

The main client objectives are concerned with return requirements and risk tolerance. If an investor expresses their expectations only in terms of returns, there is a danger that a high-target return will lead to an investment manager investing in higher risk assets and the resulting risk may not be acceptable to the client.

The primary factor to consider is the risk tolerance of the client, including their ability and willingness to take on risk. In other words, it is necessary to start with a client's 'hoped for' target return and then temper this by applying their attitude to, and capacity for, risk to end up with a more balanced view of their objectives.

3.5.1 Investment Objectives

In collecting the information above, the adviser will have started to build a picture of the client's needs and will classify these needs along the lines of the following:

- Maximising future growth.
- Protecting the real value of capital.
- Generating an essential level of income.
- Protecting against (provision for) future events, eg, saving for children's education and protection policies to inheritance tax (IHT) planning.

The adviser will want to convert this into an understandable investment objective and will use classifications such as:

- income
- income and growth
- growth, and
- outright growth.

1 Financial Conduct Authority, May 2017. Assessing Suitability Review. Retrieved from https://www.fca.org.uk/publication/multi-firm-reviews/assessing-suitability-review.pdf (Accessed: June 2025)

2 Financial Conduct Authority, March 2024. Retirement income advice: Advice Suitability and Consumer Outcomes (TR24/1). Retrieved from https://www.fca.org.uk/publication/thematic-reviews/tr24-1.pdf (Accessed: June 2025)

The purpose of this is to establish a common understanding of what the client is trying to achieve. The adviser may not personally manage the client's investment portfolio and so there is a need to have common terms of reference so that any investment decisions are suitable for what the client is aiming to achieve. The adviser will, therefore, want to ensure that the client understands the terminology being used and agrees that the correct investment objective has been selected. A typical definition of each investment objective is as follows:

- **Income** – the client is seeking a higher level of current income at the expense of potential future growth of capital.
- **Income and growth** – the client needs a certain amount of current income but also wants to invest to achieve potential future growth in income and capital.
- **Growth** – the client is not seeking any particular level of income and their primary objective is capital appreciation.
- **Outright growth** – the client is seeking maximum return through a broad range of investment strategies which generally involve a high level of risk.

Once the client's investment objectives have been agreed, the adviser needs to look at developing an investment strategy that can be used to achieve these objectives. In developing an investment strategy, the adviser will need to determine the following:

- Risk profile
- Investment preferences
- Liquidity requirements
- Time horizons
- Tax status

We will look at each of these below.

FCA Guidance

Information regarding the investment objectives of a customer must include, where relevant, information on the length of time for which they wish to hold the investment, their preferences regarding risk taking, their risk profile, and the purposes of the investment.

3.5.2 Risk Profile

Volatility in the prices of investments or the overall value of an investment portfolio is inevitable. At a personal level, this translates into the risk that prices may be depressed at the time when the client needs funds and will mean that they will not achieve their investment goals.

A client needs to have a very clear understanding of their attitude to risk, as it is essential to choosing the right investment objectives. Risk attitude is a very subjective subject and is very dependent upon the emotional make-up of a person. It is also objective as well, in that age will affect how much risk a client can assume because, as they get older, there is less time to recover from poor investment decisions or market falls and so appetite to take risks may change. Experience of investing and having wealth/assets already can also influence, in a greater way, the client's risk levels (otherwise known as the client's utility to risk).

Although risk is an emotive subject, establishing a client's tolerance towards risk need not be subjective. Indeed, an objective measure of a client's risk tolerance is provided by the risks that will need to be taken if the client's stated investment objective is to be met. If the client believes these risks are too great, then the objective itself will need to be revised.

Attitude to risk will affect the investment strategy that is implemented. Firms will generally have their own set of definitions and will want to categorise a client within one so that suitable investments can be selected. To properly understand a client's attitude to risk, the adviser needs to link this back to their investment objectives and demonstrate how the selection of a risk classification will drive the choice of investments held in a portfolio. The adviser should ensure that:

- risk is explained in terms that a client can understand
- where the client has little experience or knowledge of investments, a detailed and clear explanation of the inherent risk of each investment is given, and
- when presenting investment recommendations, the adviser should explain why the recommended investments are consistent with the client's attitude to risk.

It is essential to remember that ascertaining a client's true attitude to risk and capacity for loss is critical to assessing suitability and making any investment recommendation.

3.5.3 Investment Preferences

An adviser will also need to establish whether the client has any specific investment preferences that need to be considered within the investment strategy. These may take the form of restrictions or a requirement to follow a particular investment theme.

Some investors may wish to impose restrictions on what should be bought and sold within their portfolio. For example, they may impose a restriction that a holding cannot be disposed of or they may prefer to exclude certain investment sectors from their portfolios, such as armaments.

Alternatively, a client may want to concentrate solely on a particular investment theme, such as ESG or they may require the portfolio to be constructed in accordance with Islamic principles.

3.5.4 Liquidity Requirements

A client may have known liabilities that will arise in the future which will need to be planned for, but it will also be necessary to factor in how the client will raise funds if needed. Markets can be volatile and so the investment strategy needs to take account of the need for funds to be readily realisable without having to sell securities at depressed prices.

Liquidity refers to the amount of funds a client might need both in the short and long term. When constructing an investment portfolio, it is essential that an emergency cash reserve is put to one side which the client can access without having to disturb longer-term investments. If there are known liabilities that may arise in future years, consideration should also be given as to how funds will be realised at that time. Consideration needs to be given as to whether it is sensible to plan on realising profits from equities from time to time as market conditions may be such as to require losses to be

established unnecessarily. Instead, conservative standards suggest investing an appropriate amount in bonds that are due to mature near the time needed so that there is certainty of the availability of funds, subject to the prices of those bonds and the availability of suitable ones.

In planning terms, the adviser should agree with the client how much of a cash reserve should be held. Recognising the long-term nature of investment, this should represent their expected cash needs over, say, three to five years.

This should then be supplemented by ensuring that the portfolio will contain investments that are readily realisable in the event of an emergency and which otherwise will be available to top up the cash reserve in future years. One way this could be achieved is by using a bond ladder, which involves buying bonds with a range of different maturities (eg, three, five, seven and ten years). As each matures, funds can become available for the investor to withdraw or can be reinvested in later maturities. Alternatively, structured products, such as guaranteed capital growth bonds, could meet the same objective.

The lower the client's liquidity requirements and the longer their timescale, the greater will be the choice of assets available to meet the client's investment objective. The need for high liquidity allied to a short timescale, demands that the client should invest in lower-risk assets such as cash and short-dated bonds, which offer a potentially lower return than equities; if the opposite is true, the portfolio can be more proportionately weighted towards equities and other risk assets. Whatever their requirements, it is important the client maintains sufficient liquidity to meet both known commitments and possible contingencies.

3.5.5 Time Horizons

Time horizon refers to the period over which a client can consider investing their funds. Definitions vary, but short term is usually considered to be from one to four years, medium term refers to a period from five to ten years, and long term is considered to be for a period of ten years or more.

Time horizon is very relevant when selecting the types of investment that may be suitable for a client. It is generally stated that an investor should only invest in equities if they can do so for a minimum period of five years. This is to make the point that growth from equities comes about from long-term investment and the need to have the time perspective that can allow an investor to ride out periods of market volatility.

Assuming that the client is able to invest for the longer term then their stage of life will have an important effect on the investment strategy followed.

The investment strategy that is developed to meet their needs will use an asset allocation process to design a portfolio that fits with the client's personal circumstances, investment objectives, attitude to risk and capacity for loss. The adviser needs to recognise, however, that this will change as the client gets older and so as their requirements change, the investment strategy will need to change with them as will the percentages allocated to different asset classes.

As a process, it is known as '**lifestyling**'. Below, we will look at some potential asset allocations that could be used at different ages of a client. Here, we assume a typical UK-based client with a moderate attitude to risk at the outset. The allocations provided are indicative. The key point here is that as clients get older, their allocations to riskier assets should decrease to ensure their goals are met. Stock markets and other riskier assets have a tendency to outperform safer markets over the long run, but they are also more volatile. It would be unwise for any client to have a high allocation to equities when they are approaching retirement. An equity market crash at that point would have a devastating effect on their wealth. Allocation is arguably more of an art than a science and past performance is not a reliable guide for the future.

Age Group: Under 40

With at least 25 years to go to retirement, the client is building up their income and savings for the future. They can afford a high degree of exposure to the stock market and can accept the likelihood of greater volatility in smaller companies, international shares and higher-risk assets in exchange for the higher long-term returns that can be generated.

Asset Class	Under 40
Cash	2.5%
Bonds	7.5%
UK shares	35%
International shares	42.5%
Alternatives*	12.5%

* Property, infrastructure, absolute return funds, hedge funds, private equity and other uncorrelated assets

Age Group: 40 to 49

The client is now more financially secure with greater income but expenses are building up for the children's education. On the investment front, the long term is now becoming the medium term as there are fewer **economic cycles** to ride before retirement. It is time to gradually reduce the exposure to equities and increase the proportion in bonds.

Asset Class	Under 40	40 to 49
Cash	2.5%	2.5%
Bonds	7.5%	12.5%
UK shares	35%	32.5%
International shares	42.5%	37.5%
Alternatives*	12.5%	15%

* Property, infrastructure, absolute return funds, hedge funds, private equity and other uncorrelated assets

Age Group: 50 to 55

Previously, this age bracket would have stretched until age 59, but this has shortened since the advent of pensions freedoms with most retirees now being able to access their accrued pensions from 55. The client is probably far better off now than ever, the children have left home and they have a greater level of disposable income that they are using to meet their dreams and enjoy greater leisure activities. This client will also be increasing their savings, as protection policies could be coming to an end and mortgage payments are now less. Maintaining this will be important, as will greater security in their finances, as they will not want a stock market downturn to ruin the work in growing their assets.

Asset Class	Under 40	40 to 49	50 to 55
Cash	2.5%	2.5%	5%
Bonds	7.5%	12.5%	17.5%
UK shares	35%	32.5%	30%
International shares	40%	37.5%	32.5%
Alternatives*	15%	15%	15%

* Property, infrastructure, absolute return funds, hedge funds, private equity and other uncorrelated assets

Age Group: 55 to 69

The client has now reached that age where accumulating wealth has given way to the need for income and stability. The portfolio will now need to generate income to enable the client to maintain their standard of living and this will involve further reducing the exposure to equities and increasing the percentage held in cash assets.

Asset Class	Under 40	40 to 49	50 to 55	55 to 69
Cash	2.5%	2.5%	5%	5%
Bonds	7.5%	12.5%	17.5%	25%
UK shares	35%	32.5%	30%	30%
International shares	40%	37.5%	32.5%	22.5%
Alternatives*	15%	15%	15%	17.5%

* Property, infrastructure, absolute return funds, hedge funds, private equity and other uncorrelated assets

Age Group: 70 and Over

The client is now in a position where they need absolute certainty that they have an investment portfolio that can meet their income needs and are little prepared to put their capital at risk.

Asset Class	Under 40	40 to 49	50 to 55	55 to 69	70 and over
Cash	2.5%	2.5%	5%	5%	5%
Bonds	7.5%	12.5%	17.5%	25%	40.0%
UK shares	35%	32.5%	30%	30%	18%
International shares	40%	37.5%	32.5%	22.5%	15.0%
Alternatives*	15%	15%	15%	17.5%	22%

* Property, infrastructure, absolute return funds, hedge funds, private equity and other uncorrelated assets

These examples demonstrate how wealth managers can use asset allocation as a tool for ensuring that the high-level construction of the recommended portfolio matches the client's circumstances and their attitude to risk. Wealth managers should always be mindful of the changing risks to capital over the long term, including market sensitivity for equities and interest rate risk for fixed income. Candidates should continually critique rather than generalise asset classes on an ongoing basis, based on **macroeconomic** data, valuation and market behaviour. Only then can candidates review their asset allocation against client objectives and risk profile.

A multi-asset class portfolio can lower volatility and improve the risk-adjusted return and income. However, correlations rise during times of market stress and as we saw, for example, in 2022, bonds and equities fell in lockstep.

3.5.6 Tax Status

The tax status of the client and the taxes to which any investment income or gains will be subject may have a major impact on the investment strategy that is adopted and how a portfolio is constructed. For example, with a higher rate taxpayer the strategy adopted may be to target achieving capital growth with low income levels to maximise the after-tax return.

The adviser will, therefore, need to establish:

- the client's residency and domicile position
- the client's income tax position (now and any future changes)
- how tax will affect any investment income
- any tax allowances which can be utilised
- how CGT will affect any gains or losses made
- any CGT allowances which can be utilised
- eligibility for any tax-free accounts
- opportunities for deferring any tax due, and
- the client's marital status to assess asset transfers between spouses.

An adviser must establish the client's residence and domicile status, as they may affect how any investments are structured. Although tax rules vary from country to country, establishing the client's tax position is essential so that their investments can be organised in a way that attracts the least tax

possible on returns, without bending the rules of the tax system. This requires the adviser to be aware of what taxes may affect the client, such as taxes on any income arising or on any capital gains, how these taxes are calculated and what allowances may be available.

4. Analysing a Client's Financial Position

Once the fact-find and discussions with the client has taken place the next stage is to collate all of the data that has been collected, analyse the client's financial position and prioritise the areas where action is needed. This involves turning the data into a comprehensible form that allows it to be readily analysed. This can be broken down into a number of areas such as:

- net assets statement
- cash flow statement
- tax analysis, and
- lifetime cash flow projections.

4.1 Net Assets Statement

The net assets statement is simply a personal balance sheet that shows the client's assets and liabilities and their net worth.

It is useful to have a structured approach to preparing a net assets statement as ordering the assets and liabilities in groups will aid the analysis of the client's position and makes it clearer and easier to identify any issues that need to be investigated further.

The following is a simplified net assets statement format.

Assets		
Cash Assets	Current Accounts	£
	Savings Accounts	£
	Total	£
Property	Address	£
	Property Funds	£
	Total	£
Bonds	Government Bonds	£
	Corporate Bonds	£
	Bond Funds	£
	Total	£
Equities	Direct Equities	£
	Equity Funds	£
	Total	£

Alternative Assets	Hedge Funds	£
	Absolute Return Funds	£
	Structured Products	£
	Total	£
Other Assets	Insurance Bonds	£
	Pension Funds	£
	Other Assets	£
	Total	£
	Total Assets	£
Liabilities		
Property	Mortgage – Address	£
	Mortgage – Address	£
	Total	£
Other Liabilities	Credit Cards	£
	Loans	£
	Total	£
	Total Liabilities	£
Net Worth		**£**

As most clients' assets are complex, it would make sense to have separate statements for each asset class that show the detail of what the client's position is so that the above example becomes a summary statement. By presenting the statement in this summary way, the client's assets and liabilities can be clearly seen.

An asset allocation summary should also be produced showing the percentage of assets allocated to different asset classes and yields. In addition:

- Each asset class can then show allocations to areas such as large cap shares, sub-sectors or by overall sector.
- Some investments, such as investment bonds or multi-asset funds, fall into more than one asset class. These can show the most recent apportionment of the fund among the asset classes.
- A similar approach can be adopted for pension funds, where the client can have control over how the funds are invested and allocated between asset classes.

Presenting the client's assets in this way allows an analysis of their current position to be undertaken and then compared against their investment objectives and risk profile. The analysis should look to identify a range of issues including:

- any mismatch between the client's risk profile and the overall portfolio
- whether the assets are appropriate for the client's objectives

- any over-allocation to one asset class or market
- whether there are too many products with one provider, and
- an assessment of the probability of the client meeting their investment targets.

The structure of the portfolio and the past performance of investments and funds can then be investigated to identify:

- asset class, sector and market percentage breakdown
- large exposures to single investments
- past performance of individual investments and mutual funds
- volatility of the individual investments held compared to the client's risk profile, and
- the drawdown for the portfolio compared to the client's risk profile – that is the maximum percentage loss in value over the period of ownership.

The results of this analysis should generate a series of issues that require addressing for an optimal investment solution that meets the client's needs.

4.2 Cash Flow Statement

A cash flow statement will show the client's income and expenditure. The content of the statement will be determined by factors such as the complexity of the client's income sources and the extent to which income is an important factor in the evaluation of an investment strategy.

A simplified format of a cash flow statement based on the summary net assets statement shown previously is as follows.

Income		Monthly	Annually
Cash Assets	Current Accounts	£	£
	Savings Accounts	£	£
	Total	£	£
Property	Address	£	£
	Property Funds	£	£
	Total	£	£
Bonds	Government Bonds	£	£
	Corporate Bonds	£	£
	Bond Funds	£	£
	Total	£	£
Equities	Direct Equities	£	£
	Equity Funds	£	£
	Total	£	£
Alternative Assets	Hedge Funds	£	£
	Absolute Return Funds	£	£

	Structured Products	£	£
	Total	£	£
Other Assets	Insurance Bonds	£	£
	Pension Funds	£	£
	Other Assets	£	£
	Total	£	£
	Total Income	£	£
Outgoings			
Property	Mortgage	£	£
	Maintenance	£	£
	Total	£	£
Other Liabilities	Household Expenses	£	£
	Holidays and Discretionary Spending	£	£
	Total	£	£
	Total Outgoings	£	£
Net Income		**£**	

Sources of income should be shown after tax.

As each individual's income and expenses vary widely according to circumstances, the actual headings used could be very different depending on the client. The summary could also show how much expenditure is fixed and how much is discretionary.

The reasons for preparing a cash flow statement will vary by client but could include the following:

- Quantifying the income that needs to be generated from investments to meet the client's income requirement.
- Identifying where there is a surplus of income over expenditure and the opportunities to plan the investment of these funds.
- Current cash flow can also be used as a basis for estimating future income and expenditure in retirement and what would happen if the client became seriously ill and was unable to work.

4.3 Tax Analysis

Tax can have a major impact on both income and the taxation of capital gains and consequently on the selection of investments that are appropriate for a client. Taxation is covered in more detail in chapter 6.

An understanding of how a client's income is taxed is essential. Tax calculations will point to whether income-generating assets or capital growth is the more appropriate and tax efficient approach.

Calculating net income after tax is an important part of the cash flow statement. The analysis could 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 CGT that might be payable.

If a client is liable to tax on CGT, details of the acquisition costs are needed to identify any liability to tax that may arise on disposal of their current assets and whether timing of such disposals is needed.

The aim of the analysis should be to highlight the key issues in income tax and CGT planning for the client. These might include the following:

- How much income is subject to tax at higher rates, to highlight the opportunities for higher-rate tax relief on pension contributions, where available, and tax relief on other investments, such as **new issues** of **venture capital trusts (VCTs)** and **enterprise investment schemes (EISs)**, and **seed enterprise investment schemes (SEISs)**, and the possible use of Gift Aid.
- Tax planning opportunities in terms of spreading the ownership of assets between spouses/civil partners and making full use of the personal savings allowance and dividend allowance, or with regard to inheritance tax, use of the nil-rate band or the exemptions concerning gifts to charities.
- Analysis of the investments held in tax wrappers to determine whether they are appropriate.
- The potential CGT or income tax liability on switching investments.
- The scope for avoiding some CGT by spreading disposals over more than one year to maximise use of the client's annual CGT exemptions.
- The likelihood that the client will become a basic-rate taxpayer at some point in the future, at which time it might be worth encashing investments that would be subject to the lower rate of CGT or to a lower rate of income tax than in the current situation, the latter being relevant to life assurance bonds and roll-up funds offshore.

4.4 Lifetime Cash Flow Projections

A lifetime cash flow projection is one that can be prepared once the analysis of the client's circumstances have been completed and will incorporate cash flows based on existing assets and investment recommendations.

It shows longer-term cash flow movements in order to identify where clients will have surplus or deficits and is useful to identify precisely what actions are needed. These cash flow projections provide year-by-year summaries of cash paid to the client and cash paid out by the client, showing those years in which there is a surplus and the years in which there is a deficit and demonstrating the potential accumulated surplus or deficit. These are best presented as a combination of figures and graphics and can be a powerful tool as it allows the client to see what will take place in graphic form.

Lifetime cash flow projections are increasingly being used to forecast clients' income and expenditure profiles over the long term. 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 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.

Projections can also take into account expected returns from investments but these should be viewed very cautiously. Predicting future returns is notoriously inaccurate, so why would a structured advice process rely on an imponderable? It is far better to show clients what it is realistic to expect and then discuss the potential for a better outcome if the investment solutions selected perform as hoped and, vice versa, what the potential downsides are.

There are several computerised packages that reduce the amount of time and effort in compiling the data and making the analysis, but 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. The computer programs vary in their sophistication and the degree to which they make very broad assumptions about future income and expenditure and aspects such as tax. It is important to understand the principles and to be sceptical of the outcomes; otherwise the 'GIGO' (garbage in, garbage out) principle may apply.

5. Developing Solutions

After determining a client's objectives and risk profile and after analysing the client's current financial position and any constraints, the final stage of the investment advice process is the development of solutions that are suitable for the needs of the client.

The FCA requires advisers to have enough personal and financial information about a client to be able to give suitable financial advice, particularly whether 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.

The requirements include:

- ensuring clients are aware of the importance of providing accurate and up-to-date information
- undertaking valid and reliable assessments of their client's knowledge and experience and risk they are willing and able to take, including their ability to bear the investment risk
- ensuring all tools employed in the suitability assessment process are appropriately designed for use with their clients and are fit-for-purpose, with any limitations identified and actively mitigated through the suitability assessment process
- ensuring questions used in the process are likely to be understood by clients, capture an accurate reflection of the client's views and needs, and the information necessary to undertake the suitability assessment, and
- taking steps, as appropriate, to ensure the consistency of client information. This includes, for example, considering whether there are obvious inaccuracies in the information provided by clients.

5.1 Client Information

As seen, gathering client information is the second stage of the six-step financial planning process.

When operating in today's regulatory environment, it is important that advisers are as certain as they can be that they have acted in the client's best interests. Advisers who are unable to evidence the collection of sufficient KYC records will find it difficult to show that, even if they have.

Advisers need to explain to clients the importance of providing information and the connection between that and suitable advice. Information about the suitability assessment should help clients to understand the purpose of the requirements and should encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation and investment objectives.

Information to Clients about the Suitability Assessment

Regulatory guidance states that investment firms should inform clients, clearly and simply, that the reason for assessing suitability is to enable the firm to act in the client's best interest. At no stage should investment firms create any ambiguity or confusion about their own responsibilities in the process.

Financial services firms are required to highlight to the client that it is important to gather complete and accurate information so that they can recommend suitable products or services for the client. It is up to the firms to decide how they will inform their clients about the suitability assessment, but the format used should enable controls to check if the information was provided.

Accurate and up-to-date client information is essential in putting together a financial plan. All information received from the client, whether hard or soft facts should be accurately recorded and collated in such a way that it can be presented back to the client for verification.

Trust and Client Information

The trust relationship works both ways:

- The adviser must trust the client to disclose all material personal and financial information in order to be able to provide the correct advice.
- The client must trust the adviser to be knowledgeable and up to date in order to recommend products and services that actually meet their goals and aspirations, professional enough to place principles over personal gain, and to have the highest levels of integrity.

The key to gaining and retaining the trust of clients is to keep the client's needs at the centre of all recommendations and to explain these in terms the client can fully understand, including the risks involved and to agree any plans with the client rather than dictate them.

When working with client data, the adviser needs to be able to identify any gaps or inconsistencies in the information and take appropriate action to correct these.

Regulatory Guidance on Reliability of Client Information

Clients are expected to provide correct, up-to-date and complete information necessary for the suitability assessment; however, investment firms need to take reasonable steps to check the reliability of information collected about clients. Firms remain responsible for ensuring they have adequate information to conduct a suitability assessment. For example, firms should consider whether there are any obvious inaccuracies in the information provided by their clients. They will need to ensure that the questions they address to their clients are likely to be understood correctly and that any other method used to collect information is designed in a way to get the information required for a suitability assessment.

It is often necessary to follow up to gather further details not originally captured during the initial discussion and fact-find meeting. This often becomes apparent on reviewing the information when conducting analysis of the client's position. Clients may have information which is out of date and perhaps are unable to provide copies of documentation which contain full details of the current arrangements.

Regulatory guidance states that in order to ensure the consistency of client information, firms should view the information collected as a whole. Firms should be alert to any relevant contradictions between different pieces of information collected, and contact the client in order to resolve any material potential inconsistencies or inaccuracies.

In order to obtain sufficient detail, it is often necessary to obtain a letter of authority from the client which is sent to a provider together with a questionnaire requesting details required by the adviser. The letter of authority is often valid for 12 months; it may or may not include an instruction for any servicing rights to be transferred if there is no present relationship with another adviser, or if the client is planning to change their adviser. The better the quality of the collected information, the easier it is to collate and analyse it.

5.2 Prioritisation and Affordability

The importance of gathering KYC information and building a detailed picture of a client's personal and financial circumstances, current and future needs and aspirations have been covered in detail. It is vital to be able to effectively identify them and respond to them while bearing in mind that not all needs can be addressed immediately and that the client may not be able to afford to fund each product at once.

As discussed in earlier sections, a client's perception of need may be different from the reality, and it is important for the adviser to anticipate how these needs may change as the client passes through key life events and therefore build a degree of flexibility into the advice given.

It is important to recognise that the client may have a specific need, but does not wish to address the need at the time or may not be able to afford to do so. In such cases, the responsibility of the adviser is to make the client aware of the relative importance of the requirement, any implications of not addressing the issue, and any future strategies that could be employed when the client is ready to proceed.

It is important to know the amount of any available investible capital and any surplus monthly (or annual) income that the client may have available towards meeting goals and objectives, to ensure that any recommendations made in the financial plan are affordable. This will also help to decide which goals and priorities should be dealt with in the plan if it is apparent that there are insufficient assets to deal with all of them at this time.

Advisers operate in a complex marketplace and deal with often complex financial issues for clients and, as each client's circumstances are different, there will inevitably come a time where the adviser is faced with a situation where a suitable product for a client's needs simply does not exist.

Where no suitable product is available, no recommendation should be made. Part of the issue surrounding the provision of advice where no suitable product exists is that of the potential for mis-selling, especially if the client perceives that an adviser has recommended a product in order to charge a fee rather than to suit the client.

5.3 Recommendations and Due Diligence

The end product of the process of collecting client information, analysis and prioritisation are the investment recommendations themselves. Potential investment, retirement and protection solutions are contained in the chapters that follow.

The circumstances of every individual are unique, and it is essential that an adviser considers which investment solutions are appropriate to meet the varying needs of a client before making any recommendations. Specifically, the adviser has to be able to justify each recommendation by explaining the advantages and disadvantages of each option. Any relationship or **correlation** between products or services must also be fully explored and explained.

The FCA's suitability guidance requires firms to act in the clients' best interests and take reasonable steps to ensure that any investment selection (including the underlying asset-allocation) is suitable. Suitability depends on a number of factors, including the risk clients are willing and able to take. An investment selection that fails to take account of all relevant factors may be unsuitable.

For example, poor outcomes can occur if firms:

- do not take appropriate account of all aspects of a client's investment objectives and financial situations as well as their knowledge and experience
- fail to challenge cases where automatically generated investment selections (for example, from model portfolios or asset-allocation tools) are unsuitable for individual clients
- fail to ensure recommendations or transactions are consistent with the risk description confirmed with the client
- rely solely on volatility as a proxy for risk
- do not recognise the importance of considering diversification, or
- fail to understand the nature and risks of products or assets selected for clients.

An adviser must be able to fully explain to the client, in a way that the client will understand, how each recommendation meets their identified financial goals. If a recommendation requires the use of a particular product, then any options need to be fully described and the relative advantages and disadvantages of any alternatives pointed out.

The adviser needs to justify how any recommendations meet the client's specific circumstances and explain the recommendations in a manner the client can understand, including, for example:

- characteristics, correlation, advantages and disadvantages of different products
- economic context of the advice and significance of main economic indicators
- interrelationship in estate planning between wills, trust, protection, IHT, CGT and retirement with investment planning
- explanation of appropriate financial protection products to clients and how they meet client needs
- comparison of the different options available
- explanation of when a previously agreed action is no longer beneficial to the client
- advantages and disadvantages of the proposed approaches
- how the action takes account of future needs, and
- how the action will be handled, including the need for monitoring and review.

Investment, retirement and protection planning must also be done in the context of the wider economic environment. The economic climate and economic projections may impact the solutions chosen and explaining the rationale for this to the client also maximises the end result. If, due to unforeseen circumstances, it does not, a clear rationale for any recommendations made will allow the client to still appreciate that the recommendations were made with their interests in mind. The integrity of the adviser and of the advice given is of the greatest importance to the issue of client trust, so it must be made very clear to any client why and how any recommendations suit their specific requirements.

5.3.1 Assumptions

In analysing the client's financial position and calculating expected outcomes or shortfalls and any requirements for additional provisions, calculations will need to be carried out taking account of the current position, as well as external factors which may impact the outcomes in the future.

A number of assumptions may need to be made when performing these calculations, including:

- assumed rates of return
- future inflation rates
- future expenditure patterns
- rate of earnings increases
- school and university fee increases
- annuity and/or pension drawdown rates
- future tax rates
- life expectancy, and
- future social security benefits.

This list is by no means exhaustive, but where assumptions are made, these should be recorded in the financial plan. Some assumptions may have been agreed with the client during the client meeting or the adviser may use a standard set of assumptions – again, these assumptions should be recorded in the financial plan so that all parties can clearly see the assumptions that have been used and on which the recommendations are based. Many assumptions are likely to change over time and all assumptions should be justified, showing why the assumption is reasoned, reasonable and relevant to the client's financial plan.

5.3.2 Due Diligence and Suitability

FCA Rules do not prescribe a methodology that firms must adopt in making investment selections. However, firms must have a robust process that ensures that all relevant suitability factors are properly taken into account.

Firms are required to conduct due diligence and ensure the products they recommend are suitable for their clients. Firms will be required to have policies and procedures in place to ensure they understand the nature and features of the products they select, and will be required to assess whether alternatives are available that would better meet clients' objectives.

The FCA thematic review on this subject explains that research and due diligence form part of a wider range of requirements which, together, combine to ensure firms deliver satisfactory client outcomes. These include the following:

- **Competence** – the firm must ensure its advisers are adequately competent on the subject of the product or service concerned. Advisers must have permissions in order to recommend and advise on certain products.
- **Research and due diligence** – this refers to the process carried out by the firm to assess the nature of the investment, its risks and benefits and the provider (to establish whether they believe it appropriate to entrust the provider with client assets). The firm needs to understand these factors in order to judge whether the solution is suitable.
- **Assessing suitability** – once advisers are competent in the nature of the investments and understand the individual product or service, they should be able to judge for each client if the solution is suitable.

What constitutes a reasonable level of research and due diligence will depend on the adviser's recommendation and the needs of the client. Although the objective of research and due diligence is the same across different investments, services and providers, there will be differences in the time and effort taken to achieve it. For example, it will usually take less time to assess a product from a familiar provider investing in familiar assets and longer when considering unfamiliar assets.

When firms carry out research and due diligence they should consider whether they can rely on the information supplied by the provider, such as marketing material. Firms can rely on factual information provided by other regulated firms as part of their research and due diligence process, for example, the asset allocation. However, they should not rely on the provider's opinion, for example, on the investment's risk level.

5.3.3 Specialist Advice

At times, advisers may need to refer a client to a specialist to obtain advice they cannot offer. This could be for financial planning advice, for example pension transfer advice or for advice from another profession, eg, a tax adviser or a solicitor. It is important that all of those involved in advising a client do so in a collaborative manner to ensure the client is receiving the correct advice. For example, a solicitor could create a discretionary trust deed, a wealth manager could manage the assets within the trust, and a tax adviser could advise on the periodic and exit charges of the trust.

Where clients have assets or interests in other countries, or wish to invest abroad, wealth managers should liaise with suitably qualified specialists in the relevant jurisdictions. Cross-border issues, such as regulatory and tax requirements, can be complex and seeking local expertise ensures that the advice provided is comprehensive and compliant with both UK and overseas regulations. This collaborative approach helps to safeguard the client's interests and ensures that all aspects of their financial affairs are properly addressed.

5.3.4 Technical Knowledge

It is vital for the financial adviser to continually update their technical knowledge of what is offered by the vast array of providers, involving tax, legal and accountancy experts as appropriate. The approach or charging structures of providers may be of great importance, depending on the client's preferences and philosophy, for example ethical, responsible and sustainable investment. All of these areas must be considered along with the complex interplay between one financial solution and another and any changes instigated by providers, regulators, tax authorities and governments.

Qualifications of Advisers

Guidance states that financial services firms are required to ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise for the discharge of the responsibilities allocated to them.

Advisers and other staff involved in providing advice must understand the role they play in the suitability assessment process, including sufficient knowledge of the relevant regulatory requirements and procedures, to discharge their responsibilities. They must have the skills and qualifications necessary to be able to assess the needs and circumstances of the client. They are also required to have sufficient expertise in financial markets to understand the financial instruments to be recommended (or purchased on the client's behalf), and to determine that the features of the instrument match the needs and circumstances of the client.

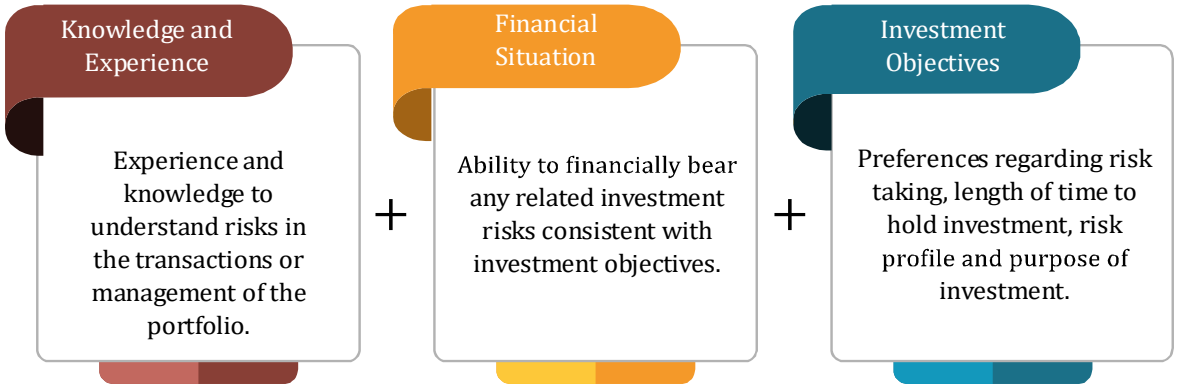
Essentially, financial planning is highly complex, and the role of the adviser is to guide the client to the best solutions by offering best advice and practical advice – particularly where the client has a limited budget to fund solutions.

5.4 Assessing Suitability

Rules on suitability apply when firms make personal recommendations related to designated investments, and when they manage investments. These rules exist to ensure that firms take all reasonable steps to see that recommendations, or decisions to trade, are suitable for the client.

In order to assess the suitability of an investment decision for any particular client, the adviser should look at three different elements concerning that client:

1. Knowledge and experience in the investment field relevant to the specific type of designated investment or service.
2. Financial situation.
3. Investment objectives.



The extent of information collected to do this may vary. In determining what information is necessary and relevant, investment firms should consider the following, in relation to a client's knowledge and experience, financial situation and investment objectives:

- The type of financial instrument or transaction that the firm may recommend or enter into, including the complexity and level of risk.
- The nature and extent of the service that the firm may provide.
- The nature, needs and circumstances of the client.

Regulatory Guidance on Extent of Client Information Needed

When providing access to complex or risky financial instruments, firms should collect more in-depth information so they can assess the client's capacity to understand, and financially bear, the risks associated with such instruments.

For illiquid instruments, details of the length of time that the client will hold the investment is needed along with such additional information about the client's financial situation necessary to ensure whether the client's financial situation allows them to invest or be invested in such instruments.

The information collected should take account of the services provided. With discretionary investment management, for example, the level of knowledge may be less detailed than for advisory investment management. Nevertheless, the client should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio. Firms should gain a very clear understanding and knowledge of the investment profile of the client.

More information should be collected when advice is being provided on a client's entire financial position than where only specific advice is provided. More in-depth information would also need to be collected for older and potentially vulnerable clients asking for investment advice services for the first time.

While the extent of the information to be collected may vary, the standard for ensuring that a recommendation or an investment made on the client's behalf is suitable for the client will always remain the same. If an investment firm does not obtain sufficient information to provide an investment advice or portfolio management service that is suitable for the client, it must not provide the service.

Regulatory guidance also requires firms to take steps to ensure that the client understands the notion of investment risk as well as the relationship between risk and return on investments. To enable the client's understanding of investment risk, firms should consider using indicative, comprehensible examples of the levels of loss that may arise depending on the level of risk taken, and should assess the client's response to such scenarios. The client should be made aware that the purpose of such examples, and their responses to them, is to help determine the client's risk profile, and therefore the types of financial instruments (and risks attached to them), that are suitable.

Suitability assessment means the whole process of collecting information about a client, and the subsequent assessment of the suitability of a given financial instrument for that client.

The suitability assessment is not limited to recommendations to buy a financial instrument; every recommendation must be suitable, whether it is a recommendation to buy, hold or sell, for example.

FCA Guidance on Assessing Suitability

A firm must take reasonable steps to ensure that a personal recommendation, or decision to trade, is suitable for its customer. As part of this, firms must obtain from the customer such information as is necessary to understand the essential facts about them and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

- meets the customer's investment objectives
- is such that the customer is able financially to bear any related investment risks consistent with their investment objectives, and
- is such that the customer has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of their portfolio.

Failure to obtain all the relevant information or evaluate it properly can lead to the recommended transaction or decision to trade being unsuitable for the customer. Overall, firms must ensure that they are acting honestly, fairly and professionally in accordance with the best interests of the customer and treat customers fairly.

5.5 Suitability Report

Most advisers present their recommendations in the form of a report. In order to make it easier for clients to fully understand these, best practice is to present an outline of the client's circumstances and needs with a summary of the recommendations, followed by more detailed sections on risk profile, asset allocation and investment and wrapper selection.

A suitability report may also be needed on an ongoing basis where the firm provides portfolio management services or the firm has informed the client that it will carry out periodic assessment of suitability. The periodic report must contain an updated statement of how the client's investments meet the preferences, objectives and other characteristics of the client.

Regulatory Requirements

Regulations require investment firms, when providing investment advice, to provide a report to the retail client that must include:

- an outline of the advice given, and
- how the recommendation provided is suitable for the retail client, including how it meets the client's objectives and personal circumstances with reference to the investment term required, client's knowledge and experience and client's attitude to risk and capacity for loss.

There are also rules surrounding where a periodic review of suitability may be required. This includes, for example, where a client is likely to need to seek advice to bring a portfolio of investments back in line with the original recommended allocation where there is a probability that the portfolio could deviate from the target asset allocation.

5.5.1 Content of a Suitability Report

A formal written report can put the products recommended into the context of the client's circumstances and objectives. There is no single correct way to construct a report, but its likely contents are shown in the following table.

Financial Plan	
Cover page	This covers what the document is, who it is for, when it was prepared and completed (and who by). It may also state the tax year or rates used.
Contents page	This should list the main headings of the document and relevant page numbers of each section to ease reference. It should also include a list of the appendices.
Introduction	A note on the structure and purpose of the plan and how the plan has come about. It should state whether the advice is given on an independent (whole of market) or restricted basis and where the advice being given is on a focused basis only eg, 'You wanted me to only consider your pension arrangements and not address other areas of financial planning'.
Objectives and priorities	A statement of the client's objectives and priorities, indicating which areas the client has asked you to consider and which other areas will be addressed in your next meeting, where relevant.
Assumptions	A statement of the assumptions used in the financial plan, along with justification for those assumptions (where the justifications are lengthy, these may be placed in the appendices).
Attitudes	An explanation of the agreed risk profile and statements regarding the client's attitudes to mortality, morbidity, investment risk and any other relevant attitudinal data.
Assets and liabilities	A summary of the client's assets and liabilities with comments where appropriate.

Financial Plan	
Income and expenditure	A summary of the client's net income and expenditure to establish a net spendable income figure with comments if appropriate.
Recommendations	The suitability report should set out the recommendations and how these meet the client's objectives. Areas chosen for recommendation should have their own section, including: • current position • objectives • assumptions (if not already covered) • recommendations • summary • action points.
Other issues	This states the other areas you have identified, but for which you did not include recommendations. Lists each area and what needs to be addressed and states how, and when, they will be addressed with the client.
Summary of recommendations	This should include a summary of all recommendations made (including costs where relevant) and provide an action plan, summarising all the action points from the various areas of the plan. It should include information on what happens next, who is responsible for completing each action and the timescales for completion.
Reviews	This includes information on the purpose and importance of reviews. Recommends an approach to reviews, including timescales and how, and when, the review will be initiated (ie, you will write to them to let them know how far in advance you will do this).
Appendices	It is important that a financial plan is easily digestible by the client and you should consider placing any information that may break the flow or complicate the main body of the financial plan in the appendices.

If an adviser recommends a product to a client, they need to provide the client with:

- client agreements
- suitability reports
- product information
- key features documents
- illustrations
- key information document (KID)/key investor information document (KIID)
- aggregated costs disclosure
- copy of the fact find, and
- terms and conditions.

It should also include any specific risk warnings.

As well as making investment recommendations, the report may well provide a holistic view of the client's position and will therefore include investment, retirement and protection recommendations. It will also be accompanied by appropriate product quotations, illustrations and brochures.

Appendices

This is a useful section of the financial plan to hold detailed information on which the recommendations are based. It should form a part of the financial plan, however, in case the client wants to know more or needs to see how figures included in the main body of the financial plan have been derived.

Reference should be made in the main body of the financial plan to any information placed in the appendices, so that the client knows where to look for it. The appendices might include things such as:

- the client's full risk profile
- net worth statements
- income and expenditure calculations
- tax calculations
- calculations for specific areas of recommendations
- interview notes
- a client questionnaire, and
- a copy of the fact find so the client can ensure that the information recorded is correct.

If too much information is placed in the appendices, the client may be forever flicking back and forth within the financial plan, and this is likely to break the flow of the plan. However, if too much information is placed in the main body of the financial plan, the client may suffer from 'information overload' and lose interest.

It is also recommended as a matter of good practice that any client data used is included as the basis of the plan in an appendix.

5.5.2 Clear and Understandable Reports

A report can be lengthy and, although there is no right or wrong length, a wealth manager should aim to explain simply and clearly why the recommended solutions are suitable for the client, in light of their:

- financial situation
- knowledge and experience
- investment objectives, and
- attitude to risk both in general terms and to the specific area of need and recommendation.

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 the following points.

Clear and Understandable Reports	
Logical structure	The client will find it much easier to read the report if it follows a logical order and structure.
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 revisit the structure and order of material and whether it is written in a concise style.

Clear and Understandable Reports	
Accessible language	It is essential that reports should be written in language that clients will understand and find easy to read. Most people find it easier to read short sentences and reasonably short paragraphs. They also respond to diagrams and graphs, which help them to understand the recommendations being made.
Attractive layout	The way that a report is laid out helps to make it easier to read and therefore more effective in conveying the relevant information and recommendations to clients.

5.6 Clients and Recommendations

In order to build up client trust, it is vital that the wealth manager is able to clearly summarise the content of any client meeting and what outcomes were agreed, what the adviser will action and what will be confirmed when the actions have taken place. This helps in matching the suitability of the products and/or services recommended to the client's needs and in building the relationship between the adviser and client, as well as helping to avert misunderstandings at future stages, and complements the KYC information held.

The adviser should document the following:

- Introduction, including where the meeting was held and when.
- Confirmation of any current products/plans including their key terms, penalty charges as well as the benefits, current valuation and/or transfer values.
- Client's needs analysis.
- Description of future identified needs if different to current ones.
- Client's risk attitude and capacity for loss.
- Options offered to the client, including benefits and any disadvantages of those options.
- Agreed action plan.
- Illustrations with relevant details of products/services agreed upon, including costs, ongoing charges and key terms.
- Agreed review periods and how the client will be informed/involved.
- Explanation of what can be done if the client changes their mind and any complaints procedure.

When firms and advisers provide advice or personalised information about packaged products to a client, they must provide written details of the key features of the product they are recommending. In addition, advisers need to include a KID or KIID.

The KID or KIID must be a maximum of three sides of A4-sized paper, while remaining easy to read and using characters of a legible point size.

There is some confusion as to whether a product constitutes a PRIIP or not; this can be determined by considering whether it falls within the broad definition of a PRIIP. A PRIIP is a two-in-one definition incorporating packaged retail investment products and insurance-based investment products.

These two components are separately defined as follows:

- **Packaged retail investment product** – an investment where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor.
- **Insurance-based investment product** – an insurance product which offers a maturity or surrender value that is wholly or partially exposed, directly or indirectly, to market fluctuations.

Identifying whether a product is a PRIIP may not always be straightforward due to the potentially wide concept of 'exposure to reference values' mentioned in the first definition above. The understanding in this area is still very opaque and there is ongoing confusion as to what products are defined as PRIIPs. At present, it is best to contact the providers directly and ask them to confirm if they have a KID or KIID and KFD for the recommended product, rather than trying to guess.

Clients have often overlooked the extent or importance of a particular need, and it is then the responsibility of the adviser to point this out, as the professional in this situation. It is not possible to prevent those clients who choose to ignore this, but advisers need to show that they recognised issues, highlighted them to the client and that the client has decided not to take up the recommendations. This all forms part of the details of the ongoing relationship and is evidence of acting in the client's best interests at all times.

5.6.1 Clients Not Proceeding with Advice

Determining why a client does not wish to proceed with an adviser's recommendations is as important as the KYC process and is key to developing and maintaining a long-term relationship of trust.

The process of finding out may not be easy, though, as the client may not wish to disclose the true reason.

It is possible that, as a result of perception or poor press, the client wishes to verify recommendations with a third party or conduct their own research before proceeding. There may have been a sudden change in personal circumstances which caused a delay or stop to the client following a recommendation, eg, a sudden breakdown in a marriage or a death in the family. Another possibility is that either the client or the adviser or both have failed to be clear and there has been a misunderstanding of the client's needs, goals or circumstances.

Ultimately, all that the adviser can do is to try to maintain open lines of communication, without making the client feel pressurised, listen as carefully as possible to what the client is saying and build a relationship of trust. Even if a client seeks advice and then decides they have enough information to approach a product provider direct, if the advice is right, that client is more likely to return to the same adviser in the future, especially if they then wish to take advice on a more complex product or transaction.

5.6.2 Insistent Clients

On occasion, a client who has received advice or a personal recommendation chooses to do something different than what was recommended, which can ultimately lead to poor client outcomes. The issue of insistent clients intensified with the boom in defined benefit transfers, with many advisers reporting an increase in both since the introduction of pension freedoms.

In an effort to increase advisers' confidence in its expectations when dealing with insistent clients, the FCA has issued guidance on how firms can comply with their regulatory obligations.

When proceeding with an insistent client's request, the regulator said firms must make clear '*what element of its advice is being acted against*' and that '*any further advice given is subsequent to the specific action requested by the insistent client*'. It also proposed advisers should produce two separate suitability reports for the advice acted against and any subsequent advice.

FCA Guidance on Dealing with Insistent Clients

Here are the five points the FCA proposed advisers should ensure they meet when dealing with insistent clients:

1. The original advice given complies with the requirements for giving a personal recommendation.
2. They have communicated clearly what their recommendation is and the reasons for their recommendation.
3. They have clearly communicated the risks of the alternative course of action proposed by the client and why they have not recommended it.
4. There is a clear distinction between the advice that is being acted against and any subsequent or concurrent advice. The FCA said this could be achieved through distinct suitability reports.
5. They keep a record of the process they followed and make sure the communication to and from the client makes it clear that the action is against the personal recommendation at the client's request. Best practice would be for a record of the client's intention to proceed against advice to be presented in the client's own words.

The guidance sets out three key steps that advisers must follow:

1. They must provide advice that is suitable for the client, and this advice must be clear as well. This is the normal advice process.
2. They should be clear with the client about the risks of their chosen course of action. If the advice includes a pension transfer, conversion or opt out, there may be additional requirements including having it checked by a pension transfer specialist.
3. It should be clear to the client that their actions are against your advice.

Although there are no rules specifically relating to insistent clients, advisers must follow the normal advice rules first. So, an adviser must obtain the necessary information about the client and their investment objectives, financial situation, and knowledge and experience so as to enable them to make a suitable personal recommendation. They must ascertain the client's investment objectives before making a recommendation. A request or preference by the client for a particular solution – for example accessing cash from a pension – is not an objective. They must ascertain the client's actual investment

objectives so that they can advise on a suitable course of action to meet them. Advisers should also be aware that many PI contracts will no longer cover acting for insistent clients, so care needs to be taken in this regard that the work undertaken is covered by the PI cover.

5.7 Future Reviews

As we have seen, financial planning is a cyclical process with regular reviews of the financial plan.

Ultimately, the objective of each review is to tell the client whether they remain on track to meet their objectives and, if not, what additional actions may be required. The regular reviews may provide an opportunity to consider whether a client's investment portfolio needs to be rebalanced towards a target asset allocation (if applicable). Regulations require that, where an investment firm has an ongoing relationship with the client, it should establish appropriate procedures in order to maintain adequate and updated information about the client.

A financial plan should, generally, be reviewed at least every 12 months, but ad hoc reviews may also be required if, for example, the client experiences a significant change in personal circumstances. The review should look at a range of factors, including:

- reviewing the previous advice in light of any changes to the client's circumstances and revising recommendations where necessary
- changes to goals and the amounts targeted
- reviewing and amending the assumptions used, where relevant, to take account of changing market conditions, investment returns and future inflation rates
- net worth and income and expenditure
- asset allocation and client risk profiles (including rebalancing portfolios)
- suitability of products and product wrappers held and revisiting the risk appetite and capacity for loss of the client
- obtaining any documentation that may be required in the review meeting
- checking existing terms of business documentation, and preparing updated documents, where necessary, and
- summarising the charges of the product, underlying fund costs, transaction costs, and adviser charges applied on an annual basis.

In some cases, significant changes to one or more of the above may require that a new financial plan is drafted; in others, the existing plan may be amended and updated. In either case, it is important that the client continues to fully understand how the financial plan works and how it will help them to meet their objectives.

For financial planning to be effective, it must continually adapt to the circumstances, priorities and aspirations of the client, which are guaranteed to change due to key life events, career changes, increasing age, a growing or diminishing family, changes in health and desires or needs. At each step or point in their life, the client is faced with numerous choices plus some options they may not be aware of. Providing financial advice to a client continues throughout their working life and does not stop even at the point of retirement.

5.8 Fees

Both independent and restricted advice are paid for through agreed remuneration known as 'adviser charging'. Adviser charging can be a flat fee or on an hourly rate. It can also be a percentage based on the total value of assets that the wealth manager is managing on behalf of the client.

If the client decides not to go ahead with the plan, the wealth manager has still sustained costs which the client is expected to cover. Normally, the two parties will agree up front what service will be provided and the costs of each aspect, eg, the financial plan provision and the cost of providing the products/investments.

The wealth manager may also use a platform (ie, an administration system made available by a provider that may have all the relevant products and investments in one place) which may help reduce costs for both the wealth manager and the client.

Once the client has been taken through the plan, they may rethink their priorities and what is important to them as a result of fully understanding the financial impact and costs involved, and it is possible for the plan to be changed.

Outlook for Advice

In its consumer investment data review published in 2021, the FCA suggested that an increase in transactional advice rather than ongoing advice was best for investors. This conclusion was based on research suggesting that many investors were unaware how much they were paying for advice. However, the Personal Finance Society (PFS), a professional body, has called upon financial planning professionals to help it gather evidence to prove the value of ongoing advice.

The conclusion could lead to not only a change in the way the regulator looks at the authorised firms it regulates but also new regulation. Operations that serve smaller investors are likely to be affected the most by any follow-up action from the FCA. In some cases, a way to provide more value will be to lower the advice fees and possibly waive some third-party fees, eg, stock transaction fees.

However, the main downward pressure on fees (on the smaller investor side of the market, at least) may come from the FinTech firms that are developing business models that challenge the traditional wealth managers and their fee structures.

6. Implementing the Solutions

Once the recommendations have been presented and agreed upon by the client, the next critical step is to implement them effectively and accurately. This implementation phase requires careful project management, including execution of all planned activities, and clear communications with the client regarding the next steps and expectations. Timely and accurate implementation according to the agreed plan is crucial to ensuring the plan stays on track and the intended objectives are achieved.

The implementation activities can be broadly categorised into the following areas:

Account opening and transfers

- **Complete all required paperwork and documentation** – this includes account opening forms, transfer forms, and product applications. Ensuring all documents are properly filled out and submitted in a timely manner is critical to avoid delays and ensure a smooth transition. Each form must be reviewed for accuracy, completeness, and compliance with regulatory requirements.
- **Facilitate incoming transfers** – efficiently manage the transfer of cash, securities, and other assets from existing accounts to new accounts. This process involves coordinating with previous institutions to ensure all assets are accurately and promptly transferred. Regular follow-ups and status checks are essential to ensure no assets are misplaced or delayed.
- **Open and fund new investment accounts** – establish new brokerage accounts, managed accounts, retirement accounts, annuities, and other investment accounts. Ensure these accounts are funded as per the agreed plan and ready for immediate use. This step might also involve negotiating with financial institutions to ensure the best terms for the client.
- **Ensure proper ownership titling and beneficiary designations** – establish correct ownership titling, beneficiary designations, and legal structuring such as trusts and entities. This step is crucial to align the ownership structure with the client's estate planning and wealth transfer goals. Proper legal advice may be necessary to ensure all structures are compliant with relevant laws and regulations.
- **Consolidate and close redundant accounts** – identify and close out any redundant or unnecessary accounts to simplify the client's financial landscape and reduce management complexity. This process should include a thorough review of all accounts to ensure no important accounts are closed inadvertently.

Portfolio construction

- **Execute trades for transition** – conduct necessary trades to transition existing holdings into the recommended strategic asset allocation. This involves careful planning to minimise transaction costs and tax implications. Each trade should be evaluated for its impact on the overall portfolio and the client's tax situation.
- **Purchase specific investment products** – acquire the recommended mutual funds, ETFs, individual shares/bonds, alternatives, and other securities. Each purchase should align with the strategic asset allocation and investment strategy agreed upon. Detailed analysis of each product's performance, fees, and alignment with the client's goals is crucial.
- **Rebalance the portfolio** – regularly rebalance the portfolio to maintain target weights for each asset class, ensuring the portfolio remains aligned with the client's risk tolerance and investment objectives. This might involve automated rebalancing systems or periodic reviews and adjustments.
- **Implement tax-efficient strategies** – utilise tax-efficient asset location and positioning strategies to minimise tax liabilities and enhance after-tax returns. This includes placing tax-inefficient assets in tax-advantaged accounts and utilising tax loss harvesting strategies.

Cashflow management

- **Set up systematic withdrawals and deposits** – establish systematic withdrawals, deposits, and transfers to fund the client's income and spending needs from the appropriate accounts. Ensure these transactions are timely and efficient, and adjust as necessary to meet the client's changing needs.

- **Establish income distribution instructions** – determine the amounts, frequencies, and sources of income distributions from investment accounts. This includes setting up regular income streams for retirement or other financial needs. Clear instructions and a reliable system for distributions help prevent any delays or errors.
- **Enhance tax efficiency** – implement strategies to enhance tax efficiency, such as asset location, gain/loss harvesting, and asset withdrawal sequencing. These strategies help in optimising the client's after-tax income and preserving their wealth. Regular reviews of the client's tax situation can identify additional opportunities for tax savings.

Risk management

- **Ensure coverage for recommended insurance policies** – secure the necessary insurance coverage as recommended, including life, disability, long-term care, and property/casualty insurance. Ensure all policies are in place to protect the client's assets and financial well-being. Regularly review insurance needs to ensure adequate coverage as the client's situation changes.
- **Review and update beneficiary designations** – regularly review and update beneficiary designations on retirement accounts, insurance policies, and annuities to reflect any changes in the client's situation or preferences. Ensuring that beneficiary designations are up-to-date helps avoid potential legal disputes and ensures assets are distributed according to the client's wishes.
- **Initiate estate planning updates** – work with the client's solicitor to update wills, trusts, powers of attorney, and other estate planning documents. Ensure these documents are current and aligned with the client's estate planning objectives. Regular reviews of and updates to estate plans help keep them relevant to the client's current circumstances and goals.

Coordination and documentation

- **Engage and coordinate with other professionals** – collaborate with other professionals such as accountants, bankers, discretionary managers, insurance agents, and solicitors to ensure all aspects of the plan are addressed comprehensively. Regular meetings and clear communication channels help ensure all professionals are aligned and working towards the client's goals.
- **Compile and transfer relevant documentation** – gather and transfer all necessary documentation to the respective parties involved in the implementation process. This includes ensuring all stakeholders have the information they need to perform their roles effectively. Secure and organised documentation transfer is essential for maintaining confidentiality and accuracy.
- **Confirm roles, responsibilities and next steps** – clearly define and communicate roles, responsibilities, service standards and next steps for the client and other stakeholders. This ensures everyone is on the same page and understands their contributions to the implementation process. Clear documentation of roles and responsibilities helps prevent misunderstandings and ensures accountability.
- **Maintain detailed documentation** – keep meticulous records of all implementation activities in the client's file. This documentation is essential for future reference and ongoing monitoring of the plan. Detailed records help track progress, identify areas for improvement, and provide a basis for future decisions.

Throughout the implementation phase, the wealth manager should maintain frequent communication with the client, providing clear status updates, ensuring their full understanding of the actions being taken on their behalf, and soliciting any additional information needed.

7. Reviewing Client's Situation

The financial planning process does not end once the recommendations are implemented. Continuous monitoring and periodic reviews are essential to ensure the plan remains aligned with the client's changing circumstances and goals over time.

Key monitoring activities include the following:

Portfolio reviews

- Scheduling regular portfolio reviews (eg, annually).
- Rebalancing the portfolio to maintain target asset allocations as markets move.
- Reviewing asset location, withdrawal strategies, and tax management opportunities.

Risk reassessment

- Proactively reviewing the client's risk profile, capacity for loss, and investment objectives.
- Adjusting the investment strategy if major life events occur (eg, retirement, inheritance).
- Ensuring the implemented solutions remain suitable as situations evolve.

Plan updates

- Revising projections, cash flow plans, and income needs based on actual investment performance.
- Adjusting the financial plan as required for changes in goals, tax laws, government benefits, for example.
- Incorporating any new planning needs that arise (eg, estate, charitable, tax).

Client communications

- Providing ongoing reports on portfolio performance and progress towards goals.
- Proactively communicating any material changes or updates to the client.
- Soliciting updates from the client on their life circumstances.

The frequency and depth of the monitoring process will depend on the complexity of the client's situation, their service preferences, and the agreed engagement standards. However, establishing a formal monitoring schedule with defined review periods is crucial.

Ongoing monitoring helps ensure the original recommendations remain relevant and allows for making adjustments proactively before circumstances drastically change. Comprehensive documentation of all monitoring activities is also essential from a compliance perspective.

Ultimately, initiating periodic reviews in a disciplined manner is vital to keeping the financial plan aligned with the client's best interests over the long term.

Chapter Three

Investment Planning

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Many wealth managers prioritise managing investments over all other activities. Publications tend to focus on reporting investment performance rather than best wealth management practices. However, investment planning is the most critical part of wealth management. Mistakes in this area can severely compromise the entire service, to the detriment of both the wealth manager and clients. A robust investment planning process not only ensures long-term financial health aligned with clients' financial goals but also mitigates risks.

In this chapter, we will start with investment strategy formulation, explore various investment solutions, including funds and discretionary management, detail portfolio construction, consider overseas clients, and cover ethical and sustainable investment, as well as philanthropy.

1. Investment Strategy

After determining a client's objectives and risk profile, and after analysing their current financial position and any constraints, the wealth manager will develop an investment strategy that meets the client's investment objectives and their attitude to risk. This will set out how the client's investment objectives are to be met, taking into account all primary constraints. For example, the client may have an investment objective of growth and the strategy to achieve this may be through a portfolio constructed of a mixture of direct bonds and equities supported by mutual funds for international and sector exposure. The investment strategy will, therefore, set out how the client's objectives will be achieved and what investment solutions will be appropriate and suitable.

1.1 Investment Policy Statement

The investment strategy should be broadly summed up in an investment policy statement (IPS), 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 in which the objectives are to be achieved
- a statement about the client's risk profile – in detail or an outline
- a statement about asset allocation – again in detail or an outline, and
- other issues, such as ethical/responsible/sustainable investment.

An IPS can be thought of as a summary of a client's investment objectives that captures their required returns, risk profile and any constraints that the investment (portfolio) manager will operate under. It sets these out along with the investment strategy that will be used to achieve the client's goals.

An IPS should be unique to the client, but the following table shows some of the essential factors that should be detailed.

Investment Policy Statement	
Investment objectives	• The investment objectives should be set out using a standard wording that has been explained and agreed with the client such as capital growth, wealth preservation or income. • This should spell out the goals of the client that are relevant to managing their investments, such as to generate a steady level of growth until retirement. • It should also detail any specific returns that need to be met such as a certain level of after-tax income.
Risk profile	• The client's agreed risk profile should be set out. • It should also expand on their attitude to risk and capacity for loss. • Views on volatility and drawdown.
Liquidity requirements	• Any requirements for maintaining a certain level of liquidity. • Any need to invest surplus funds or generate funds to top up the client's emergency cash reserve. • Details of known future liabilities that have to be met from the portfolio.
Time horizon	• Factors that will affect the time horizon over which the client is investing such as date of retirement or when liabilities fall due.
Tax position	• Tax position of the client and its impact on investment selection. • Use of any tax wrappers or accounts. • Any considerations that should be applied to establishing taxable capital gains.
Investment strategy	• The investment solution to be adopted to meet the client's objectives such as multi-manager funds or discretionary investment management.

Investment Policy Statement	
Asset allocation	• Should set out all permissible asset classes in which the portfolio may be invested. • A target asset allocation can be set out with the proviso that this may change depending on market factors. • Any constraints on the investment manager's ability to adjust asset allocations.
Constraints	• Any ethical/responsible/sustainable or other constraints that should be followed in construction and management of the investments. • Any restrictions on the inclusion of particular stocks within a portfolio or restrictions on the sale of any holdings.
Benchmark	• The benchmark against which the portfolio performance will be judged.
Any other factors	• Any other factors that may influence investment selection and management, including items such as early retirement considerations and costs of treatment or health care.

2. Investment Solutions

While the IPS sets out the client's risk and return objectives, it is still necessary to select an investment proposition that is appropriate, suitable and capable of achieving the client's goals.

There are a range of potential investment options to choose from that can cater for different types of client, including:

- a preferred fund panel for clients who want execution-only services
- a portfolio of low-cost mutual funds for clients who require a low-cost ongoing service
- a model portfolio service, generally for clients with a higher level of assets and investment experience, and
- discretionary fund management for clients who require bespoke investment management solutions.

There are other options; many fall within the following two types:

1. **Investment funds** – where the client invests in mutual funds or managed solutions such as multi-asset and fund of funds.
2. **Discretionary management** – where a portfolio is managed on behalf of the client by a discretionary investment manager on a model portfolio basis or as a bespoke service.

Wealth management clients are typically affluent and often require personalised services. However, the optimal solutions for them may involve a combination of the aforementioned options.

2.1 Investment Funds

The essential characteristic of this type of investment service is the use of investment funds to achieve a diversified portfolio of assets. These may include mutual funds (open-ended investment companies and unit trusts), closed-ended funds (investment trusts), absolute return funds, hedge funds, **long-term asset funds (LTAF)**, exchange-traded funds and other collective investment vehicles.

In analysing such services, differentiating factors that should be analysed include whether:

- the approach is return-focused or risk-targeted
- it involves management of a portfolio or the use of a multi-manager type solution
- it uses only traditional asset classes or also includes alternative assets
- the level of asset and geographic diversification, and
- whether the management approach is active, passive or a blend of the two.

2.1.1 Return-Focused and Risk-Targeted Funds

Many investment firms run model portfolios of investment funds that are targeted at different investment objectives such as growth, income or a balance between the two. These are regularly monitored and adjusted depending on market movements and fund manager changes. The approach is return-focused and aims to meet or exceed a benchmark target.

Risk-targeted funds are now a well-established part of the UK investment landscape. These funds aim to maximise returns while maintaining a specific, pre-defined level of risk, usually measured by volatility bands or risk ratings. Once a client's risk profile is agreed, an appropriate fund or model portfolio is selected, designed to maintain a suitable combination of asset classes that stays within the agreed risk parameters. The fund's primary objective is to ensure the asset mix continues to match the client's risk profile, rather than simply aiming to outperform a sector average. Many risk-targeted solutions now also incorporate ESG criteria, reflecting evolving client preferences and regulatory expectations.

Both approaches may take subtly different paths to achieving their goals, and it is important to understand the investment style and risk management controls used in order to analyse which approach is suitable for a client.

As a generalisation, the constraints imposed on risk targeted funds can make it difficult for the fund to outperform its benchmark and so significant outperformance should not be expected.

2.1.2 Model Portfolio Services (MPS) and Multi-Manager Funds

An investment firm may construct and manage model portfolios of funds itself or outsource the investment activity. This can be done through Model Portfolio Services (MPS), or by investing in multi-manager funds. These solutions are now widely available both as bespoke discretionary mandates and as standardised offerings via investment platforms.

Model Portfolio Services (MPSs)

MPSs are discretionary portfolios of funds managed to a defined risk/return profile. Clients hold the underlying funds directly while benefiting from professional manager selection, diversification, rebalancing and consolidated reporting under one service. MPSs have typically taken over from fund of funds as the preferred multi-manager solution, largely because they avoid the extra layer of charges in a pooled vehicle, provide greater transparency and can be easily implemented via investment platforms.

Key features of MPSs

- **Discretionary management** – the MPS provider makes investment decisions within a defined mandate, relieving the client or adviser of day-to-day portfolio management.
- **Diversification** – portfolios are spread across multiple underlying funds and asset classes.
- **Rebalancing** – portfolios are regularly adjusted to maintain the target asset allocation.
- **Reporting** – consolidated reporting across all underlying holdings simplifies monitoring and compliance.

Advantages of MPSs

- Access to professional manager selection and multi-asset diversification without additional fund layering.
- Typically lower overall costs than FoFs due to direct ownership of underlying funds.
- Easy to implement via platforms and integrate into client solutions.
- Flexible risk profiling allows advisers to match portfolios to client objectives.

Disadvantages of MPSs

- Less customisation than fully bespoke discretionary portfolios.
- Investment choice is limited to the funds approved by the MPS provider.
- Clients remain exposed to underlying fund charges, even if the MPS layer is cheaper than a FoF.

By contrast, multi-manager funds are pooled structures designed to access the expertise of multiple investment managers within a single fund. The two main approaches are:

1. **Fund of funds (FoFs)** – assets are invested in other collective funds to utilise the expertise of specialist managers in each asset class.
2. **Manager of managers (MoMs) fund** – assets are managed by specialist managers in each asset class on a segregated basis, as mandated by the multi-manager fund manager.

A FoF comprises a portfolio of retail or institutional collective investment schemes which seek to harness what is considered the best investment management talent available within a diversified portfolio. It has one overall manager and it invests in a portfolio of other existing investment funds.

In analysing such funds, it is important to understand whether they are fettered or unfettered:

- **Fettered** – they only invest in funds managed by the same group. Fettered funds claim lower costs, reduced elements of double charging and a deeper understanding of the funds they are investing in.
- **Unfettered** – they may invest in any fund and fund management group they choose. Advocates of unfettered funds argue that they achieve a much wider degree of diversification and therefore potential return.

By contrast, a MoM fund does not invest in other investment schemes. Instead, the fund arranges segregated mandates and appoints fund managers who they believe are the best in their sector to manage each. One disadvantage is that the initial investment required is usually substantially higher than that required for a FoF or other collective investment scheme. Another disadvantage is that it takes time to change an underperforming fund manager, as opposed to a FoF.

When analysing multi-manager funds it is also important to understand the composition of the underlying portfolio. Many funds will invest only in traditional assets, while others will adopt a more multi-asset approach, investing in commodities and hedge funds for example. It is important that advisers understand the component parts of each fund as these could expose investors to different types of risk. The investment style adopted may see active-only funds used, passive-only funds used or a blend of the two.

Equally, it is important to know whether the fund is return focused, and if so, what benchmark it uses or risk targeted and the extent to which this will impact on returns.

FoFs compared to MoM Funds

Compared to fund of funds, MoM funds have the following advantages and drawbacks:

- The fund will have access to institutional managers to whom a retail investor would not normally be able to gain access.
- If a portfolio manager fails to perform, the fund simply needs to replace the individual rather than selling the units and buying another and so can avoid switching costs.
- They can be cheaper than fund of funds, as they can access institutional management, which, due to scale, can offer lower fees than retail management.
- The institutional nature of the segregated mandate can, however, mean that the portfolio is overly diversified, which can turn it into the equivalent, effectively, of an overly expensive index tracker.
- The fund may not be able to access the fund managers it wants as it may not be in the interest of the other firm to allow their manager to be distracted by managing another portfolio.
- Fund of funds can access the investment funds they want, as they are investing directly.
- Although a new fund manager can be appointed, there will be delays due to contracts and notice periods, whereas the fund of funds manager can simply sell and reinvest in another fund.

In both cases, the issue of charges needs to be closely looked at and, in addition, wrapper charges need to be considered, especially pension and life bond wrappers. An investor will pay the MPS provider or multi-manager fund for its investment selection and will implicitly pick up the costs of the underlying funds as well. Whether this is an issue or not will depend upon the performance that the fund produces compared to substitutes.

2.2 Discretionary Investment Management

Private client investment management is undertaken for wealthy individuals by a range of firms specialising in wealth management. It is common for a client to be referred to a private client investment manager by a financial adviser. This may occur within the same firm or be outsourced to a discretionary fund manager. In some cases, the adviser may instead be authorised to provide a discretionary portfolio service.

Discretionary investment management services vary widely and range from model (or managed) portfolios at the lower value end of the market to bespoke portfolios that are tailored to the individual client at the other end. Model portfolios are standardised portfolios designed around a range of investment objectives and risk approaches that can be matched to a client's own objectives and risk profile. Typically, they are constructed of a mix of direct holdings and investment funds and are managed centrally in line with the portfolio's investment objective. They are designed to appeal to a wider audience, but will usually come without the range of services found in bespoke portfolio management.

Bespoke portfolio management is the traditional service offered by private banks, wealth managers, stockbrokers and private client investment managers. This involves constructing and managing a portfolio around the specific needs of a client and can be managed on a discretionary or advisory basis.

Discretionary management is where the client gives discretion to the investment firm to manage their investments on their behalf. A portfolio manager manages the portfolio and makes changes to the portfolio, without referring to the client, but within the constraints of the client's investment objectives and the investment strategy that has been agreed with them. This approach allows for timely decision-making and efficient portfolio rebalancing, which is particularly valuable in volatile markets.

Advisory management is a service offered by investment managers which recognises that some clients do not want to give up the decision making and want to remain actively involved in the management of the portfolio. A portfolio manager will consider what changes might be made to their portfolio and will discuss why those changes are needed with the client who will then decide whether to accept the advice or not.

Bespoke portfolio management will utilise a range of asset types from traditional asset classes to alternatives. ESG investing considerations are now frequently incorporated into bespoke mandates too. The minimum portfolio size for a bespoke service is quite high because of the typically higher charges involved, and is often banded so that the wealthiest investors receive the highest service levels.

Some of the characteristics of bespoke investment management are as follows:

- The investment mandate is agreed with the client with scope for increasing levels of customisation for higher amounts.
- An investment manager will be appointed to manage the portfolio and the client will often have direct access to the investment manager as well as their relationship manager.
- Both traditional and alternative asset classes will be used and existing assets can be incorporated into the portfolio and large holdings managed separately.
- Charges will usually be by negotiation and dependent on the level of service provided.
- Reporting will be sophisticated and detailed with performance reporting and analysis. Digital portals and real-time reporting are increasingly standard.

2.3 Centralised Investment Propositions

Centralised investment propositions (CIPs) are standardised frameworks used by wealth management firms to deliver investment advice and portfolio solutions efficiently and consistently. CIPs can be designed with a degree of flexibility, incorporating access to alternative and private market investments, and the ability to accommodate specific tax, legal and cross-border considerations.

The FCA considers centralised investment propositions (CIPs) to include the following standardised approaches to providing investment advice:

- Portfolio advice services, such as using model portfolios to meet the investment requirements for different risk categories of client.
- Discretionary investment management, either in-house or outsourced, where the adviser has some input into the investment strategy.

One of the thematic reviews published by the FCA deals with replacement business and centralised investment propositions. It recognised that there are benefits to offering a CIP to both the client and the firm, but it contained a clear message from the FCA that a standardised investment approach should not be used as a one-size-fits-all solution.

The regulator found examples of both good and poor practice when it came to offering a CIP solution. Noted in the following table are the factors the regulator requires a firm offering investment services to consider.

Centralised Investment Propositions	
Design and due diligence of a new CIP	• The decision to offer a CIP should take account of the needs and objectives of target clients, whether it is appropriate in light of these needs and objectives and, if so, the type of CIP that should be offered.
Client segmentation	• Where a firm has a diverse client bank, it should consider segmenting its clients and offering a range of CIP solutions to meet the needs and objectives of different client segments. • It may offer different service levels and features to suit clients with different requirements and should inform clients of the services and their costs in a way that is fair, clear and not misleading.
Using third-party solutions	• Conduct adequate due diligence into areas such as terms and conditions, charges, the provider's reputation and financial standing, range of tax wrappers available, type of underlying asset, its flexibility and adaptability to meet individual clients' needs and objectives, and finally how the provider undertakes its own due diligence into the constituent investments. • Where a firm outsources investment selections to a discretionary manager, both the introducing firm and the discretionary management firm have an obligation to ensure that a personal recommendation or a decision to trade is suitable for the client.
Portfolio construction	• Where a firm creates or uses risk-rated portfolios, it must ensure the portfolios align accurately with the risk descriptions and outputs from any risk profiling tool it employs. • Where a firm uses an asset allocation approach in constructing portfolios, it should ensure that it has a robust portfolio review process to mitigate the risk of portfolio drift. • Portfolio drift is where a portfolio is likely to move away from the recommended asset allocation due to different assets providing a different return. This risk can be mitigated by periodically rebalancing a portfolio.

Centralised Investment Propositions	
Individual suitability	• Even when a firm conducts adequate due diligence and designs its CIP to meet the needs and objectives of its target clients, it will not be suitable for all clients. A firm must, therefore, take reasonable steps to ensure a recommendation is suitable.
Competence	• An adviser should be able to identify when a recommendation for a CIP is not suitable for a client and, in such cases, they should recommend an alternative solution or make no recommendation to the client. • A firm must ensure that its advisers are competent and understand the CIP. Advisers need to demonstrate competence in all areas of advice relevant to their role.

Firms are responsible for ensuring that their systems and controls are fit for purpose, and the FCA expects firms to maintain robust systems and controls to mitigate the risk of providing unsuitable advice. This includes having an effective file review process in place which should challenge advisers on suitability matters as well as disclosure and other failings.

Assessing Suitability: Replacement Business and Centralised Investment Propositions

The FCA's finalised guidance on *Assessing Suitability: Replacement Business and Centralised Investment Propositions* (FG12/16), published in July 2012, is essential reading.

3. Portfolio Construction

With a suitable investment solution identified, attention can move to the construction of the portfolio and the asset allocation to be used.

In practical terms, many investment firms will develop a series of model portfolios to meet the investment objectives and risk profile of different types of clients. This therefore splits the process into two activities – determining an asset allocation for model portfolios and deciding which model portfolio is most suitable for the client. The adviser chooses a suitable model portfolio that takes account of the client's time horizon, the acceptable level of loss they can bear financially and their need for income.

The fundamental challenge for any asset allocation strategy is to reach decisions about the inevitable and inherent risks in holding different asset classes and the potential returns that will result from the assets selected. As with all complex decisions involving judgments about risk and reward, there is no single procedure or strategy that provides the single best solution.

A structured asset allocation process can be seen as a series of stages:

- Evaluation of the client's needs and attitude to risk.
- Assumptions about the future expected returns, risk and correlation between asset classes.

- Selecting the combination of assets that best match the investor's objectives and risk profile to give the minimum risk for the expected level of return.
- Establishing a strategic asset allocation policy (SAA) which reflects the optimal mix of assets in the long term.
- Implementing tactical asset allocation (TAA) decisions against the broad guidelines of the SAA policy in the short term.
- Undertaking periodic rebalancing of the portfolio to bring it back into line with the strategic allocation framework taking into account tax and transactions costs.
- From time to time, reviewing the SAA policy to ensure its continued suitability for the client's objectives and risk profile.

3.1 Strategic and Tactical Asset Allocation

At the SAA stage, the portfolio manager decides what proportion of the total portfolio to invest in broad asset categories such as shares, bonds, property and other alternative investments. This will be driven by the client's investment objectives, attitude to risk and time horizon. Subsequently, the portfolio will be rebalanced from time to time to bring the allocation back into line with the SAA.

TAA is about making short-term changes to the portfolio's SAA. It is based on the assumption that relative returns among asset classes will diverge temporarily from equilibrium levels, allowing the opportunity for excess returns.

The objective of TAA is to systematically exploit inefficiencies or temporary imbalances in values among different assets classes. It involves overweighting those asset classes or sub-asset classes that are expected to outperform on a relative basis and underweighting those expected to underperform.

For sophisticated clients, tactical asset allocation may also involve the use of derivatives – such as options and futures – to hedge risk or gain targeted exposure; structured products with defined payoffs to enhance returns or manage downside risk; and overlay strategies, like currency or volatility overlays, to fine-tune portfolio positions without altering the underlying asset mix.

Market timing is an example of TAA. It could involve the proportions of capital invested in any one asset class being set as a band, say, 10–20%. At any time more capital can be allocated to one class to take it to the top of its range while another is reduced to the bottom of its range. These tactical moves away from the mid-points of the permitted range for each asset class may be implemented on a short-term basis.

Increasingly, technology and quantitative models are used to support both SAA and TAA decisions, providing scenario analysis, stress testing and real-time monitoring of portfolio risk.

The following table shows some simple examples of how a portfolio manager may make short-term and tactical adjustments to a portfolio to take advantage of expectations about the near-term outlook for the overall market and specific asset classes.

Tactical Strategies		
	Market Outlook	
	Bullish	Bearish
Fixed Income	Increase exposure to longer **duration** bonds.	Reduce exposure to longer duration bonds and shorten the duration of the portfolio.
Equities	More exposure to higher **beta** stocks.	Reduce exposure to higher beta stocks and moving to more defensive holdings.
Tactical strategies	Where markets are buoyant this could involve adding exposure to emerging markets.	If markets are expected to turn bearish, this could turn to a risk off position involving eliminating the holdings altogether.
Derivatives	Buy **call options** or go long stock futures.	Buy **put options** or go short stock futures.

Implementing TAA strategies is complex and depends on the correct interpretation of financial and economic signals to predict performance and assign relative short-term asset-class weightings. Some examples are shown in the following table:

Tactical Asset Allocation Signals	
'Fed model' signals	• This involves comparing earnings yields to nominal bond yields to determine the relative attractiveness of equities over bonds. • The underlying notion is that stocks and bonds compete for the same investment funds and the higher returning asset class should be overweighted in the portfolio.
Macroeconomic signals	• This involves attempting to time the business cycle by taking advantage of variations in market risk premiums and firms' earnings. • This involves interpreting signals such as the term spread, the credit spread, unexpected inflation and industrial production. Business-cycle variables are typically implemented over intermediate time horizons.
Fundamental signals	• This involves using fundamental valuation metrics, such as dividend yield, book/market ratio, and P/E ratio, to determine the relative valuation of one share to another and take advantage of pricing anomalies.
Momentum signals	• These signals attempt to follow the short-term momentum in markets. Typical momentum signals include technical indicators, earnings growth, and changes in trading volumes, such as if the 50-day moving average crosses the 200-day moving average, giving a buy or sell signal depending on the direction of the lines. • When appropriately combined with fundamental or business-cycle signals, they can produce complementary strategies.

Tactical Asset Allocation Signals	
Sentiment signals	• These signals attempt to add value through a contrarian strategy that looks for extreme levels of sentiment, such as consumer confidence and margin borrowing, to identify deviations from equilibrium returns.

The investment strategy adopted will need to determine whether the asset allocation policy is achieved using active or passive investment management which is considered next.

3.2 Active Management

Active investment management encompasses many different styles and strategies, but the essential aim is to manage a portfolio that will produce returns greater than those of the index against which the portfolio is benchmarked. It uses **fundamental analysis**, **technical analysis** and **macroeconomic analysis** to identify future investment trends and pick attractive markets, sectors and stocks to invest in.

Active investment management strategies seek to outperform a predetermined benchmark over a specified time period or positive absolute returns over all time periods. This is achieved by employing one or more of the analysis methods above to assist in the forecasting of future events, and the timing of purchases and sales of securities.

Actively managed portfolios can be constructed on either a top-down or a bottom-up basis.

3.2.1 Top-Down Investment Management

Top-down active investment management involves a series of stages:

- The first stage is considering the big picture by assessing the prospects for each of the main asset classes within each of the world's major regions against the backdrop of the world economic, political and social environment.
- Once asset allocation has been decided upon, the next step is to consider the prospects for those sectors within the various asset classes. Sector selection decisions are usually made with reference to the weighting each sector assumes within the index against which the performance in that market is to be assessed.
- The final stage of the process is deciding upon which specific securities should be selected within the favoured sectors. A combination of fundamental and technical analysis will typically be used in arriving at the final decision.

The percentage of a portfolio invested in different asset classes will be varied to fit with the objectives and level of risk an investor chooses and so will take account of their time horizon, the acceptable level of loss they can bear financially and their need for income.

Within larger portfolio management organisations, asset allocation and top-down strategy are usually determined on a monthly basis by an asset-allocation committee. The committee draws upon forecasts of risk and return for each asset class and correlations between these returns. It is at this stage of the top-down process that quantitative models are often used, in conjunction with more conventional fundamental analysis, to assist in determining which geographical areas and asset classes are most likely to produce the most attractive risk-adjusted returns, taking full account of the client's mandate.

3.2.2 Bottom-Up Active Management

A bottom-up approach to active management describes one that focuses solely on the unique attractions of individual securities. Although the health and prospects for the world economy and markets in general are taken into account, these are secondary to factors such as whether a particular company is a possible takeover target or is about to launch an innovative product, for instance. A true bottom-up investment fund is characterised by significant tracking error as a result of assuming considerable **active risk**.

3.3 Active Investment Styles

Active portfolio management, whether top-down or bottom-up, employs one of a number of distinctive investment styles when attempting to outperform a predetermined benchmark. Some of the main types are considered below.

3.3.1 Value Investing

Value investing seeks to identify those established companies, usually cyclical in nature, that have been ignored by the market but look set for recovery. The value investor seeks to buy stocks in distressed conditions in the hope that their price will return to reflect their intrinsic value, or net worth.

Managers who adopt a value-investing strategy actively search for the shares of companies that they believe the market has undervalued. Behind the concept is the belief that markets overreact to good and bad news, and this results in share price movements that do not correspond with the long-term fundamentals of the company. These share price movements can provide an opportunity for value funds to buy when the price is deflated and sell when market correction takes place.

This strategy is based on the work of Benjamin Graham and David Dodd. Graham identified a series of tests that are still widely used in value investing. He recommended seven tests to be carried out when stocks are identified for inclusion in a defensive portfolio as described below:

1. **Adequate size** – there can be some risk attributable to the size of a company or enterprise, as a smaller company is generally subject to wider fluctuations in earnings. Graham recommended setting minimum size parameters that should be met, such as annual sales.
2. **Strong financial condition** – a company should have a current ratio of at least two (ie, cash and near-cash should be twice its near-term liabilities), and long-term debt should not exceed working capital in order to provide a strong buffer against the possibility of bankruptcy or default.
3. **Earnings stability** – the company should not have reported a loss over the past ten years, because companies that can maintain at least some level of earnings are, on the whole, more stable.
4. **Dividend record** – a company should have a history of paying dividends on its shares for at least the past 20 years in order to provide some assurance that future dividends are likely to be paid.
5. **Earnings growth** – to help ensure a company's profits keep pace with inflation, net income should have increased by one-third or greater on a per-share basis over the past ten years, using three-year averages at the beginning and end.
6. **Moderate price to earnings ratio** – the current price of a share should not exceed 15 times its average earnings for the past three years to act as a safeguard against overpaying for a security.
7. **Moderate ratio of price to assets** – the current price should not be more than one and a half times the book value of assets.

There are many value funds in the UK and they are widely found and used in client portfolios. They are often used as a component of global equity exposure alongside large cap funds and small cap funds.

A value fund seeks out investments that the market has undervalued and stocks in out-of-favour areas that offer recovery potential. It therefore requires a fund manager to have patience that the strategy will work, as it can take time for a company to turn around or for the rest of the market to recognise that the stock is undervalued. It also means that clients need to understand the strategy being used and that short-term underperformance can arise.

A focus on recovery potential, rather than earnings growth, differentiates value investing from growth investing, as does a belief that individual securities eventually revert to a fundamental or intrinsic value. This is known as reversion to the mean.

3.3.2 Growth Investing

Growth investing is a relatively aggressive investment style. It is a style of investment management that focuses on identifying companies that exhibit potential for above-average growth, even if the share price seems expensive when judged against ratios derived from fundamental analysis. This investment management style therefore ignores key data, such as PE ratios, price-book ratios or high dividend yields that are so important to funds following a value investment strategy.

A growth strategy is exposed to greater risk than a value approach as it is more dependent on judgements about the business, its markets, its management and its ability to extract future earnings growth from the industry it operates in.

True growth stocks are those that are able to differentiate their product or service from their industry peers to command a competitive advantage. This results in an ability to produce high quality and above-average earnings growth, as these earnings can be insulated from the business cycle. A growth stock can also be one that has yet to gain market prominence but has the potential to do so; growth managers are always on the lookout for the next Apple or Tesla, although there are many variations on this approach.

While growth investing might originally have meant identifying companies that could grow steadily into successful big businesses, today it refers to any investment style that aims to produce capital growth rather than income. It also includes investing in recovery shares or in special situations. Many specialist funds, such as those investing in natural resources, technology or infrastructure, are simply specialised growth funds.

3.3.3 Blend Investing

Blend investing combines value and growth approaches. Blend managers seek growth stocks, **value stocks** and stocks that exhibit characteristics of both and therefore offer the potential benefits and risks of both. Growth stocks may provide the potential for returns that exceed the overall returns of the market, but can also be more volatile. Value stocks may outpace the returns of other equity investments in some economic conditions and may also be less volatile.

Although Warren Buffett is regarded as one of the most famous proponents of value investing, he believes that there is little theoretical difference between value and growth strategies. He is famously quoted as saying '*growth and value investing are joined at the hip*', which indicates that a combination of the two strategies is probably a better approach overall. Growth stocks may perform best when the economy is strong, while value stocks have historically tended to perform better when the economy is recovering from a downturn.

As growth and value strategies move in and out of favour over time, the advantage of blend investing is that the managers can emphasise whichever style they believe is performing or will perform better. Nevertheless, the manager still needs to make judgments on the economic cycle and on the potential for the relevant style, which is no easier than any other investment decision. A powerful argument against blend funds is that the most successful individual managers of the past half-century have had one style that they have stuck to through thick and thin.

3.3.4 Income Investing

Income investing aims to identify companies that provide a steady stream of income.

Income investing may focus on mature companies that have reached a certain size and are no longer able to sustain high levels of growth. Instead of retaining earnings to invest for future growth, mature firms tend to pay out retained earnings as dividends as a way to provide a return to their shareholders. High dividend levels are prominent in certain industries such as utility companies.

The driving principle behind this strategy is to identify financially-strong companies with sustainable high dividend yields to receive a steady and predictable stream of income over the long term. As high yields are only worth something if they are sustainable, income investors will also analyse the fundamentals of a company to ensure that the business model of the company can sustain a rising dividend policy.

3.3.5 Absolute Return

An absolute return strategy seeks to make positive returns in all market conditions by employing a wide range of techniques including short selling, futures, options, derivatives, **arbitrage**, leverage and unconventional assets.

Alfred Winslow Jones is credited with forming the first absolute return fund in New York in 1949. More recently, the use of an absolute return approach has expanded dramatically with the growth of hedge funds.

Under UCITS III, onshore-regulated funds have been able to adopt many of the strategies employed by hedge funds. UCITS funds comply with the European directive for retail open ended funds which has standardised rules for the authorisation, supervision, structure and activities of funds.

UCITS-compliant funds have some of the flexibility of hedge funds, but are limited on the types of investment that they can make and the leverage that they can take on. Funds can invest only in certain eligible assets, including quoted securities, money market instruments, deposits, and certain derivatives. They cannot invest in commodities, private equity or real estate, except through index-related products.

The funds are also allowed to leverage using derivatives rather than short selling securities, but total gross exposure is limited to 200% of a fund's net asset value if they use the commitment approach to risk measurement. Sophisticated funds using derivatives for more complex transactions use value at risk (VAR) to measure exposure. The funds must offer a minimum of twice a month redemptions (although most offer daily), but there are provisions to limit redemptions in exceptional circumstances. This requirement for liquidity means that certain hedge fund strategies such as equity long/short are better suited to the UCITS framework than strategies that hold illiquid securities.

3.4 Passive Management

By contrast, passive investment management makes no attempt to distinguish between attractive and unattractive securities, and makes little or no use of the results of research into which markets, sectors and stocks might perform best. Instead, the assets of the portfolio are allocated across the constituents of an index or in a representative sample of the stock contained in an index. **Passive management** will be seen in those collective investment funds that are described as index tracker funds or in ETFs.

Passive investment management is a method that aims to match an investment portfolio with the performance of a broad-based market index. It is often referred to as 'indexing' because it entails investing in exactly the same securities, in the same proportions, as an index. It is considered a passive investment style because portfolio managers do not make decisions about which securities to buy and sell. Instead, they simply copy the index by buying the same securities that are included in a particular stock or bond market index.

This method of investment management is based on the belief that it is impossible to consistently beat the average on a risk-adjusted basis. It therefore seeks to hold a portfolio that mirrors the index it is tracking and involves only sufficient trading to ensure that the portfolio's performance is in line with the index.

Index funds are collective investment schemes designed to track the performance of an index, such as the FTSE 100 or S&P 500. They can be structured as an OEIC or unit trust, but ETF structures are now far more popular. They have grown in popularity because of their simplicity and lower costs. Another factor is concern over actively managed funds that are simply closet trackers. Many supposedly actively managed funds produce returns that are only in line with the market or worse and yet charge higher fees.

Many ETFs are domiciled in jurisdictions, such as Jersey, Dublin or Luxembourg, and so are treated as offshore funds for UK tax purposes. It is important to check that the fund has UK reporting fund status. This is significant because, unless an offshore fund has UK reporting fund status for the entire period that the investor holds it, any gain on that fund will be taxed as income instead of capital gains.

3.4.1 Advantages and Disadvantages of Passive Investing

The advantages of index-tracking funds include:

Advantages	Disadvantages
• Passive investing brings about reduced marketing, distribution and accounting costs, thus lower fees overall. • Passive funds are liquid, so investors can build on their positions or access their funds when needed. • Investing passively is very transparent, as it is always clear which assets are held in the index. • Underlying index constituents are rebalanced frequently, so passive investing results in minimal market trading. • Investors who are able to remain invested for the long term can benefit from higher returns. • A wide variety of indices are available, to suit a broad range of investing styles and risk tolerances. • The structure of ETFs (see below) means they are typically more tax efficient than mutual funds, thus making them popular with tax-sensitive investors at redemption.	• When adjusting portfolios to reflect constituent changes, investors may end up buying (or selling) securities at elevated (or depressed) prices. • Cash drag and internal costs can affect performance relative to the index ('tracking error'). • Investors are unlikely to employ any risk management strategies, such as short-selling or increasing the cash weighting, so they can never outperform the index that they follow. • Passive strategies can be overly concentrated, which can leave money vulnerable to major political and regulatory events. • Indexed portfolios are still exposed to market risk and will likely follow the index down in bear markets. • Buy and sell decisions are based on index constituents, not research. • With full replication, all securities in the tracked index are owned, even those considered to be sub-optimal.

3.4.2 Physical Replication

Traditional indexed portfolios employ one of three established tracking methods:

1. **Full replication** – this requires each constituent of the index being tracked to be held in accordance with its index weighting. Although full replication is accurate, it is also the most expensive of the three methods and therefore is only really suitable for large portfolios.
2. **Stratified sampling** – this requires a representative sample of securities from each sector of the index to be held. Although this method is less expensive, the lack of statistical analysis renders it subjective and potentially encourages biases towards those stocks with the best perceived prospects.
3. **Optimisation** – this costs less than fully replicating the index tracked, but is statistically more complex. Optimisation uses a sophisticated computer modelling technique to find a representative sample of those securities that mimic the broad characteristics of the index tracked.

Physical replication is the traditional form of index replication and is the one favoured by the largest and long-established ETF providers.

3.4.3 Synthetic Replication

Synthetic replication involves the fund manager entering into a **swap** – an over-the-counter (OTC) derivative – with a market counterparty to exchange the returns on the index for a payment. Sampling is still used to identify the optimal range of securities to be included.

This approach passes the tracking error and rebalancing risk to the counterparty, while the ETF generates exactly the performance of the index. It is also generally a lower cost method, which is why such funds have been able to significantly lower annual management fees to the range of 0.15–0.85%.

The advantage of this approach is that responsibility for tracking the index performance is passed on to the swap provider and costs are substantially lower. For markets that are not easily accessible, swap structures have an advantage over physical replication. The downside is that the investor is exposed to counterparty risk, namely that the swap provider fails to meet their obligations.

With synthetic funds, therefore, it is important to understand how counterparty risk is managed and in particular the number of counterparties used and collateral arrangements. Details are becoming increasingly readily available on ETF providers' websites.

Physical and Synthetic ETFs		
	Physical ETFs	**Synthetic ETFs**
Underlying assets	• Securities from the constituent index	• Collateral and swaps
Risks	• Market risk • Counterparty risk if using securities lending	• Market risk • Counterparty risk
Costs	• Management fee • Trading costs	• Management fee • Swap costs
Tracking error	• Level of portfolio optimisation • Treatment of dividends	• Resetting of swap contract terms

3.4.4 Tracking Error

Tracking error is often measured as the difference between a portfolio's return and the return of the benchmark or index it was meant to match. A more technical definition is that it is the **standard deviation** of the difference between the portfolio and benchmark index return.

Passively-managed portfolios seek to replicate index returns and thus minimise tracking error. Index funds are expected to mirror the returns of an index minus the expenses of running the portfolio. These expenses are referred to as the 'management expense ratio'.

A low tracking error means a portfolio is closely following its benchmark, while a high tracking error indicates the opposite. There are a number of reasons why tracking error can occur and it is important to be aware of what the deviation is and the reasons for it.

- Optimisation can result in tracking error because the portfolio is holding fewer stocks than are contained in the index in order to minimise trading costs.
- The timing of cash dividend payments can create a drag on a portfolio's performance. Most indices assume that the receipt and reinvestment of dividends occur earlier than in reality.
- Some indices are more difficult to track than others, for example, bond indices.
- Index funds that track less liquid markets or securities tend to diverge from the underlying securities because of the difficulty in trading these.
- An index fund may have limits on the maximum allocation that can be made to an individual security. If an index is dominated by a number of large stocks, then the fund may be unable to replicate this and may have to adjust for it instead.

Many index fund providers believe that some amount of tracking error is inevitable. Each index fund has different factors that affect the amount of tracking error that occurs, and so it is wise to check reported performance and understand how the portfolio is constructed and how the fund goes about replicating the performance of an index.

3.4.5 Evaluating Index Funds

Stock market indices act as a barometer of what is happening in the market and are also used as the basis for index tracker funds and ETFs. Most index funds are based on **market capitalisation** weighted indices, such as the FTSE 100 or S&P 500, where the largest stocks in the index by market value have the biggest influence on the index's value.

The table below shows some of the factors that an adviser should consider when evaluating the suitability of ETFs.

Assessing Index Funds	
Underlying index	• Components of the index being tracked and any issues in replicating the underlying holdings. • Type of index and whether it tracks the total return or just capital appreciation.
Structure	• Whether physical or synthetic replication is used. • Type of optimisation employed. • How it tracks the index and the level of tracking error. • Counterparty risk for swaps and securities lending and how these are managed. • The quality and quantity of collateral held and the process for marking-to-market and collateral calls. • The use, if any, of leverage or complex tracking strategies.
Tax	• Domicile of the fund and UK reporting fund status.

Assessing Index Funds	
Costs	• Ongoing management charges and level of portfolio transaction costs. • Trading costs including bid-offer spread and brokers' commission.
Dealing	• Level of liquidity for ready dealing in the secondary market. • Level of dealing by authorised participants (market makers) with the fund and any intra-day impact this has on the spread away from the fund's NAV.

It is important to note that bond indices are often constructed in an entirely different way from equity indices and this may have an impact on any index tracker products designed to mirror their performance.

Most bonds are not as liquid as equities, and on moving away from government bonds, liquidity drops dramatically. This lack of frequent trading presents issues for the calculation of bond indices. It means that the index calculation needs to use price estimates in determining index values.

The implication is that funds that track bond indices have to use their own valuation models, which can produce results different from those produced by the index providers. Both are attempting to estimate what is happening in the bond markets, but with imperfect information they can end up with different results. It is therefore essential to understand that an index-tracking fund that seeks to mirror the performance of a bond index, or another asset that is relatively illiquid, may well produce returns that are at **variance** with the index.

3.5 Active versus Passive Debate

A topic of some debate among investors is that relatively few active managers consistently outperform their benchmark indices, despite the high charges they levy; and the contention that those that do outperform are just lucky. Some investors therefore believe that lower-cost passive funds provide a better solution, while supporters of active investing maintain that active investors can produce persistent outperformance through careful analysis and expertise.

Arguments about the merits and shortcomings of active and passive investing began several decades ago. The debate really took hold in 2000, when Jack Bogle wrote his book '*Common Sense about Mutual Funds*[1]'. Here, he argued the investment case for low-cost index funds, on the basis that markets are unbeatable in the long term. The subject remains one of the most divisive issues in the world of investing today.

Notably, the question of which strategy is superior often largely focuses on the US stock market (which is perhaps unsurprising, considering the US is the world's largest market and houses some of the world's most widely held stocks). According to research by the S&P Dow Jones Indices[2], most large-cap equity fund managers have underperformed the S&P 500 for many years. On the other hand, active fixed-income funds have a greater historical tendency to outperform passive strategies in the US compared to active equity funds.

1 Bogle, J.C., 2000. Common sense on mutual funds: New imperatives for the intelligent investor. John Wiley & Sons.
2 S&P Dow Jones Indices, Mid-Year 2025. SPIVA U.S. Scorecard. Retrieved from https://www.spglobal.com/spdji/en/spiva/article/spiva-us/ (Accessed: September 2025)

However, not all markets are the same, with each having a different mix of companies, industries, market capitalisations, among other factors.

Additionally, individual markets can demonstrate different characteristics in distinct time periods. According to Hartford Funds[3], for example, active and passive investing appears to be cyclical in nature, with active strategies tending to outperform passive ones during market corrections, since they are able to capture more upside during a recovery. Arguably, therefore, investors should examine the merits of each investing style on a market-by-market basis, rather than a 'one-size-fits-all' approach.

Outside the US, in both developed and emerging markets, historical data have at times shown that the average active equity manager outperformed their benchmark index, suggesting active strategies may add value in these regions. However, recent SPIVA reports show that majority underperformance has become more prevalent even outside the US. The situation differs for fixed income, where SPIVA consistently finds active bond funds underperform against bond index funds, making passive fixed-income strategies generally preferable over many time frames[4].

In reality, there is no clear right or wrong answer in the active/passive debate. For example, not all passives are cheap, and many active managers have been pressured to reduce fees to remain competitive. Moreover, the expanding range of hybrid strategies, such as smart beta and factor-investing, further complicates the discussion. It is also important to remember that past performance is no indicator of future returns, and, therefore, investment decisions should not be based solely on historical data.

Furthermore, there are growing concerns highlighted by recent research that the rise of passive investing may be distorting market functioning – through increased concentration, return co-movement, and reduced price discovery – which could eventually create risks for passive investors in the long run.

3.6 Combining Active and Passive Management

Having considered both active and passive management, it should be noted that these strategies are not mutually exclusive. Passively and actively managed funds can be combined in what is known as core-satellite management. This is achieved by indexing, say, 70–80% of the portfolio's value (the core) so as to minimise the risk of underperformance, and then fine-tuning this by investing the remainder in a number of specialist actively-managed funds or individual securities (known as the satellites).

The core can also be run on an enhanced index basis, whereby specialist investment management techniques are employed to add value. These include stock lending and anticipating the entry and exit of constituents from the index being tracked.

In addition, indexation and active management can be combined within index tilts. Rather than holding each index constituent in strict accordance with its index weighting, each is marginally overweighted or under-weighted relative to the index based on its perceived prospects.

3 Hartford Funds, 2025. The Cyclical Nature of Active & Passive Investing. Retrieved from https://www.hartfordfunds.com/insights/market-perspectives/equity/cyclical-nature-active-passive-investing.html (Accessed: September 2025)

4 S&P Dow Jones Indices, SPIVA Scorecards, 2025. Retrieved from https://www.spglobal.com/spdji/en/research-insights/spiva/ (Accessed: September 2025)

3.7 Currency Hedging

Exposure to foreign currencies potentially alters the return and risk profile of international investments, meaning that investors, therefore, need to decide whether to retain or to hedge the implicit currency exposure associated with investing abroad.

Sudden market losses can leave a lasting mark on the track record of a portfolio as well as presenting clients with the psychological challenge of either riding out market downturns or switching at the wrong time to more cautious assets. Drawdown in the value of a portfolio can take a considerable time to recover and wealth managers need to use conventional measures such as reducing equity exposure, seeking low volatility exposure and increasing diversification but may also consider the use of **hedging** programmes for appropriate clients.

3.8 Beyond Traditional Asset Classes

Portfolio construction can extend beyond traditional assets to include direct investments, real assets and bespoke structures to enhance diversification, return potential and alignment with client objectives. Direct investments – such as venture capital, private equity or stakes in private companies – may offer attractive returns but are typically illiquid, complex and long term.

Real assets like property, infrastructure and natural resources provide income, inflation protection and low correlation with traditional markets. Co-investments allow investors to access specific opportunities alongside fund managers, often with greater transparency and lower fees.

These approaches require thorough due diligence, clear governance and careful consideration of liquidity, tax and legal factors, especially for cross-border investments.

4. Investment Considerations for Overseas Clients

The UK tax landscape for overseas investors has undergone significant changes following the Autumn Budget 2024. From 6 April 2025, the concept of domicile will no longer be relevant to UK taxation and therefore the remittance basis of taxation for non-UK domiciled individuals has been abolished. It has been replaced by a new residence-based regime for foreign income and gains. This shift has altered investment considerations for overseas clients.

New Residence-Based Regime

Under the new system, an individual's tax liability will be primarily determined by their residence status, as defined by the Statutory Residence Test, covered in chapter 6. The previous distinctions based on domicile are no longer relevant for tax purposes.

Four-Year Foreign Income and Gains (FIG) Regime

A key feature of the new system is the four-year FIG regime for new arrivals to the UK. This allows eligible individuals who opt into the regime to exclude unremitted foreign income and gains (FIG) from UK tax for up to four years after becoming a UK resident. However, it is important to note that those claiming this regime will lose their personal allowances and capital gains tax annual exempt amount.

Inheritance Tax Changes

The Inheritance Tax (IHT) rules have also been modified. New arrivers are not subject to IHT on non-UK assets for the first 10 years after becoming a UK resident. After this, IHT will be chargeable on the taxpayer's worldwide estate. A new 'tail' provision keeps long-term residents within the scope of IHT for a period after leaving the UK. This change emphasises the importance of considering the length of UK residence in long-term financial planning.

Investment Strategies Under the New Regime

- **Offshore investments** – while offshore investments remain relevant, their tax treatment has changed. Income and gains from these investments are taxable in the UK unless covered by the FIG regime.
- **Offshore bonds** – these may still offer tax advantages, particularly for those planning to leave the UK after their FIG regime period ends. However, the benefits need to be reassessed under the new rules.
- **UK investments** – investments in UK assets, including property and shares, are subject to UK tax regardless of residence status.
- **Business investment relief** – investments in unquoted trading companies in the UK through Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), may offer even greater opportunities.

Portfolio Construction Considerations

The new tax regime necessitates a fresh approach to portfolio construction for overseas clients investing in the UK. While the fundamental principles of diversification and risk management remain crucial, the tax implications of investment decisions have shifted:

- **Asset location** – the distinction between UK and non-UK assets remains important, but for different reasons under the new regime.
- **Timing of disposals** – careful planning of when to realise gains or income can still offer tax advantages, particularly for those under the FIG regime.
- **Use of tax-efficient wrappers** – ISAs and pension contributions have become more attractive for overseas investors who are now fully within the UK tax net.

As the implications of the new regime continue to unfold, flexibility and adaptability in investment strategy will be key to navigating the evolving UK tax landscape.

Transitional Arrangements

The transition from the old non-dom regime to the new system has involved complex rules. Investors who were previously non-domiciled should have reviewed their existing structures and investments to ensure compliance with the new regime.

Impact on Global Mobility and Investments

The new tax regime has significantly influenced global mobility decisions for high-net-worth individuals and international executives. The UK's attractiveness as a destination for wealthy individuals has been affected, leading to shifts in global investment patterns.

Several reports published in Q2 2025 by the Financial Times, Bloomberg and others confirm a marked increase in relocations and asset transfers out of the UK, as well as heightened interest in alternative jurisdictions such as Italy, Portugal, Switzerland and the UAE. Private banks and advisers have noted that a significant number of clients are actively reviewing their residency and investment strategies in response to the new rules.

Professional Advice

Wealth managers and tax advisers have had to reassess existing strategies and develop new approaches tailored to the new tax landscape.

The investment landscape for overseas clients in the UK has fundamentally changed. While opportunities for tax-efficient investing still exist, they require careful navigation of the new rules and potentially new investment structures. As the implementation details of the new regime continue to evolve, staying informed and adaptable will be key to effective wealth management for overseas clients in the UK.

5. Ethical, Responsible and Sustainable Considerations

In today's world, many individuals are concerned about the environment, social issues, business practices and ethical issues. As a result, many want to reflect their personal values in the investments they make whether that is avoiding the likes of tobacco and oil shares, supporting environmentally conscious companies or using their funds for impact investing that generate social and environmental impact alongside a financial return. This demand has accelerated in recent years, with responsible investment now a mainstream expectation and regulatory priority. Millennial investors, typically those born in the 1980s and 1990s, are often particularly keen to put their money into companies which make a positive contribution to the environment and society.

Investors who hold core beliefs may require these to be taken into account within the investment advice and portfolio management provided. Ethical, responsible and sustainable investment involves different risks that may need to be assessed – less liquidity, greater concentration of assets and unexpected price volatility. It is important to note that, if it is the client's wish for an ethical, responsible or sustainable approach, this does not override the suitability obligation to ensure the client can financially bear the risk and to assess the client's knowledge and experience to understand the risks.

5.1 Background to Ethical Investment

Ethical investment traces some of its earlier thinking back to the 18th century when Thomas Malthus, in his 1798 book '*An Essay on the Principles of Population*', warned that population growth would outpace the planet's ability to support and sustain human needs. It was also around this time that founder of Methodism, John Wesley, set out the principles of social investing in his sermon '*The Use of Money*', in which he invited his fellow worshippers and investors not to harm their neighbours through their business practices and to avoid certain industries, thus giving rise to early investment exclusions.

In the early 1900s, the Methodist Church decided to start investing (having previously viewed it as a form of gambling), but with the proviso that certain types of companies had to be excluded, specifically those involved in gambling and alcohol. The Quakers followed suit shortly thereafter, seeking instead to avoid weapons manufacture.

5.1.1 Social Issues

The political climate of the 1950s and 1960s saw developments in the modern SRI movement including gender and racial equality, civil rights and labour rights. Dr Martin Luther King established a model for SRI efforts, combining ongoing dialogue with boycotts and direct action targeting specific corporations.

SRI had an important role in ending the apartheid government in South Africa. In 1971, Reverend Leon Sullivan (a board member for General Motors in the US at the time) drafted a stringent code of conduct for practising business in South Africa. These Sullivan Principles, as they became known, emphasised how employees should be treated in terms of equal pay and working conditions, among other matters. As a result, cities, states, colleges, faith-based groups and pension funds throughout the US began divesting from companies operating in South Africa. In 1976, the United Nations (UN) imposed a mandatory arms embargo against South Africa and through to the early 1990s, large institutions avoided investment in South Africa under apartheid. The subsequent negative flow of investment eventually forced a group of businesses, representing 75% of South African employers, to draft a charter calling for an end to apartheid.

While the coronavirus (COVID-19) pandemic is clearly a tragedy on a human level, it has raised social awareness, resulting in increased demand for investments aiming to combat those issues. For example, according to Oxfam, the inequality gap between the world's richest and poorest people widened[5]. Job losses meant many households lost a large proportion (if not all) of their income, pushing millions of people into extreme poverty (ie, they were living on less than $1.90 a day). Conversely, the wealth of the world's ten richest people reportedly doubled.

Further, for some years, the quality of jobs has been at the centre of media attention, with a rise in the number of self-employed workers and those on zero-hours contracts (whereby an employer has no obligation to provide any minimum working hours and workers are not obliged to accept any work offered). While this 'gig economy' (so called as workers get paid for each 'gig' they carry out) provides a more flexible approach to employment, concerns have been raised surrounding workers' legal rights[6]. With individuals desperate for work, an increasing number of people accepted zero-hours contracts and entered the gig economy during the pandemic – internationally, this growth in the gig economy is expected to continue in the years ahead[7], which is raising concerns about violation of employment rights.

5 Oxfam, 2023. Fight Inequality. Retrieved from https://www.oxfam.org.uk/get-involved/campaign-with-oxfam/bridging-inequality-gap-making-things-fair/ (Accessed: March 2023)

6 The World Bank, December 2015. Regulating the Gig Economy. Retrieved from https://www.worldbank.org/en/news/feature/2015/12/22/regulating-the-gig-economy (Accessed: March 2023)

7 Statista, January 2021. Projected gross volume of the gig economy from 2018 to 2023. Retrieved from https://www.statista.com/statistics/1034564/gig-economy-projected-gross-volume/ (Accessed: March 2023)

In 2022, Russia began a large-scale military attack on Ukraine, which further raised awareness of social issues. Russia's actions were condemned by Western governments, who accused it of breaking international law[8] and violating human rights[9]. In response, within a matter of days, a wide-ranging number of unified economic sanctions were imposed[10] – for example: governments banned or began phasing out imports of Russian oil; companies and organisations boycotted Russian products; Russian banks were cut off from Swift (an international payments network used by nearly all banks worldwide); and stock exchanges halted trading in Russia-linked companies and funds. The latter resulted in index providers FTSE Russell and MSCI pulling Russia from their widely-tracked emerging market indices, on the basis that those stocks are 'uninvestable'[11].

However, this response was not universal. Many countries outside the West – including much of Asia, Africa and the Middle East – did not impose sanctions and continued doing business with Russia. These regions account for a significant share of global economic growth and wealth creation. Wealth managers should recognise that client perspectives and responsible investment approaches may vary depending on domicile and international exposure. The Ukraine crisis highlighted how geopolitical events can have immediate impacts on portfolio values, reputational risk and the ethical positioning of investment strategies, while also demonstrating both the power and the limits of collective investor action in response to breaches of international law – as, despite several years of Western measures, the war continues.

5.1.2 Environmental Issues

Environmental awareness came to the forefront in the 1980s, following disasters such as Chernobyl and the Exxon Valdez oil spill. This resulted in investors becoming increasingly focused on a broader range of environmental issues. Importantly, it was around this time that investors began to change their way of thinking, by not only deliberately avoiding companies whose activities were damaging to the environment, but also considering how companies were making a positive impact.

Shortly thereafter, in 1992, the UN Framework Convention on Climate Change (UNFCCC) was created. The UNFCCC brought together over 190 countries with the shared goal of addressing the challenges posed by climate change. It established the annual Conference of the Parties (COP), which has since become the principal forum for international climate negotiations and the development of coordinated policy responses to global warming.

Over the past decade, the COP meetings have played a pivotal role in shaping climate policy and investment practice. The Paris Agreement (also called COP21) was a big step forward in the international fight against climate change due to its wide-reaching scope and the number of signatories involved. Aiming to limit global temperature increases to 1.5°C (and well below 2°C) of preindustrial levels, primarily by reducing greenhouse gas emissions, it is the first ever legally-binding climate change agreement on all countries of the international community.

8 Council on Foreign Relations, February 2022. How Russia's Invasion of Ukraine Violates International Law. Retrieved from https://www.cfr.org/article/how-russias-invasion-ukraine-violates-international-law (Accessed: March 2023)

9 Amnesty International, March 2022. Russia/Ukraine: Invasion of Ukraine is an act of aggression and human rights catastrophe. Retrieved from https://www.amnesty.org/en/latest/news/2022/03/russia-ukraine-invasion-of-ukraine-is-an-act-of-aggression-and-human-rights-catastrophe/ (Accessed: March 2023)

10 Financial Times, March 2022. Russia sanctions list: What the west imposed over the Ukraine invasion. Retrieved from https://www.ft.com/content/6f3ce193-ab7d-4449-ac1b-751d49b1aaf8 (Accessed: March 2023)

11 Bloomberg, March 2022. Russia's 'Uninvestable' Stocks Cut by MSCI, FTSE Russell. Retrieved from https://www.bloomberg.com/news/articles/2022-03-02/msci-pulls-russian-equities-out-of-its-key-emerging-market-index (Accessed: March 2023)

Today, it has been ratified by almost 195 countries in both developed and developing markets[12], representing about 95% of CO_2 emissions. The Paris Agreement also established a framework for countries to submit and update their own climate action plans, known as Nationally Determined Contributions (NDCs), and to report transparently on their progress.

In its Climate Change report of 2021[13], the Intergovernmental Panel on Climate Change (IPCC) projected that 'global surface temperature will continue to increase until at least the mid-century. Global warming of 1.5°C and 2°C will be exceeded during the 21st century unless deep reductions in CO_2 and other greenhouse gas emissions occur in the coming decades'. Climate scientists and activists therefore argue that more needs to be done to tackle climate change[14].

Recent years have seen further momentum. COP26, which took place in Glasgow in 2021, has been described by climate change experts as the most significant climate event since the Paris Agreement. This is because, for the first time since 2015, world leaders had to report back on their progress made on their previous commitments for climate action. Additionally, they had to submit even more ambitious NDCs, for ending their contribution to climate change. So far, governments of over 140 countries have set or are considering net-zero emissions or neutrality targets[15].

The non-uniformity of temperature rises was a key focal point of COP27, which took place in 2022 in Egypt. One of the key outcomes was an agreement by the summit to establish a 'loss and damage' fund, whereby rich nations will provide compensation to vulnerable poorer countries for the losses they face due to climate change[16]. This conference took place months after Russia's invasion of Ukraine, which imposed increased economic strains on all countries. Despite this, the International Monetary Fund (IMF) noted that a timely green transition remains essential for global economic stability[17] as it will put countries in control of their own destiny.

COP28, held in Dubai in 2023, resulted in the Global Renewables and Energy Efficiency Pledge, with 130 countries committing to triple renewable energy capacity and double energy efficiency improvements by 2030. However, the conference was also criticised for limited progress on phasing out fossil fuels and on global carbon pricing. COP29, held in Baku, Azerbaijan in 2024, focused on climate finance and implementing past agreements. Key outcomes included a new $300 billion annual finance target for developing countries by 2035 and progress on operationalising the Loss and Damage Fund. However, no agreement was reached on phasing out fossil fuels.

12 United Nations, 2022. The Paris Agreement. Retrieved from https://www.un.org/en/climatechange/paris-agreement (Accessed: March 2023)

13 IPCC, 2021. Climate Change 2021: The Physical Science Basis. Retrieved from https://www.ipcc.ch/report/ar6/wg1/downloads/report/IPCC_AR6_WGI_Full_Report.pdf (Accessed: March 2023)

14 World Economic Forum, January 2021. 3,000 scientists call for governments and businesses to 'step up' adaptation to climate change. Retrieved from https://www.weforum.org/agenda/2021/01/business-governments-address-climate-change/ (Accessed: March 2023)

15 Energy & Climate Intelligence Unit, 2023. Net Zero Scorecard. Retrieved from https://eciu.net/netzerotracker (Accessed: March 2023)

16 United Nations, November 2022. COP27 Reaches Breakthrough Agreement on New "Loss and Damage" Fund for Vulnerable Countries. Retrieved from https://unfccc.int/news/cop27-reaches-breakthrough-agreement-on-new-loss-and-damage-fund-for-vulnerable-countries (Accessed: March 2023)

17 International Monetary Fund, October 2022. World Economic Outlook. Retrieved from https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022 (Accessed: March 2023)

Climate U-turn in the US and Impact on Financial Services

Following political shifts in the US, a significant climate policy U-turn has occurred. The US first announced withdrawal from the Paris Climate Agreement in 2017, with formal exit in November 2020. It rejoined in 2021 but initiated a second withdrawal in January 2025, effective January 2026, reaffirming its distancing from global climate commitments. Despite this, the US participated actively in COP29 in 2024 but is expected to have a reduced or non-participatory role at COP30 in 2025.

Rising political pressure from Republican-led states has targeted ESG investing, demanding a return to traditional fiduciary duties prioritising financial returns. These pressures led to departures from key climate coalitions: major US banks including JPMorgan, BofA, Goldman Sachs, Citi, Morgan Stanley and Wells Fargo exited the Net-Zero Banking Alliance (NZBA) by mid-2025. US asset managers, such as BlackRock and Vanguard, also left the Net Zero Asset Managers initiative (NZAM).

In contrast, European banks initially maintained stronger commitments to NZBA, though some, such as Barclays, HSBC, UBS and Triodos Bank, have recently reconsidered memberships. Triodos Bank left the NZBA in April 2025 to protest a vote by the alliance to lower its climate ambition, including dropping the mandatory 1.5°C alignment target. European asset managers continue to support NZAM robustly, backed by a supportive regulatory environment and active climate stewardship by asset owners.

To learn more about the UNFCCC's COP meetings, including past conferences and outcomes: https://unfccc.int/process-and-meetings/conferences/past-conferences/past-conferences-overview

5.1.3 ESG versus Ethical Investment

There is a significant difference between ethical investment and ESG investment. The former, typically, uses moral and ethical judgments and negative screening to decide which companies to invest in, but it offers no guarantee of performance. The latter, on the other hand, looks at finding value in companies that do not impact the environment, have a social conscience and are well governed. The theory is that these companies will outperform other companies.

5.2 ESG Approaches

ESG refers to any investment that takes environmental, social, ethical or **governance** issues into account to a significant extent. Examples of these issues are as follows:

- **Environment** – environmental challenges, such as climate change, pollution, biodiversity, environmental management, waste, the use of natural resources, including energy, water, forestry and mining.
- **Social** – issues that relate to people, such as human rights, labour standards, child labour, equal opportunities, food supply, product safety, data security and local community engagement.
- **Governance** – issues relating to company management, such as board structure, executive remuneration, bonuses, avoidance of bribery and corruption, and risk and opportunity control.

In practice, these areas can be subdivided into many issues, with new issues coming forward all the time. The key point to recognise here is that funds focus on different issues and fund managers take different views on issues. Some cover a wide range of issues; others focus on a small number. Some research issues in great detail; others are more high level. Many cluster issues together into themes,

such as 'sustainability' or 'the environment' – as these are areas of increasing importance and interest to both individuals and investors. To complicate matters further, some funds only invest in companies with strong environmental practices, while others avoid companies with poor environmental policies.

In November 2019, the Investment Association issued a Responsible Investment Framework for UK investment funds, which demonstrates the increasing importance of this area. The term 'responsible investment' was selected to reflect the broad range of approaches that can be adopted and provide a common language that can be used to provide greater clarity in time to investors and advisers.

The framework builds on the definitions developed by the Global Sustainable Investment Alliance (GSIA). The Investment Association's Responsible Investment Framework has been widely adopted across the UK fund industry, while the GSIA definitions have become a common international reference point for industry standards.

GSIA Definitions	
Negative/exclusionary screening	The exclusion from a fund or portfolio of certain sectors, companies, or practices based on specific ESG criteria.
Positive/best-in-class screening	Investment in sectors, companies, or projects selected for positive ESG performance relative to industry peers.
Norms-based screening	Screening of investments against minimum standards of business practice based on international norms.
Integration of ESG factors	The deliberate and methodical integration of environmental, social, and governance factors into financial analysis by investment managers.
Sustainability-themed investing	Investment in themes or assets specifically related to sustainability such as clean energy, sustainable agriculture or gender equity.
Impact/community investing	Targeted investments, typically made in private markets, aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose.
Corporate engagement and shareholder action	The use of shareholder power to influence corporate behaviour, including through direct corporate engagement (ie, communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals and proxy voting that is guided by comprehensive ESG guidelines.

The definitions give an indication of the potential range of approaches that funds may adopt. It is important, therefore, to understand the approach adopted by a fund in detail before an adviser can match a suitable fund with the client's expressed objectives. The number of issues a fund considers can have a significant impact on where it might invest but how it deals with those issues has a greater impact on its investment strategy. It is therefore necessary to understand the fund's investment strategy or approach.

There are a range of approaches that can be taken and some of the main ones are noted below:

- **Responsible engagement**
  - This involves using investment ownership to encourage progress on ESG issues where there is a business case for encouraging change.
  - It involves using dialogue, voting and responsible shareholder activism to encourage positive change and to help reduce ESG risk.
  - It can be integrated across a fund manager's entire investment portfolio, particular asset types or used with other SRI approaches.
- **Thematic investment and positive screening strategies**
  - Both of these involve directing investment towards companies that meet a fund's positive ESG objectives such as themes or business attributes it considers to be positive, beneficial or desirable.
  - The impact on investment decisions can vary significantly. Some funds focus on a single sector or issue, others are broad based, some invest in a narrow range of industries, and others invest widely in companies that achieve certain standards.
  - Themed funds, such as environmental funds and sustainability funds, generally have positive approaches of this kind – although some also have areas that they avoid.
- **Avoidance or negative screening**
  - This involves avoiding investments in companies that are involved in activities that a fund manager has defined as 'unacceptable' or 'unethical'.
  - It is a major feature of ethically screened funds.
  - The impact on investment strategy varies – some funds exclude companies with only minor involvement in excluded activities, whereas others are less strict and balance the positive benefits of companies against their negative attributes.

The way in which issues and approaches are combined varies greatly and there is now a wide range of options available to investors. They can, however, be grouped into a number of styles.

- **Responsible engagement** – these are regular funds which employ a range of dialogue and voting-based strategies to encourage better business practices across both institutional and retail investment assets.
- **Sustainability** – these funds focus on the sustainability agenda when considering where to invest. Strategies vary from focus on specific issues to best in sector.
- **Balanced ethical** – these are ethically screened funds that balance the positive and negative aspects of company behaviour across a range of ethical, social and environmental issues. They are likely to combine a number of SRI approaches.
- **Environmentally themed** – these funds integrate environmental opportunities and risks into their investment decisions by focusing on specific themes.
- **Negative ethical** – the primary approach of these funds is the strict avoidance of a range of activities that do not meet more traditional, ethical or values-based standards. These funds tend to explicitly avoid more companies than any other approach.
- **Faith-based** – there is an emerging but very limited group of funds that invest in line with a specific set of religious values. This style has similarities with the more traditional negative ethical options as their core focus is avoidance.
- **Clean technology** – these funds specialise in market leading clean technology and environmental solutions companies. These are thematic funds and do not have ethical screening criteria.

While there are areas of crossover between many of the styles, these reflect the most common fund strategies and also the most common client aims and are a useful starting point for discussion with a client.

The recent period has seen a flurry of new fund launches as asset management firms launch new products to meet potential demand. The FCA has stated that it has encountered applications for the authorisation of investment funds and changes to existing funds' investment objectives that do not contain sufficient and clear information. Some contain claims that do not bear scrutiny, reinforcing the point above that detailed research into the strategy a fund follows is needed. The FCA's letter to asset management firms provides a series of principles that firms are expected to follow and warrants reading as the principles give a useful checklist against which to review the details of a fund's offering[18].

5.2.1 The Rise of ESG

ESG factors were first mentioned in the 2005 study entitled *'Who Cares Wins'*. The Who Cares Wins conference in 2005 first brought together institutional investors, asset managers, buy-side and sell-side research analysts, global consultants and government bodies and regulators to examine the role of ESG value drivers in asset management and financial research.

Gavin Power, Senior Officer, UN Global Compact, Office of the Secretary-General wrote the following foreword to the Who Cares Wins report:

> '*Through the Who Cares Wins initiative, the Global Compact Office – working with partners such as the Swiss Government and International Finance Corporation – has been actively engaging with mainstream financial companies and organisations in an effort to assist in the integration of environmental, social and governance ('ESG') issues in investment analysis, processes and decision-making. The conference convened in Zurich on 25 August 2005 marked an important milestone in this effort, bringing together senior executives from across the financial spectrum. A powerful and historic convergence is clearly under way, between the objectives and concerns of the United Nations and those of the private sector, including – crucially – the financial markets. Peace, security and development go hand-in-hand with prosperity and growing markets. As finance, trade and investment deepen the connections between people and societies, companies and investors are increasingly faced with global – and potentially material – ESG issues. The Global Compact stands ready to support efforts to advance understanding and implementation in this rapidly evolving field*'.

The UN Global Compact, is the world's largest corporate sustainability initiative. It supports companies to:

- do business responsibly by aligning their strategies and operations with ten principles on human rights, labour, environment and anti-corruption, and
- take strategic actions to advance broader societal goals, such as the UN Sustainable Development Goals (SDGs), with an emphasis on collaboration and innovation.

The UN Global Compact Network UK established a working group to support dialogue and best practice on climate-related financial disclosures, originally focused on the TCFD framework. Although the TCFD was disbanded, its recommendations have been integrated into international standards, and TCFD-

18 Financial Conduct Authority, 2021. Guiding principles on the design, delivery and disclosure of ESG and sustainable investment funds. Retrieved from: https://www.fca.org.uk/news/news-stories/guiding-principles-on-design-delivery-disclosure-esg-sustainable-investment-funds (Accessed: July 2025)

aligned disclosures continue to underpin UK and global regulatory requirements (see the ESG Standards section below).

On 17 December 2021, the FCA introduced an ESG sourcebook containing rules and guidance for asset managers and certain FCA-regulated asset owners to make disclosures consistent with the recommendations of the TCFD. Since then, more rules on ESG followed to address, among other issues, greenwashing, a form of marketing used by certain companies to persuade the public that the organisation and their products are environmentally friendly when they are not. We cover all the main rules later in section 5.

5.2.2 Greenwashing

Research[19] shows that investing responsibly, sustainably and ethically can improve investment returns or, at the very least, does not harm them. That is, assuming the companies that individuals choose to support are following the environmental and societal claims they are making.

While many companies have used growing demand for ethical, responsible and sustainable products as an opportunity to improve their environmental and social performance, others have been accused of attempting to capitalise on this demand by simply rebranding themselves. This so-called 'washing' (eg, greenwashing) is becoming increasingly common and more sophisticated as more companies jump on the 'sustainable' bandwagon[20]. As such, it is important for investors to satisfy themselves that a company is as 'good' as it says it is (eg, by analysing its alignment with global/national targets on climate change).

One of the most well-known examples of greenwashing is Volkswagen which, in 2015, made it look like its vehicles' nitrogen oxide emissions were significantly lower than they actually were. Consequently, Volkswagen suffered huge reputational damage, loss of customer trust, and the chief executive was charged with fraud and conspiracy. Further, the company was ordered by the federal judge to pay a $2.8 billion criminal fine[21].

It is not only energy and related companies that have greenwashed. In recent years, meat alternative brand Quorn Foods (regarding its carbon footprint)[22], Nest Labs (the efficiency of its programmable/smart thermostats)[23] and Procter & Gamble (the flushability of its flushable wipes)[24] have been accused of making dubious claims.

19 Edmans, A., 2011. Does the stock market fully value intangibles? Employee satisfaction and equity prices. Journal of Financial economics, 101(3), pp.621-640. https://doi.org/10.1016/j.jfineco.2011.03.021

20 Bloomberg, September 2021. Regulators Intensify ESG Scrutiny as Greenwashing Explodes. Retrieved from https://www.bloomberg.com/news/articles/2021-09-01/regulatory-scrutiny-of-esg-greenwashing-is-intensifying?leadSource=uverify%20wall (Accessed: March 2023)

21 The United States Department of Justice, January 2017. Volkswagen AG Agrees to Plead Guilty and Pay $4.3 Billion in Criminal and Civil Penalties; Six Volkswagen Executives and Employees are Indicted in Connection with Conspiracy to Cheat U.S. Emissions Tests. Retrieved from https://www.justice.gov/opa/pr/volkswagen-ag-agrees-plead-guilty-and-pay-43-billion-criminal-and-civil-penalties-six (Accessed: March 2023)

22 Advertising Standards Agency, September 2020, ASA Ruling on Marlo Foods Ltd t/a Quorn Foods. Retrieved from https://www.asa.org.uk/rulings/marlow-foods-ltd-g20-1061634-marlow-foods-ltd.html (Accessed: March 2023)

23 BBB National Programs, June 2013. https://bbbprograms.org/archive/nad-recommends-nest-labs-modify-discontinue-certain-advertising-claims-for-nest-programmable-thermostats-claims-challenged-by-honeywell

24 The Business Journals, December 2018. P&G settles class-action lawsuit. Retrieved from https://www.bizjournals.com/bizwomen/news/latest-news/2018/12/p-g-settles-class-action-lawsuit.html?page=all (Accessed: March 2023)

What are Signs of Greenwashing?

To avoid greenwashing, investors must carefully and thoroughly evaluate a variety of factors, such as the investment focus, selection criteria and evaluation methodology, before investing.

However, there is a lack of quality research, which makes it difficult (if not impossible) for investors to make informed decisions about the environmental quality of the underlying assets. Additionally, one of the key obstacles is the lack of standardisation as to what constitutes a green investment.

Evaluation criteria vary between businesses. For example, key criteria for a bank would be who they are lending money to and how liberal they are with their lending policies. If a bank is willing to easily extend credit to businesses and organisations whose activities are damaging to the environment, then it may not be the most responsible bank to invest in. In contrast, for companies operating in highly polluting industries (eg, oil exploration), how are they managing their environmental risks? Those with strict policies and procedures in place regarding inspections, investigations and monitoring should be looked upon more favourably by investors.

Other signs indicating that ethical, responsible and sustainable practices are not embedded within the corporate culture include where managers:

- **make questionable claims about the positive impact of their business** – eg, a bicycle manufacturer has a positive impact on the environment as carbon emissions of its products are lower than other modes of transportation), and
- **provide vague information** – eg, they simply claim their product is responsible, sustainable or ethical, but they do not provide any details as to why this is.

Even when a company's products are made from recycled materials, or alternatives to traditional materials, it must be remembered that the supply chain may still have a significant impact on the environment. That said, there is no such thing as a perfect company, so investors have to draw the line somewhere as to what is and is not acceptable to them.

Mitigating the Risk of Greenwashing

Compliance (or lack thereof) with stewardship codes and regulations, as well as alignment with global or national targets on climate change mitigation (and how their outcomes contribute to those targets), serve as a useful tool for evaluating a company's performance towards sustainable development. This can help to identify those that are involved in greenwashing and, in turn, help to prevent the associated risks.

5.2.3 ESG Standards

Businesses that want to be considered for ESG funds and other investment products should assess their current ESG state and plan their impact journey:

- The assessment should include the ESG policies and metrics they need (there are many standards to choose from), data points they need, UN SDGs they can pursue, and a system for tracking progress.
- The plan should include a roadmap to get to the ESG state that their investors and other stakeholders want to see in the future.

The ESG ratings rely heavily on self-reporting by the companies they rate and there are many standards companies can choose from at present. Companies can employ a variety of approaches and data to support their ESG policies and pursue SDGs.

Below are some of the main standards setters that guide sustainability reporting.

Organisation	Description
Task Force on Climate-Related Financial Disclosures (TCFD)	The TCFD was established by the G20 Financial Stability Board in December 2015 to develop recommendations on climate-related financial disclosures for companies. Its framework, comprising 11 recommended disclosures across four core areas – governance, strategy, risk management, and metrics and targets – has been widely adopted to help investors, lenders, and insurers assess and price climate-related risks. Although the TCFD was officially disbanded in late 2023, its recommendations remain highly influential and have been incorporated into international sustainability reporting standards, notably those of the ISSB (below). As a result, TCFD-aligned disclosures continue to underpin regulatory requirements in the UK and globally.
Global Reporting Initiative	The Global Reporting Initiative (GRI) provides reporting guidelines to inform all stakeholders. GRI helps businesses, governments and other organisations understand and communicate their impact. It is an independent international organisation formed in 1997 by the US-based non-profits Ceres and Tellus Institute, with the support of the United Nations Environment Programme (UNEP). It is based in the Netherlands, with seven regional offices around the world. The GRI standards are the most widely adopted worldwide. Most of the Global Fortune 500 companies publish a GRI report.
CDP	The CDP (formally known as Carbon Disclosure Project) is an international non-profit organisation that drives companies and governments to reduce their greenhouse gas emissions, safeguard water resources and protect forests. CDP was inspired by the GRI's concept of environmental disclosure in 2002 but focused from day one on companies rather than nations. Thousands of companies disclose their environmental information through CDP. Investors with over US$130 trillion in assets request companies disclose through CDP on climate change, water security and forests.
IFRS Foundation	The IFRS Foundation develops globally accepted standards through two boards, the International Accounting Standards Board (IASB) and the created International Sustainability Standards Board (ISSB). The latter was established in 2022, merging several existing sustainability standards bodies. The ISSB delivers IFRS Sustainability Disclosure Standards, which set out how a company discloses information about sustainability-related factors that may help or hinder a company in creating value. Its Accounting Standards are required in over 140 jurisdictions. The two boards work closely.

Organisation	Description
B Lab	B Lab is the non-profit network transforming the global economy to benefit all people, communities, and the planet. It began in 2006 in Berwyn, Pennsylvania with the idea that a different kind of economy was not only possible but necessary – and that business could lead the way towards a new, stakeholder-driven model. B Lab awards the B corporation certification (B Corp) to companies that meet high standards of social and environmental performance, accountability, and transparency. The 'B' stands for beneficial. B Corps include brands owned by Unilever, as well as small businesses.

(This list is by no means exhaustive, but aims to outline some of the most important initiatives.)

The Impact Management Project (IMP), supported by the World Economic Forum (WEF), has brought together the organisations above and others to build and further global consensus on how to measure, assess and report impacts on people and the environment. The main contribution of the WEF is around the metrics for **stakeholder capitalism** (as opposed to **shareholder capitalism**). It seeks to improve how companies measure and demonstrate their performance against the ESG factors and track their positive contributions toward the SDGs consistently. The aforementioned TCFD is also involved in the conversations and is a leading developer of recommendations related to climate change.

5.2.4 Sustainable Development Goals (SDGs)

The UN SDGs are a collection of 17 interlinked global goals, adopted by all 193 UN member states in 2015 as a universal call to action to end poverty, protect the planet, and ensure that by 2030 all people enjoy peace and prosperity.

The 17 global goals are:

1. No Poverty.
2. Zero Hunger.
3. Good Health and Well-being.
4. Quality Education.
5. Gender Equality.
6. Clean Water and Sanitation.
7. Affordable and Clean Energy.
8. Decent Work and Economic Growth.
9. Industry, Innovation and Infrastructure.
10. Reduced Inequality.
11. Sustainable Cities and Communities.
12. Responsible Consumption and Production.
13. Climate Action.
14. Life Below Water.
15. Life on Land.
16. Peace and Justice Strong Institutions.
17. Partnerships to Achieve the Goal.

They provide a blueprint that organisations, including businesses of all sizes, can use to implement their ESG policies. A business does not need to pursue them all, but it can choose those relevant to its stakeholders and that the organisation can deliver. Responsible business and investment will be essential to achieving change through the SDGs.

In addition, the SDGs are also entering financial regulation in the UK, the EU and other jurisdictions.

The High-Level Political Forum (HLPF), a UN platform, reviews the progress of the SDGs annually. The UN SDGs Report provides an annual overview of the world's implementation efforts.

The ESG factors are now the building blocks of a sustainable business. They are about the planet and people as well as the durability of the business.

5.2.5 Government Regulation

Some critics argue that voluntary disclosures on environmental performance are ineffective, as firms are not bound by any regulation, nor are they held accountable when they act irresponsibly. Government regulation can therefore play an important role in the prevention of greenwashing.

A wave of regulations aiming to protect consumers against false environmental claims have recently, or are due to, come into force. Examples include the following:

- **The EU** – in 2021, the EU launched the Sustainable Finance Disclosure Regulation (SFDR)[25], which requires certain regulated firms to provide prescript and standardised disclosures on how they integrate ESG factors. Additionally, a new anti-greenwashing law proposal – the Green claims directive – requires companies promoting their products as 'climate neutral' or 'containing recycled materials' to support their green claims with evidence. The EU Commission's proposal has progressed through key stages of the legislative process. The European Parliament adopted its first negotiating position in March 2024, while the Council adopted its general approach in June 2024. Negotiations between the EU institutions are expected to result in a final agreement on the Green Claims Directive by the end of 2024, at the earliest.[26]
- **The UK** – in 2021, the FCA published its final rules (PS21/24) on climate-related disclosures for asset managers, life insurers and FCA-regulated pension providers[27]. The rules require such firms to make mandatory disclosures and reports that are consistent with the TCFD recommendations, with the aim of '*increasing transparency on climate-related risks and opportunities, and enabling consumers to make considered choices*'.
  Further, the UK has launched its own Sustainability Disclosure Requirements (SDR), which is covered in section 5.2.6 below.
- **The US** – the Federal Trade Commission (FTC) finalised its Environmental Marketing Guides (also called the Green Guides) in 2020. The guides include warnings about the use of blanket claims in advertisements and marketing, such as 'environmentally friendly' or 'natural', and the use of third-

25 Eurosif, November 2019. Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN (Accessed: March 2023)

26 Linklaters, June 2024. EU: Council adopts negotiating position on the Green Claims Directive. Retrieved from https://sustainablefutures.linklaters.com/post/102jbcb/eu-council-adopts-negotiating-position-on-the-green-claims-directive (Accessed: December 2024)

27 Financial Conduct Authority, December 2021. Policy Statement PS21/24: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers. Retrieved from https://www.fca.org.uk/publication/policy/ps21-24.pdf (Accessed: March 2023)

party certifications and seals of approval where the terms of qualification are not specified. The FTC can take enforcement action against, as well as fine, any firms making deceptive claims.

- **China** – in 2017, the People's Bank of China (PBOC or PBC) and the China Securities Regulatory Commission (CSRC) introduced new guidelines for green bonds in response to difficulties among foreign investors in Chinese securities regarding a lack of transparency. These guidelines introduced regulatory requirements unique to the Chinese market whereby independent green bond verifiers must confirm a bond's 'green' credentials each year, and a breach of the regulations will be subject to a penalty.

5.2.6 Climate and sustainability disclosure requirements in the UK

The UK regulatory environment for sustainable finance has evolved significantly, introducing robust requirements for climate-related and broader sustainability disclosures.

Climate-related Disclosures

The FCA's Policy Statement PS21/24 (December 2021) – Enhancing climate-related disclosures – serves as a foundational element within the broader Sustainability Disclosure Requirements (SDR) framework (covered next). It requires certain asset managers, life insurers and FCA-regulated pension providers to make regular climate-related disclosures. These requirements were introduced via the new ESG Sourcebook in the FCA Handbook, aligning with the TCFD framework. FCA aims to:

- Help clients and consumers make informed choices.
- Encourage capital allocation toward greener investments.
- Mitigate risk from climate-related exposures.
- Promote competition through improved disclosure.

The policy has been implemented in phases, based on firm size:

- Phase 1 (from 1 January 2022) applies to asset managers with over £50 billion in **assets under management (AUM)** and asset owners (life insurers and FCA-regulated pension providers) with over £25 billion.
- Phase 2 (from 1 January 2023) extends the requirements to firms with over £5 billion AUM or administration, based on a three-year rolling average.
- Firms below the £5 billion threshold are currently exempt, though the FCA has committed to reviewing this exemption around 2025-2026.

Implementation timeline:

- Phase 1 firms were required to publish their first disclosures by 30 June 2023 (covering 2022 data).
- Phase 2 firms must report by 30 June 2024, covering data for 2023.

The new regime mandates annual reports by 30 June covering the previous calendar year:

- **Entity-level climate risk reports** – TCFD-aligned reporting on how the firm addresses climate-related risks and opportunities across governance, strategy, risk management and metrics/targets. These reports must be prominently displayed on the firm's website.

- **Product/portfolio-level disclosures** – climate-related information aligned with TCFD metrics, such as Scope 1, 2, 3 greenhouse gas emissions, total emissions, carbon footprint and weighted average carbon intensity, for each relevant product or portfolio. Disclosures must be accessible publicly or provided on request to eligible clients.

It is acceptable to use proxies or assumptions where data gaps exist. However, firms must explain limitations and outline steps to improve data quality. Cross-referencing is permissible, eg, where firms are part of a group or delegate to third-party managers, provided deviations are explained and client access is facilitated.

Implications for wealth managers:

- **Due diligence & product selection** – advisers need to review both entity- and product-level climate disclosures to assess suitability alongside financial metrics.
- **Client communication** – climate disclosures support informed conversations with clients on risk, ESG preferences and transition readiness.
- **Reporting & monitoring** – firms must monitor evolving regulatory expectations and refine data, processes and disclosures over time.
- **ESG integration** – this requirement complements other ESG rules, such as SDR, forming part of a comprehensive sustainability framework.

S21/24 complements the upcoming UK Sustainability Reporting Standards (UK SRS).

The SDR and Investment Labels

The FCA has introduced comprehensive rules and guidance to facilitate the flow of sustainability information between companies, consumers, investors and capital markets as part of the UK government's Sustainability Disclosure Requirements (SDR) framework. This regime represents a major step in the UK's regulatory approach to sustainable finance and ensures that all investors have access to clear, accurate and comparable information about the sustainability profile of their investments. This is to build trust and transparency in the sustainable investment market while supporting the UK's transition to a net zero economy. The SDR was finalised in late 2023 and early 2024, with phased implementation beginning in 2024 and continuing into 2025.

The SDR introduces several key measures:

- **Anti-greenwashing rule** – all FCA-authorised firms must ensure that any sustainability-related claims are fair, clear and not misleading. This rule applies to all communications, including marketing and product documentation. The FCA is also consulting on additional guidance to help firms interpret and comply with this rule.
- **Naming and marketing rules** – investment products must use sustainability-related terms accurately in their names and marketing materials. This is designed to prevent the misuse of terms such as 'green', 'ESG' or 'sustainable' unless the product genuinely meets the relevant criteria.
- **Investment product labels** – four distinct labels have been introduced to help consumers navigate the investment product landscape and enhance trust:
  - **Sustainability focus** – for products investing mainly in assets that meet a credible standard of sustainability.
  - **Sustainability improvers** – for products aiming to improve the sustainability profile of their underlying assets over time.

    - **Sustainability impact** – for products that target measurable positive social or environmental outcomes.
    - **Sustainability mixed goals** – for products combining two or more of the above objectives.
- **Consumer-facing information** – firms must provide consumers with clear, accessible information to help them understand the key sustainability features of a product. This includes a summary of the product's sustainability objective, approach and performance against relevant metrics.
- **Detailed disclosures for institutional investors and interested consumers** – more comprehensive information is required in pre-contractual documents, ongoing product-level reports and entity-level disclosures. These disclosures cover methodologies, data sources, governance, risk management and progress towards sustainability goals.
- **Requirements for distributors** – distributors, such as platforms and advisers, must ensure that product-level information, including the sustainability labels, is made available to consumers, supporting informed decision-making.

For wealth managers, SDR has direct implications for client interactions and suitability assessments:

- **Understanding client preferences** – wealth managers are expected to identify and record clients' sustainability preferences during fact-finding. While explicit suitability rules are pending, the FCA advises firms to refine processes to accurately capture these preferences.
- **Product selection** – wealth managers should use SDR-compliant disclosures and fund labels to match clients with products aligning to their stated sustainability objectives and risk tolerance.
- **Ongoing communication** – although SDR focuses primarily on product disclosures, the FCA's anti-greenwashing rule (in effect from 31 May 2024) requires firms to ensure sustainability claims remain clear, fair, and not misleading over time.
- **Managing risk** – clear sustainability disclosure helps protect clients from greenwashing, a key FCA focus, supporting informed recommendations based on robust, reliable data.

Comparison of the EU SFDR and UK SDR

The EU Sustainable Finance Disclosure Regulation (SFDR) and the UK Sustainability Disclosure Requirements (SDR) both aim to increase transparency and reduce greenwashing in sustainable investing, but they differ in approach and detail. SFDR, which applies across the EU, classifies investment products into Articles 6, 8, or 9 based on their sustainability characteristics and requires both entity- and product-level disclosures, closely linked to the EU Taxonomy. In contrast, the UK SDR introduces its own set of rules, including four specific product labels and an anti-greenwashing requirement, with a strong focus on clear, consumer-facing information. While both frameworks require firms to disclose how ESG factors are integrated into investment processes, firms operating in both jurisdictions must manage two distinct sets of requirements, reflecting the UK's and EU's evolving but separate regulatory priorities[28].

The UK SRS

The UK Sustainability Reporting Standards (SRS) are a new core component of the UK's Sustainability Disclosure Requirements (SDR) framework. These standards are designed to align with those set by the International Sustainability Standards Board (ISSB), specifically IFRS S1 (general sustainability) and IFRS S2 (climate). The objective is to provide high-quality, comparable sustainability information that meets the needs of investors and other stakeholders.

28 Norton Rose Fulbright, May 2024. The EU SFDR and UK SDR examined. Retrieved from: https://www.nortonrosefulbright.com/en/knowledge/publications/2fd487aa/the-eu-sfdr-and-uk-sdr-examined (Accessed: July 2024)

The UK government is expected to publish the first set of endorsed UK SRS in the first quarter of 2025, following a period of public consultation. After the standards are adopted, the Financial Conduct Authority (FCA) will consult on proposals to require UK-listed companies to report in line with the UK SRS.

While the primary focus is on corporate reporting, the introduction of the UK SRS will also benefit wealth managers. Enhanced quality and consistency of sustainability data will support more robust investment analysis, facilitate informed product selection, and improve the transparency of client reporting.

How they work together

While PS21/24, SDR and the UK SRS each address different aspects of sustainability disclosure, together they form a comprehensive and complementary regime. PS21/24 ensures that asset managers and providers report on climate-related risks and opportunities in line with TCFD recommendations. PS23/16 expands this approach to all aspects of ESG, introducing anti-greenwashing measures, product labelling and enhanced consumer disclosures. The UK SRS, meanwhile, sets a consistent national standard for corporate sustainability reporting, aligned with international best practice. This flow of reliable information – from corporates to investment managers to end-investors – supports robust investment analysis, informed product selection and greater transparency for clients, reinforcing the UK's position as a leader in sustainable finance.

The table below summarises the main disclosure requirements within the UK's Sustainability Disclosure Requirements (SDR) regime:

Requirement	Focus	Applies to	Key Features	Implementation
PS21/24	Climate-related disclosures (TCFD)	Asset managers, insurers, pensions	Entity & product-level TCFD-aligned disclosures	2022–2023 (phased)
PS23/16 (SDR)	Sustainability disclosures (all ESG factors not just climate)	All FCA firms, product providers	Anti-greenwashing, labels, consumer disclosures	2024–2025 (phased)
UK SRS	Corporate sustainability reporting	UK-listed companies (initially)	ISSB-aligned, high-quality, comparable sustainability data	2025 (expected)

5.2.7 ESG Ratings

ESG ratings measure a company's exposure to long-term ESG risks. There are multiple ESG rating providers, with MSCI and Sustainalytics being recognised as major players due to their extensive coverage. In addition, Bloomberg and Refinitiv are notable providers in this space. Furthermore, credit ratings agencies such as Moody's, S&P, and Fitch also offer ESG ratings. MSCI ESG Ratings aim to assess a company's management of financially relevant ESG risks and opportunities.

They utilise a rules-based methodology to identify industry leaders and laggards based on their exposure to ESG risks and their ability to effectively manage those risks compared to their peers. MSCI ESG Ratings range from leader (AAA, AA), average (A, BBB, BB), to laggard (B, CCC).

Critics state that large and high-profile companies in the financial services sector worldwide have used greenwashing to promote ratings, indices, funds and other investment products, which have little connection with ESG issues. In fact, even a superficial analysis would show that their impact is irrelevant, at best. Arguably, the core problem is that the ratings used do not measure a company's impact on the planet or people. They do the opposite – they measure the potential impact of the world on the company and its shareholders. This would explain why, for example, most of the companies in the S&P 500 are in ESG funds. These include businesses that are anything but clean.

ESG ratings are different from credit ratings. Credit ratings from different agencies are similar – they are based on the same financial data and measure the same risk that a company will default on its debt and credit agencies are regulated.

On the other hand, ESG ratings of one provider can be very different from the ratings of another. ESG-rating providers use their own proprietary methods. As such, they are not very transparent and rely heavily on self-reporting by the companies they rate. No regulator authorises the method or the ratings. The company's CO2 emissions, the most important cause of climate change, may not even be considered in an ESG rating if it is not considered a risk to the company's profitability.

In addition, conflicts of interest may affect the validity of ESG ratings. Recent research led by the University of Hong Kong suggests that ESG rating providers tend to give higher ESG ratings to firms owned by the same shareholders who own the rater, and that this is more pronounced when a large institutional investor owns the rating providers. Despite this, firms were predicted to have more future negative ESG incidents.

Regulation for ESG Ratings

In 2024, the EU introduced the first-ever set of rules for ESG ratings agencies. This regulation aims to boost transparency and investor confidence in the ESG ratings market.

ESG ratings providers operating in the EU will need:

- Authorisation from the European Securities and Markets Authority (ESMA).
- Enhanced disclosures for methodologies, rating assumptions and weighting of factors.
- Provision of separate ratings for environmental, social and governance factors, in addition to aggregated ESG ratings.
- Separation of business from certain other activities for the prevention and management of conflicts of interests.

Temporary Regime for Smaller Providers

Smaller ESG raters in the EU can opt into a temporary lighter regime for the first three years, subject to general governance principles and ESMA oversight, benefiting from reduced fees.

The UK plans to introduce legislative steps to regulate ESG ratings later this year, and these steps are expected to be similar to the EU regulation.

5.2.7 Small and Medium-Sized Enterprises (SMEs)

These sustainability initiatives are increasingly being adopted by regulators worldwide, primarily with larger companies and asset managers in mind. However, it is expected that they will eventually also reach small and medium-sized companies (SMEs) due to supply chain dynamics.

For example, an increasing number of companies are adopting the standards put forth by the Greenhouse Gas Protocol (GHGP), a partnership between the World Resources Institute (WRI) and the Business Council for Sustainable Development (WBCSD).

The GHGP divides emissions into three Scopes:

- **Scope 1** – direct emissions from owned or controlled sources.
- **Scope 2** – indirect emissions from the generation of purchased energy.
- **Scope 3** – all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company.

SMEs make up around 90% of businesses worldwide. Many of them are part of the supply chains of larger corporations and, therefore, more and more of them will be hit by Scope 3.

5.2.8 Faith-based Investment

Traditionally, ethical investment options have centred around avoiding investments in companies involved in activities such as tobacco, gambling, or weapons manufacturing. These negative screens reflect a desire to steer clear of industries that conflict with certain moral or ethical beliefs. The emerging faith-based funds take this concept a step further by incorporating specific religious values into their investment criteria. The emergence of religiously aligned funds highlights the increasing importance of values-driven investing. It demonstrates that investors are no longer solely concerned with financial returns but also with the ethical and moral implications of their investment decisions. By aligning their portfolios with their religious values, individuals can feel a sense of purpose and integrity in their financial endeavours.

A 2022 report by The Oxford Faith-Aligned Impact Finance Project (OxFAIF) mapped 360 organisations globally, revealing a total net asset value of approximately $5 trillion. Islamic investment surpasses other religious groups, with $3 trillion in sovereign capital and $1 trillion in private finance. Christian, Dharmic, and Jewish capital amounts to $260 billion, $300 billion, and $16 billion, respectively. These findings highlight the potential of faith-aligned investing in advancing sustainable development goals.

Islamic capital constitutes a significant portion of faith-aligned capital due to the prohibition of interest and avoidance of industries like gambling, alcohol, and arms trade. Sophia Shepodd Innocenti established the Global Islamic Impact Investing Forum to help Muslim investors align their investments with their faith. Innocenti believes that by auditing and modelling Sharia-compliant investments appropriately, it is possible to match Muslim investors with investments that support the UN's SDGs. She realised that the majority of Sharia-compliant investing could contribute to these goals if approached correctly.

In the UK, despite a decline in the number of believers, Christianity remains the dominant religion in the UK. However, the availability of Christianity-influenced investment products is limited. The Church

of England is a significant player in the UK, managing a £10 billion endowment fund through its church commissioners. Recently, there has been movement in the UK Christian investment space with the launch of a new range of funds by Epworth Investment Management in collaboration with Canaccord Genuity Wealth Management. These funds aim to meet the rising demand from investors who want to align their investments with Christian ethics.

The UK stands out as the primary hub for Islamic finance in the Western world, offering extensive professional services and education for the global industry. With strengths in **Sukuk** listing and Islamic Fintech, the UK ranks 27th worldwide in Islamic finance development. The report, supported by LSEG's participation in the UK's Islamic finance committees, highlights the regulatory landscape, performance across major segments, and innovative advancements, emphasising the UK's vital position within the global Islamic finance ecosystem.

Faith-based investing and ESG investing diverge in their approaches and motivations. Faith-based investing is guided by religious beliefs, imposing restrictions on investments based on moral and ethical principles. Investors prioritise companies aligned with their faith, avoiding those engaged in activities conflicting with their beliefs, such as alcohol, tobacco, and predatory lending. On the other hand, ESG investing takes a broader view, considering environmental, social, and governance factors that can impact long-term financial performance. It aims to evaluate companies based on their sustainability practices, climate impact, labour relations, and more.

As the faith-based investment trend continues to gain traction, it is likely that we will witness the expansion of religiously aligned investment options. Investors who prioritise their faith alongside financial growth will have an increasing array of funds to choose from, allowing them to make investments decisions that resonate with their faith. By aligning their investment portfolios with their religious values, investors can achieve a greater sense of purpose, integrity, and fulfilment in their financial endeavours, knowing that their money is being deployed in accordance with their deeply held convictions.

5.3 Assessing a Client's Ethical Considerations

As part of the fact-find process, a client's ethical considerations will be highlighted and it is important to probe further and explore what they require in more detail.

An adviser should aim to understand:

- the client's areas of concern which will indicate the main investment themes that may be suitable or those that need to be avoided, and
- the level of concern and degree of commitment that the client has to the issues which will indicate the proportion of funds that may be allocated to this area and the extent to which such factors should be considered in the context of pure investment issues of risk and return.

It is important, therefore, for advisers to have a basic high-level understanding of key social, environmental and ethical issues likely to be of concern to some clients and be able to provide guidance to clients to identify potential solutions.

Having identified the key social, environmental and ethical issues that are of concern to a client, the next step is to identify an investment or fund that will best suit the client's needs and wishes and which are consistent with their attitude to risk.

5.4 Investment Performance

The risk and return mix of an ESG fund will differ depending upon its approach and the investment strategy it adopts.

A common misconception with this type of investing is that it will involve accepting lower investment returns compared to mainstream investments. EIRIS has undertaken research which shows that ethical investing need not necessarily involve accepting lower performance. Several of their studies undertaken over the last decade or so have indicated that investing according to ethical criteria may make little difference to overall financial performance, depending on the ethical policy applied: five ethical indices created by EIRIS produced financial returns roughly equivalent to the returns from the FTSE All-Share Index.

It is important to note that it is not performance that is the most important factor here, but whether the portfolio is suitable for the needs of the client. Hence, with regards to performance, the investment manager should discuss with the client an ethically constructed benchmark to be judged against.

A conventional fund and an ethical fund may both be compared to the same index, such as the FTSE All-Share Index. A conventional fund has many companies to choose from that satisfy its investment objectives, whereas an ethical fund can be restricted somewhat by negative screening. As a result, some ethical funds may underperform the benchmark against which they have been measured. This has led to the development of a number of ethical indices. Some believe that these indices represent a more appropriate benchmark for an ethical fund, while others believe ethical funds should continue to be compared with mainstream indices to dispel ideas of underperformance.

There is a range of ethical indices that can be used to track performance, including the following:

- **FTSE4Good** indices were launched in 2001 with the help of EIRIS. They have been designed to measure the performance of companies that meet globally recognised corporate responsibility standards, and to facilitate investment in those companies. The series includes four tradable and five benchmark indices, representing global, European, US, Japan and UK markets.
- **Dow Jones Sustainability Indices** track the financial performance of the leading sustainability-driven companies worldwide and provide asset managers with reliable and objective benchmarks to manage sustainability portfolios.
- The **FTSE KLD 400 Social Index** is modelled on the S&P 500 Index screened for environmental, social and governance factors and is a widely recognised benchmark for measuring the impact of social and environmental screening on investment portfolios.
- The **MSCI Low Carbon Index** family is part of the UN PDC project and has created a number of global equity indices based on the main market-cap indices. MSCI say the indices help identify potential risks associated with the transition to a low carbon economy while representing the performance of the broad equity market. The first benchmarks are designed to address carbon emissions and fossil fuel reserves.

6. Philanthropy and Impact Investing

Philosophically, philanthropy is a form of investing that lies at an extreme beyond impact investing, as philanthropists expect to see no financial return from their investment or donation (or, should they decide to give away their wealth, to even receive back their initial stake). It is the donating of money, goods, services, time and effort to support a socially beneficial cause. It is a major source of funding for medical research, humanitarian aid as well as for arts and education. This can range from simply giving money and time to a more strategic approach to managing and achieving an individual or family's philanthropic goals.

In the past few years, there have been remarkable, positive developments in British philanthropy, with new ways of giving matched by a growing infrastructure of advisers to help individuals give more effectively. These trends are driven in part by the significant growth in wealth among the richest, as well as the growing number of self-made millionaires.

Wealth managers need to be in a position to be able to effectively support the philanthropic aims of their clients to meet this growing need. The support most commonly provided by professional advisers includes setting up a charitable trust, advising on tax benefits, introducing clients to other philanthropist clients, and connecting donors to charities they might support.

Wealth managers need to go beyond discussing purely technical legal and tax issues to discussing the client's personal motivations and goals and providing a structured approach. Helping clients achieve their philanthropic aims involves agreeing with the client what their philanthropic interests and goals are, determining the most appropriate structure to carry this out and then, if appropriate, managing a philanthropic portfolio.

In agreeing with a client as to what their philanthropic interests and goals are, the wealth manager needs to establish some of the following factors as they will influence what is the most appropriate structure to utilise:

- What the client wants to achieve from their philanthropic activity.
- The type of activity they want to support and the number of organisations they may wish to contribute to.
- Whether they wish to provide donations only or have direct involvement in the charities and causes they wish to support.
- How they wish to measure the effectiveness of their contributions.
- Whether they wish to provide donations directly or establish a charitable trust.
- What estate planning arrangements (if any) they wish to provide for in their wills.

Having determined what the client is attempting to achieve, the wealth manager can then turn to identifying the most appropriate way in which the gifts can be made. This may simply involve identifying suitable charities and causes and making donations directly to them or, for wealthier clients, creating a charitable trust that will manage a portfolio of investments and manage the ongoing donations from the income or gains generated.

Having decided on an appropriate method or structure to facilitate donations, the final stage is to implement a strategy for the management and evaluation of contributions. This may go beyond traditional investment management to identifying specialist advisers in the fields the client wishes to benefit from.

There are a growing range of philanthropy services being offered by professional advisers to encourage wealthy individuals to develop their own charitable giving. There is also a growing range of sources of information aimed at connecting wealthy individuals with charitable causes, such as the Institute for Philanthropy and Philanthropy UK. As with all financial transactions, donations should be carried out with correct tax planning so as to avoid unexpected tax charges arising, and to offset the client's tax liability wherever possible within the confines of the law, spirit of HMRC guidelines and best practice.

6.1 Mixed Motive Funds

Charitable investment generally falls into one of two categories:

1. A 'normal' financial investment that seeks to generate the best possible return for an acceptable level of risk, but may conflict with the charity's charitable purposes.
2. Investments that seek to further the charity's objectives but may not deliver a market-rate financial return.

Both are accepted methods of investment as long as they are undertaken for the charity's best interests.

Where a charity's investment cannot be wholly justified as either one of these two categories, it may be possible to justify it as a 'mixed motive' (also called 'mixed purpose') investment – in other words, it does not provide a sufficient investment return, nor does it contribute sufficiently to the charity's purposes. An example is a charity that wishes to invest in a property, in part for the investment returns received, and in part to allow a third party that is contributing to the charity's aims to use the property.

This is a relatively new area for philanthropy. The mixed motive funds can pool and diversify their non-profit capital investments through the fund, which are normally illiquid. This may present a more liquid and easier way to invest across a range of good causes without the need to make direct investments. There may also be tax advantages, but caution is required. However, it delegates the decision-making process to the fund, it may make risk assessment of individual investments more difficult, and there may also be liquidity risks if other investors suddenly attempt to withdraw.

Further information can be found at: www.thinknpc.org

6.2 Impact Investing

Impact investing refers to investment in companies to generate a positive environmental or social impact alongside a financial return. That is not to say that impact investors will not expect a decent financial return, but they are prepared to consider the positive or beneficial impact of their investment as part of their overall 'return' (ie, they consider both financial and non-financial benefits).

The core characteristics of impact investing include:

- the intention to have a positive social or environmental impact through investments
- impact investments are expected to generate a financial return on capital, and
- investments target returns that range from a risk-adjusted market rate to below market returns (sometimes called concessionary return impact investing).

An example of the first approach would be a private equity investment in a worthy cause that aims to provide a typical return on capital. The second approach requires the investor to accept a smaller than normal return on capital, for example, a return of 5% from a debt security rather than the market rate of 10% where the funds are used for education in a developing market.

According to a report published at the end of 2022 by Philanthropy Impact (a charity that incorporates Philanthropy UK and others), the government plays a crucial role in enabling, incentivising, and supporting philanthropy and social investment.

There are a number of highlights particularly relevant for financial advisers:

- Financial advisers have a crucial role in supporting clients with philanthropy and social investment. Particularly for wealthier clients, advisers can drive significant transformation for those transitioning from regular to major donors.
- The Charity Commission intends to update its investment guidance following a recent High Court ruling supporting trustees investing endowments in line with charitable purposes. This will necessitate financial advisory support for trustees of endowed foundations.
- The absence of a legal requirement for UK advisers to align client investments with their social and financial goals diminishes their motivation to develop expertise in this area.
- While financial regulations in the EU mandate that advisers collect information on sustainability preferences from clients, the Financial Conduct Authority (FCA) has not made sustainability mandatory in the UK. Nonetheless, the FCA has initiated a consultation with the financial services sector this year.
- The government should monitor the outcomes of the ongoing FCA consultation and the guidance provided by the Charity Commission. It should then determine whether these initiatives sufficiently motivate financial advisers to align investments with clients' objectives.

However, good financial advisers should not wait for the government to lead on this. They should help their clients integrate impact investments into broader financial or philanthropic strategies. Working with clients, they should determine what part of their overall portfolio to devote to this area and to understand that it involves lower returns, reduced liquidity and higher risk. This would allow investors to deploy their wealth to do social good at the same time as pursuing their financial objectives.

6.3 Social Investment by Pension Funds and Charities

Social impact investment seeks to have a positive impact as well as generate a financial return. As part of the challenge to bring responsible and specifically social impact investing into the mainstream, the UK government commissioned research into how environmental and social issues – as well as financial ones – can be considered by pension funds and charities.

The Law Commission was tasked by government to look at what changes were needed to enable a proportion of pension fund investments to be directed at social impact and whether any changes to the powers of trustees were needed when making social investments.

The Law Commission issued a report in 2014, entitled *Fiduciary Duties of Investment Intermediaries*, and guidance which considered when pension trustees can take environmental and social factors into account when making investment decisions. The guidance clarified that pension trustees should take into account factors which are financially material to the performance of an investment, balancing returns against risks. This includes risks to the long-term sustainability of a company's performance.

Although financial return should be trustees' predominant concern, the law is sufficiently flexible to allow other, subordinate concerns to be taken into account in some circumstances. The law permits pension trustees to make investment decisions that are based on non-financial factors (such as environmental and social concerns), provided that they have good reason to think that scheme members share the concern and there is no risk of significant financial detriment to the fund.

For charities, the Law Commission reviewed certain aspects of the law relating to social investment by charities. Charities exist for the benefit of the public and must have exclusively charitable purposes. Traditionally, charities have spent their funds on charitable objectives and have invested their funds in such a way as to generate funds for future initiatives. Social investment neatly combines both of these objectives by achieving its charitable objective and receiving a financial benefit.

The Law Commission found that some charity trustees make social investments without having any concerns about the scope of their powers and duties, whilst others were unsure of their powers or concerned about a breach of their duties. It found that there is a misconception that charity trustees have a duty to maximise financial returns when making social investments and further misconceptions about the type of social investments a charity can make.

As a result, it proposed the introduction of a new statutory power for charity trustees to make social investments which was subsequently passed into law in 2016. When making a social investment, charity trustees must be satisfied that it is in the best interests of the charity to do so, having regard to the expected overall benefit to the charity from the social investment, comprising the expected furtherance of the charity's objects and the expected financial return. The power applies unless it has been expressly excluded or modified by the charity's governing document.

The Charities Commission has since updated its guidance to charity trustees to incorporate the specific recommendations of the Law Commission.

- **Assessing social investment**
  - In determining whether a social investment would be in the best interest of the charity, the charity trustees must assess:
    - The expected financial return and the expected mission benefit (how the investment furthers the charity's objective) from the investment.
    - The likely cost of making the investment in terms of any foregone financial return and/or any foregone mission benefit.
  - However, charity trustees are not required to attach a precise monetary value to either the expected financial return or the expected mission benefit as part of that assessment though they may choose to do so.

- If the charity trustees are using permanent endowment, the trustees must anticipate that the social investment will preserve the capital for future beneficiaries.

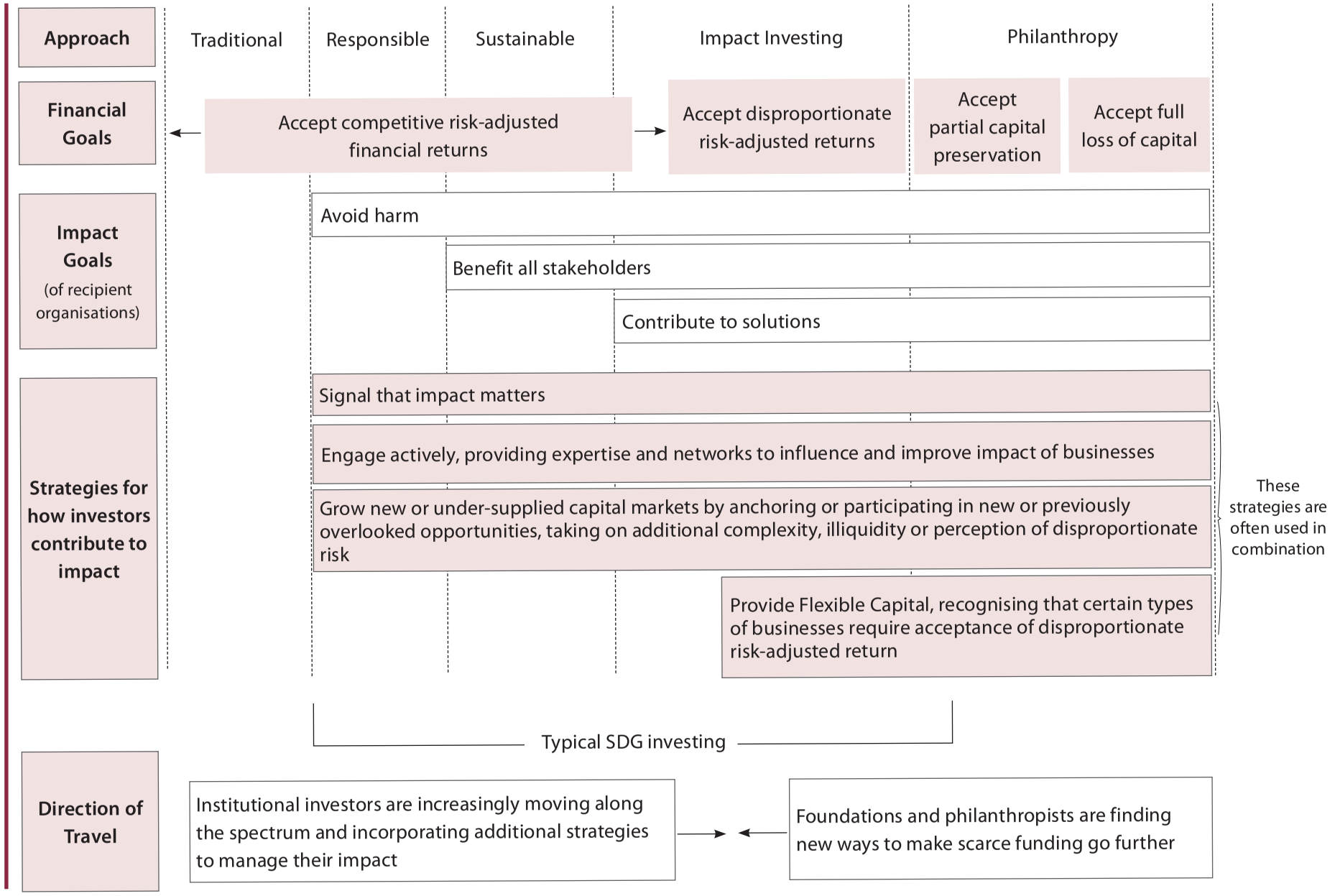
- **Assessing specific social investment**
  - The duration of the social investment and how and when funds might be withdrawn.
  - The risks of the social investment failing to deliver, or underperforming in the delivery of, the expected mission benefit and the expected financial return.
  - How the performance of the social investment will be measured, assessed and monitored.
  - The relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies.
  - The tax treatment of the social investment.

6.4 Social Impact Investment Advice

Social impact investing provides finance to organisations addressing social and/or environmental needs, with the explicit expectation of a measurable social and financial return.

For some years, there has been evidence of a growing interest in investments in social impact investing but market growth has been hampered by a lack of clarity in the subject by advisers. In 2017, an industry-led independent group in partnership with the Government commissioned an 'Impact Investment Adviser Tool' to clarify the social impact investment strategies, products and characteristics.

Social impact investing builds on ethical and sustainable investing and unlike traditional investments or philanthropy, seeks to d**eliver a financial return on investment, a social return** and the availability of capital to recycle. How it fits with other investment strategies is highlighted in the following *Spectrum of Capital* diagram (*Source: UK National Advisory Board on Impact Investing, 2017* and *Impact Management Project, 2017*).


Approach
Traditional
Responsible
Sustainable
Impact Investing
Philanthropy
Financial Goals
Accept competitive risk-adjusted financial returns
Accept disproportionate risk-adjusted returns
Accept partial capital preservation
Accept full loss of capital
Impact Goals (of recipient organisations)
Avoid harm
Benefit all stakeholders
Contribute to solutions
Strategies for how investors contribute to impact
Signal that impact matters
Engage actively, providing expertise and networks to influence and improve impact of businesses
Grow new or under-supplied capital markets by anchoring or participating in new or previously overlooked opportunities, taking on additional complexity, illiquidity or perception of disproportionate risk
Provide Flexible Capital, recognising that certain types of businesses require acceptance of disproportionate risk-adjusted return
These strategies are often used in combination
Typical SDG investing
Direction of Travel
Institutional investors are increasingly moving along the spectrum and incorporating additional strategies to manage their impact
Foundations and philanthropists are finding new ways to make scarce funding go further

The 'Impact Investment Adviser Tool' was designed to increase knowledge of impact investment among investment firms and advisers alike and encourage them to start offering it to clients. The tool comprises the following:

- An **educational model** that outlines the different approaches within investing and shows how creating impact can be included in the advisory process.
- An **access point to knowledge** on funds that create impact.
- A **conversational pack** which adapts according to different levels of adviser's knowledge and skill, providing tools to use with clients to articulate their preferences when investing in funds that create impact.

The educational model visually demonstrates how different approaches sit on a scale between traditional investment and philanthropy. The conversational pack is designed to guide an adviser through discussions with the client and provide a resource that can be used and adapted. The tool can be accessed on the government's website by searching for 'Impact Investment Adviser Tool'. There are also links to other useful resources.

7. Client Management

The actual execution of the portfolio management strategy should be monitored regularly to ensure satisfactory progress against stated objectives, suitability, costs/charges and performance criteria.

Part of the wealth management function is to regularly review the appropriateness and effectiveness of measures to manage risks. In some cases, this is done by an investment oversight department, such as performance and risk, compliance or a portfolio monitoring team. However, responsibility rests on the wealth manager and the firm to ensure that if it is delegated in this way, it is completed correctly.

The wealth manager should have a reasonable grasp of both the client and the lifecycle of the asset, including back office and operational processes, from initially putting through the trade to the eventual maturing of a client's investment.

Relevant documentation, registrations and other matters of compliance with legislation, reporting and taxation-related matters should be considered as vital to the portfolio monitoring process.

In addition, the portfolio manager and their team need to keep abreast of all relevant changes in legislation and financial regulation in order to ensure that they are complying with the most current methods of reporting and following industry best practice. Wealth managers need to be aware of these changes and re-appraise any changes in suitability for their clients.

7.1 Client Reporting

The Conduct of Business Rules requires that a firm provide the client with details of trades undertaken and with periodic reports on the current structure of the portfolio and its performance.

7.1.1 Trade Reporting

Following the introduction of MiFID II, there are now extensive rules on record keeping of client orders and decisions to deal in addition to the previous rules on record keeping of transactions.

From 3 January 2018, firms subject to MiFID II transaction-reporting obligations are not able to execute a trade on behalf of a client who is eligible for a legal entity identifier (LEI) and does not have one.

An LEI is a unique identifier for persons that are legal entities or structures including companies, charities, trusts and **small self-administered schemes (SSAS)**. An LEI is a code unique to that legal entity or structure. When an LEI code is allocated to you, the code is included in a global data system. This enables every legal entity or structure that is a party to a relevant financial transaction to be identified in any jurisdiction.

If a client is a legal entity or structure, including a company charity or trust, they need to obtain an LEI code if they want the firm to act on their instructions or make a decision to trade on their behalf.

Client Orders

Investment firms are required to maintain detailed records after receiving a client order or making a decision to deal and make these available to regulators on request. The list below shows the extensive list of records that are required to be kept.

1. Name and designation of the client.
2. Name and designation of any relevant person acting on behalf of the client.
3. A designation to identify the trader (Trader ID) responsible within the investment firm for the investment decision.
4. A designation to identify the algorithm (Algo ID) responsible within the investment firm for the investment decision.
5. Buy/sell indicator.
6. Instrument identification.
7. Unit price and price notation.
8. Price.
9. Price multiplier.
10. Currency 1.
11. Currency 2.
12. Initial quantity and quantity notation.
13. Validity period.
14. Type of the order.
15. Any other details, conditions and particular instructions from the client.
16. The date and exact time of the receipt of the order or the date and exact time of when the decision to deal was made.

Extensive records also have to be kept for the processing of the order. Whilst some of the details are the same, you should note the additional records that are needed should allow a trade to be tracked through its processing stages.

Trade Confirmations

When trades are `undertaken for clients, details of the transaction need to be sent to the client in the form of a contract note or written statement. This applies to trades executed on a stock exchange and to transactions in open-ended investment schemes.

Trade confirmations are a critical part of the trading process. They serve as the legal contract between the two counterparties and contain vital information about the trade, such as quantity and price, commission and settlement instructions. Trade confirmations also communicate certain information that the broker is obligated to disclose by the regulator.

The confirmation shows when the sale of shares took place, the price the shares were sold at, the total proceeds after costs and when settlement will take place. In other words, it provides an effective summary of the information that the investor needs to know.

The actual format of a trade confirmation will vary from firm to firm and by type of instrument traded. For derivatives, for example, the confirmation should detail the type of future or option contract entered into, the strike price and the expiry date. The confirmation must, however, meet the minimum requirements laid out in COBS.

The rules in COBS require the following information to be included in trade confirmations:

- Name of the firm.
- Name or designation of the client.
- Trading day.
- Trading time.
- Type of order (for example, a limit order or a market order).
- Venue identification.
- Instrument identification.
- Buy/sell indicator.
- Nature of the order if other than buy/sell.
- Quantity.
- Unit price.
- Total consideration.
- Total of the commissions and expenses charged.
- The rate of exchange obtained where the transaction involves a conversion of currency.
- The client's responsibilities in relation to the settlement of the transaction, including the time limit for payment or delivery as well as the appropriate account details where these details and responsibilities have not previously been notified to the client.
- If the client's counterparty was the firm itself, the fact that this was the case unless the order was executed through a trading system that facilitates anonymous trading.

Where a transaction in unit trusts or open-ended investment companies is undertaken, the following information must be included:

- The management company.
- Name of the unit holder.
- Date and time of receipt of the order and method of payment.
- Date of execution.

- Name of the fund.
- Type of order (subscription or redemption).
- Number of units involved.
- The unit price at which the units were subscribed or redeemed.
- The reference valuation date.
- Gross value of the order including charges for subscription or net amount after charges for redemptions.
- Total sum of the commissions and expenses charged and where the investor so requests, an itemised breakdown.

Where transactions in derivatives are undertaken, the essential information that should be provided is as follows:

- For transactions in a derivative:
  - the maturity, delivery or expiry date of the derivative
  - in the case of an option, a reference to the last exercise date, whether it can be exercised before maturity and the strike price, and
  - if the transaction closes out an open futures position, all essential details required in respect of each contract comprised in the open position and each contract by which it was closed out and the profit or loss to the client arising out of **closing out** that position (a difference account).
- For the exercise of an option:
  - the date of exercise, and either the time of exercise or that the client will be notified of that time on request
  - whether the exercise creates a sale or purchase in the underlying asset, and
  - the strike price of the option (for a currency option, the rate of exchange will be the same as the strike price) and, if applicable, the total consideration from, or to, the client.
- The fact that the transaction involves any dividend or capitalisation or other right which has been declared, but which has not been paid, allotted or otherwise, becomes effective in respect of the investment, and under the terms of the transaction the benefit of which will not pass to the purchaser.

After a broker has executed a deal, its reporting system will automatically generate and issue a trade confirmation. The COBS rules require these to be issued promptly to clients.

For institutional clients, trade confirmations will usually be issued intraday using electronic trade confirmation systems. Electronic trade confirmation systems allow firms to implement automation into the post-trade process by comparing the instructions from the investment manager's order management systems with the details communicated by the executing broker. This is known as trade matching and uses electronic systems such as CREST, Omgeo or SWIFT messaging.

For retail clients, the rules in COBS specify that confirmations should be issued no later than the business day following execution of the trade. If the investment manager executes the trade through a third party, ie, a broker, then the contract note needs to be issued no later than the business day following receipt by the manager. Other points to note are as follows:

- If a trade is executed after the close of business on the stock market, the trade is treated as having been executed the following day and the timescale for issue starts from then.
- Where a trade is executed in tranches, a single contract note can be provided and the prices averaged so long as details of the underlying trades are provided to the client on request.

Discretionary investment managers who manage portfolios on behalf of clients often include in their terms and conditions that individual trade confirmations will not be issued and instead issue statements to clients from time to time that contain details of the transactions undertaken. From the regulator's perspective, this is acceptable provided that the client agrees in writing and the same information is provided.

A firm should keep records of any trade confirmation issued to clients for a period of at least five years from the date of the trade.

7.1.2 Periodic Reporting

Where a firm manages investment on behalf of a retail client, they must provide regular reports to the client on their investment portfolio, how the portfolio has performed and the transactions that have taken place. These are known as periodic reports and the content must meet the standards set out in COBS.

The range of reports included in the periodic reporting pack to clients about their investment portfolios include:

- investment valuations
- performance reports
- transaction reports
- corporate action statements
- cash and income statements
- tax reports, and
- derivative reports (if applicable).

In addition to these, guidance also highlights the requirement that in addition to the performance of the portfolio, an investment firm should include a fair and balanced review of the activities undertaken during the relevant period.

Periodic reports must be issued at least every three months except where the investment firm provides its clients with access to an online system where up-to-date valuations of the client's portfolio and relevant information can be and the firm has evidence that the client has accessed a valuation of their portfolio at least once during the relevant quarter.

If the investment management service permits the use of leverage either through borrowing or the use of derivatives, then the periodic reports must be issued monthly.

In terms of frequency of issue, there are different regulatory requirements as the FCA currently have different rules for discretionary investment management and advisory management. In summary, they are as follows:

- **COBS 16A.4** sets out the rules for periodic reporting for discretionary investment management and in summary requires firms to issue periodic reports quarterly or monthly where leverage is used.
- **COBS 16.3** sets out the rules for periodic reporting for non-MiFID investment services, such as advisory investment management, and requires periodic reports to be issued six-monthly – with

provisions for monthly reporting where leverage is used, the client being able to request quarterly reports, or for an annual report to be sent where the client elects to receive reports of trades on a transaction by transaction basis.

Investment Valuations

An investment firm will provide valuations of a client's investment portfolio on a regular basis. A valuation needs to show the holdings within a client's portfolio, but it should be presented in such a way that it allows a degree of analysis of the portfolio to be readily appreciated.

Content of Investment Valuations	
Holdings	• Number of shares or **nominal value (NV)** of stock held in each company. • Whether any shares are partly paid. • Number of shares in any OEICs/units in any unit trusts. • Nominal value of any bonds held along with details of the issuer and the maturity date. • Details of any open positions in exchange-traded or OTC futures and options.
Valuation	• The price used for each investment. • The basis of valuation (eg, whether mid prices are used). • The prices used for open-ended funds and where funds are dual priced, what price basis is used. • Where the investment is not quoted in the base currency of the portfolio, the **exchange rate** used to convert into sterling. • For illiquid holdings, how prices are estimated.
Analysis	• Breakdown of the portfolio by asset class, market and sector.

The firm should document the basis of valuation, including how prices are estimated for illiquid holdings, in the notes to the periodic report. The regulations require that, where possible, investments should be valued using a reputable source and the reliability of the source of prices should be kept under regular review.

The market price of many assets can be identified as the last price at which they traded on an exchange but not all assets can be valued in this way. Obtaining accurate prices for highly liquid shares can be straightforward. With a highly liquid stock the quoted bid-offer spread is likely to give an acceptable indication of the value of the holding. With a small cap share the issue would be significantly greater as **spreads** are much wider and there is far less liquidity.

The issue is potentially greater in bonds where there can be even less liquidity. Bonds are often traded directly with brokers, so are valued using broker quotes rather than traded prices. Other assets may be infrequently traded on an exchange or with brokers, in which case the last traded price or broker quote might be stale. As a result, in the absence of traded or quoted market prices, an investment firm has to evaluate fair prices using various models.

Fair Value Pricing

Fair value is an estimate of what an asset is worth on the open market. It applies in accounting and refers to the value of an asset or a liability for which a market price cannot be readily determined. The goal of fair value measurement is to estimate as best as possible the prices at which the positions held would change hands in orderly transactions based on current information and conditions.

Where the investment firm has reasonable grounds to believe that no reliable price exists for a security or the most recent price available does not reflect their best estimate of the value of a security at the valuation point, it should value an investment at a price which, in its opinion, reflects a fair and reasonable price for that investment – the fair value price.

The Investment Association (IA) is responsible for the UK statement of recommended practice (SORP) for authorised funds and defines fair value with its guidance referring to three levels of judgment. The highest, most reliable level is Level 1, while the lowest and least reliable level is Level 3. A fund is required to use the highest level of input that is available to measure fair value.

- **Level 1**
  - This is a quoted price in an active market and must be used to measure fair value whenever available, with certain limited exceptions.
  - An active market is one in which transactions are taking place regularly on an arm's length basis. What is active is a matter of judgment and depends upon the factors and circumstances of the market concerned.
  - Characteristics of an inactive market include: a significant decline in the volume of trading activity, available prices that vary significantly over time or between participants, and prices that are stale. Once a market is determined as inactive then considerable care is required as fair value measurement becomes more subjective under inactive market conditions.
- **Level 2**
  - This is where quoted active market prices are not available. Instead, inputs to a valuation model can be directly drawn from market evidence such as market interest rates or prices.
- **Level 3**
  - The inputs to a valuation model are based upon a preparer's own judgment about the assumptions that another market participant would use.

Performance Reports

As we will see in the next section, when managing investments on behalf of a client, it is necessary to select a suitable benchmark against which the performance of the portfolio can be judged. The periodic report, therefore, needs to provide details of the performance of the portfolio and details of the performance of the benchmark for comparison.

Transaction Reports

A client needs to be advised of details of the trades that are undertaken within their portfolio. As we saw earlier, under the COBS rules, a client needs to be advised promptly of the trades that are undertaken on their behalf. This can be achieved by sending a contract note after the trade has been executed or issuing a statement as part of the periodic report pack with the same details. If the latter option is chosen, then clients must agree in writing and the statement must contain the same level of details.

Corporate Action Statements

Apart from trading, the other main reason why changes will take place within a portfolio is the effect of corporate actions. Within the periodic report pack, there will usually be a statement detailing the corporate actions that have taken place during the period covered by the report. This will cover the terms of the corporate action and the impact on the client's holding.

Cash and Income Statements

The capital cash statement will show details of the cash transactions that have taken place in the portfolio, while the income statement will itemise the dividends and interest received and any deductible payments made.

Tax Reports

Most investment firms will also issue annual tax reporting packs to clients annually or more frequently if appropriate to the client. The reporting pack will typically contain capital gains tax (CGT) reports and tax certificates.

- The CGT reports will show each holding within the portfolio and their base cost for CGT. As trades or corporate actions take place, the report will detail how the base cost for a holding changes. Where a client is unable to supply accurate CGT acquisition costs, the report may show the assumed value that is being used when managing the portfolio.
- Depending on the service provided, CGT reports may also be provided on realised capital gains that the client or their tax adviser can use to complete their tax return.
- The tax reporting pack will also contain a tax certificate. This shows the consolidated picture of the dividends and interest received in the portfolio and should be structured in the same way as the income needs to be reported in the client's tax return.

Derivative Reports

When providing a periodic statement to a retail client where derivatives are used, a firm should also consider including:

- The collateral value in respect of any contingent liability transaction in the client's portfolio during the relevant period.
- For each open option written by the client – the share, future, index or other investment involved; the trade price and date for the opening transaction, unless the valuation statement follows the statement for the period in which the option was opened; the market price of the contract; and the **exercise price** of the contract.
- Option account valuations may show an average trade price and market price in respect of an option series if the client buys a number of contracts within the same series.

7.1.3 Performance Reporting

Once the portfolio has been constructed, the portfolio manager and client need to agree on a realistic benchmark against which the performance of the portfolio can be judged. The choice of benchmark will depend on the precise asset split adopted and should be compatible with the risk and expected return

profile of the portfolio. If an index is used, this should represent a feasible investment alternative to the portfolio constructed.

The Conduct of Business Rules require firms that provide a portfolio management service to establish an appropriate method of evaluation and comparison such as a meaningful benchmark, based on the investment objectives of the client and the types of financial instruments included in the client portfolio, so as to enable the client for whom the service is provided to assess the firm's performance.

The rules on reporting to clients also require that periodic reports include a comparison of performance during the period covered by the statement with the investment performance benchmark agreed between the firm and the client.

If the performance of an investment fund or investment manager is to be assessed, the first issue to address is how to measure that performance. Investment performance is usually monitored by comparing it to a relevant benchmark. To be useful, a benchmark should align with the style and risk adopted by the investment manager and should be:

- specified in advance
- appropriate to the manager's investment approach and style
- measurable so that its value can be calculated on a frequent basis
- unambiguous in its construction
- reflective of the manager's current investment opinions and knowledge and experience of the securities included within the benchmark
- accepted by the investment manager who will be accountable for deviations in construction of the portfolio due to active management, and
- investable so that it is possible to replicate the benchmark.

The ways in which portfolio performance is assessed can be grouped into three main categories.

1. **Comparison with a relevant bond or stock market index**
   - An index comparison provides a clear indication of whether the portfolio's returns exceed that of the bond or stock market index that is being used as the benchmark return.
   - As well as the main stock market indices that are generally seen, many sub-indices have been created over the years which allow a more precise comparison to be made.
2. **Comparison with similar funds or a relevant universe comparison**
   - Investment returns can also be measured against the performance of other fund managers or portfolios which have similar investment objectives and constraints.
   - A group of similar portfolios is referred to as an investment universe.
3. **Comparison with a custom benchmark**
   - Customised benchmarks are often developed for funds with unique investment objectives or constraints.
   - If a portfolio spans several asset classes a composite index may need to be constructed by selecting several relevant indices and then multiplying each asset class weighting to arrive at a composite return.

If an index is to be used as a benchmark, it is important to understand how it is constructed. There are three main calculation methods used in the construction of a market index – price-weighted, market-value-weighted and equal value-weighted.

1. **Price-Weighted**
   - These are constructed on the assumption that an equal number of shares are held in each of the underlying index constituents.
   - The index is calculated by summing the total of each constituent's share price and comparing this total to that of the base period.
   - However, as these equal holdings are weighted according to each constituent's share price, those constituents with a high share price, relative to that of other constituents, have a greater influence on the index value.
   - Although such indices are difficult to justify and interpret, the most famous of these is the Dow Jones Industrial Average (DJIA).
2. **Market-Value-Weighted**
   - In these indices, larger companies account for proportionately more of the index as they are weighted according to each company's market capitalisation.
   - The FTSE 100 is constructed on a market capitalisation weighted basis.
3. **Equal Value-Weighted**
   - In certain markets, the largest companies can comprise a disproportionately large weighting in the index and, therefore, an index constructed on a market capitalisation basis can give a misleading impression.
   - An equal-weighted index assumes that equal amounts are invested in each share in the index.

Most of the major indices used in performance measurement are market value weighted indices such as: the S&P 500 and other S&P indices; the Morgan Stanley Capital International index, and the FTSE 100 and FTSE All-Share indices.

Under market-capitalisation weighted indices, the total market capitalisation of a company is included, irrespective of who is actually holding the shares and whether they are freely available for trading. Market-capitalisation weighted indices are usually adjusted for available shares or their free float.

The free-float methodology includes only that proportion of a company's issued shares that are available for trading in the market. It generally excludes promoters' holdings, government holdings, strategic holdings and other locked-in shares, such as family or founder shareholdings, which will not come to the market in the normal course of trading. Their introduction was driven by investors who wanted to remove the distortion that unavailable to trade holdings brought to global indices and the impact that had on resulting asset allocation decisions.

The free-float method is seen as a better way of calculating market capitalisation, because it provides a more accurate reflection of market movements. When using a free-float methodology, the resulting market capitalisation is smaller than what would result from a full-market capitalisation method. This is useful for performance measurement, as it provides a benchmark more closely related to what money managers can actually buy.

There are various types of benchmarks in use, but the primary types are shown in the following table:

Types of Benchmark	
Absolute	• These have an objective of aiming to exceed a minimum target return. • For example, some absolute return funds have an objective to deliver positive returns over a rolling one-, two- or three-year period of a specified margin over a benchmark rate such as SONIA or euro short-term rate (€STR).
Manager universes	• This uses peer group averages to determine the benchmark, by taking the performance of the median manager as the benchmark. • As a result, it cannot be specified in advance and has been criticised as creating a herd mentality, rather than a focus on the need of the portfolio.
Broad market indices	• There are several broad market indices that can be used such as the MSCI World Index, the S&P 500 and the FTSE All-Share. • They have the advantage that they are well-recognised, easy to understand and readily measurable. Their drawback is that the manager's investment style may be different.
Style indices	• These represent a proportion of the available securities within an asset category that can be effectively grouped together, such as large-capitalisation stocks or small cap-stocks.
Factor models	• This is a benchmark that is created by relating one or more systematic sources of returns (factors or exposures) to returns of the benchmark. • The factors that make up the benchmark may be areas such as performance of the market, the sector or company size. • Whilst they can help explain how performance is achieved, they are not easy to understand, are not specified in advance and can be ambiguous and expensive to use.
Returns-based	• These compare a manager's return to the returns of several style indices that best explain the manager's return. • They are generally easy to use and measurable, but the mix of underlying styles may not reflect the manager's investment process.
Custom-based	• These use a selection of securities that best reflects the investment manager's approach to produce a composite or synthetic benchmark.

Customised benchmarks are often developed for funds with unique investment objectives or constraints.

If a portfolio spans several asset classes, a composite index may need to be constructed by selecting several relevant indices and then multiplying each asset class by a weighting, to arrive at a composite return.

An example is the private investor indices produced by the Personal Investment Management and Financial Advice Association (PIMFA). There are different private investor indices, which each have different asset allocations and are composed of related indices, to reflect the differing aims of investors.

7.2 Changes that Can Affect a Client Portfolio

Once a portfolio has been established for a client, it will need to be kept under regular review and changes made as and when appropriate due to changes in the client's circumstances, the financial environment, or as a result of product changes.

7.2.1 Portfolio Reviews

It is important to ensure that the management of a client's portfolio is reviewed regularly. The frequency of review should be agreed with the client and should take into account any changes in the client's circumstances or requirements. For example, the portfolio may have been initially created to generate a capital return, while the client may now require more of an income.

Changes in the performance of the underlying assets may also require a rebalancing of the asset allocation from time to time. For example, the outperformance of the equity holdings, compared with the other assets such as bonds and property, may move the portfolio significantly away from the strategic asset allocation agreed for the client and alter the risk profile of the overall portfolio. Portfolio rebalancing relates to adjustments in the levels of exposure to the various asset classes and should be reviewed as part of the scheduled portfolio review or earlier, if changes in the economic cycle mean that a greater or less exposure is required in other areas.

It is important to understand the need for rebalancing. On the one hand, a criticism levelled at rebalancing is that it forces wealth managers to take from the winners and add to the underperforming securities. On the other hand, rebalancing rotates from assets that become overvalued to those undervalued. Rebalancing, therefore, needs to be weighed against the strategy, client mandate and the expected return and volatility. For example, a client signing up to a balanced strategy should have the reassurance that their portfolio always retains the shape and risk-adjusted profile of a balanced portfolio.

Various portfolio-balancing techniques can be employed to ensure that the asset allocation is adjusted to remain in line with what was originally agreed.

7.2.2 Corporate Actions

Corporate actions, such as a **rights issue**, will impact the pricing of securities and, in certain circumstances, the decision by a company to engage in a secondary offering, or proposal to alter its capital structure, might trigger a major response from the markets. In these circumstances, a decision may be made to change a portfolio holding in the wake of the proposed corporate action. Likewise, existing bond holders may not always like corporate actions in favour of equity holders.

Changes to the underlying holdings within a portfolio due to a corporate action should trigger a review of the portfolio, to ensure that the level of overall exposure to that particular stock has not been altered significantly.

7.2.3 Changes in the Financial Environment

Economic changes can impact the portfolio and will require a review to assess their impact and determine a strategy for minimising their impact. Examples include a change to tax laws and rates of taxation of gains or income generated from within an investment portfolio, including amendments to legislation surrounding certain investment vehicles such as pensions, ISAs, EISs, SEISs and VCTs.

Financial innovation over the last 30 years has been extraordinary. The introduction of new products onto the market can also require a review, due to improved charging structures or additional features and benefits that were not offered by the original contract or were not available at the time. Equally, products can become unsuitable or tax changes may make products that were impractical a potential investment solution for clients. More recently, attitudes to tax planning may change, making anything other than conventional tax-saving schemes no longer acceptable.

Changes in the economic environment may affect the client's attitude to **risk** or their financial position. For example, job uncertainty can change the client's perception of risk and experiencing a major event such as a financial crisis or a pandemic can see clients become far more cautious than previously. Equally, the client's circumstances are unlikely to remain constant for very long; for instance:

- Changes in assets or income can take place relatively rapidly and have profound effects.
- Life events, such as marriage, parenthood, divorce, a job move or retirement, can happen in a planned or unplanned way. The financial plan has to adapt to these events.
- 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.
- Economic and financial conditions change and this can affect how clients view their assets and the potential for return. For example, in the last decade or so, persistently low interest rates prompted many investors to switch from deposit-based investments to alternative homes for their savings.

Although one would not expect investor objectives and long-term strategies to be changing in response to short-term market changes, there will inevitably need to be a reassessment of strategies in light of longer-term changes in the market environment.

- The risks of individual asset classes and the relationship between different asset classes will alter over time.
- New asset classes may also become accessible to private client investors.

If a portfolio has to be rebalanced following an unexpected development in client circumstances, then the portfolio manager should reassess the entire SAA. Rather than making piecemeal changes and attempting to reimplement a revised version of the previous allocation strategy, it would be preferable to devise a new SAA which takes into account the new circumstances. This could lead to a reclassification of the investor's profile and risk-tolerance characteristics.

7.2.4 Changes in the Client's Circumstances

Changes in the client's personal circumstances can have a bearing on the structure of the portfolio and will require a review, eg, when a requirement for growth changes to one for regular income or access to a lump sum to assist with an unplanned expense.

With private clients, there will be a number of circumstances that can lead to major changes in their objectives and the constraints. These include, but are not limited to:

- inheritance
- illness
- marriage
- divorce, and
- changes in employment, redundancy or retirement.

There are changes which can take place in any one of these areas and more. If a client loses a regular source of income, even temporarily, for example, there may be a need to liquidate a part of the client's holdings in order to raise cash. To the extent that the current portfolio has an adequate allocation of cash and short-term money market instruments available (which it should have if the financial planning was done properly), this may not present any immediate issues.

In some circumstances, the client may have to draw on their portfolio; however, selling a more liquid part of a portfolio will alter the balance of the remaining assets and will require a rebalancing exercise to be performed as per the client mandate. However, if there is sufficient liquidity across the entire portfolio, the portfolio manager can sell assets evenly in line with the asset allocation.

If the client's need for cash is in excess of the current allocation of very liquid instruments, then the need to liquidate longer-term and perhaps less liquid holdings within the portfolio may be more consequential. The redemption of certain instruments may attract penalties and charges, the need to liquidate equities at a time when the overall market is performing poorly could lead to capital losses and loss of future dividend income and, if there are derivatives in a portfolio which have been used for tactical asset allocation, then the timing of the exit from derivatives contracts can be very sensitive and could trigger premature losses which would not have arisen if the instruments were held to maturity.

More generally, as a private client gets older and approaches retirement there will usually be a need to take less risk and focus on income rather than capital gains. Typically, this involves moving a portfolio away from equity investments and increasing the weighting in fixed-income investments.

The importance of reviewing the investment policy statement (IPS) on a regular basis cannot be overstated. The IPS may need to be revised as a result of changes in client circumstances, regulations, taxation and the market environment.

In practice, the adviser should ensure that they have a strict administrative process in place to ensure that the client mandate is reviewed, both at the agreed anniversary dates and during the interim period when any changes occur.

Capturing changes to the client's circumstances is a different matter. Some individuals like to keep their adviser informed and will contact them as and when changes occur, or are anticipated. Indeed, part of the adviser's job should be to encourage this form of regular communication or information-sharing. For those clients who are less forthcoming, the adviser should take steps to schedule regular contact into their diary, to ensure that any changes or developments in the client's personal circumstances are known.

The adviser may also consider preparing a cut-down version of a fact-find as a review questionnaire to send to the client in advance of the next review, which can incorporate changes to income/expenditure, employment, personal status, assets/liabilities and revised/new financial objectives. The completion of such a questionnaire can then be used to set the agenda for the next review meeting and means the adviser is prepared to discuss in outline what changes they feel may need to be made.

Changes to the client's personal circumstances may also require the input of other professionals, such as solicitors or accountants. Most firms have links with firms to whom they are happy to refer their clients for advice on matters relating to divorce, starting a new business or selling an existing business. If these links are not already in place, then it makes good business sense to arrange them and ensure that your clients are aware of these additional services.

7.2.5 Benchmark Review

A review of the benchmark may be required if it is no longer representative of the portfolio objective or contains assets which the portfolio no longer has exposure to.

Equally, a portfolio manager should review the suitability of the benchmark used each time an assessment of the portfolio's performance is undertaken. Once the mathematical exercise of assessing the performance of the portfolio has been undertaken, the portfolio manager should be looking at performance against the benchmark and questioning why the portfolio over or under performed. In some cases, this will be due to the right asset allocation decisions but sometimes, it will also highlight that the agreed benchmark may not be the best one used for that client mandate.

Bear in mind that the terms benchmark and index are often used synonymously. However, there is a difference. A benchmark is a reference against which the performance of an investment can be measured, while an index is a hypothetical portfolio of instruments representing an asset class, market or sector, which is typically used as benchmark.

Two of the most well-known indices are the FTSE 100 and MSCI World, calculated and published by the FTSE Group and MSCI respectively. Both companies maintain many other indices, some created in association with other organisations. PIMFA, formerly known as the Wealth Management Association (WMA), provides the methodology for two index series:

1. The MSCI PIMFA Private Investor Index Series
2. The MSCI PIMFA Equity Risk Index Series

Both are designed to represent their respective weightings, show returns of selected multi-asset-class strategies and are used as benchmarks to compare the performance and returns of private client investment portfolios.

An alternative approach would be to construct your own benchmark, using a range of existing indices. However, it could be difficult to maintain and increase costs.

8. WealthTech and Other Fintech Innovations

The invention of Bitcoin in 2008 played a crucial role in igniting the Fintech revolution, paving the way for alternative financial solutions that harness cutting-edge technologies. Since then, the financial services industry has witnessed a surge of innovation, encompassing areas like payments, banking, lending, investment, insurance, and regulation. These advancements leverage blockchain, mobile devices, AI, and data analytics to enhance efficiency and accessibility in finance.

8.1 WealthTech

WealthTech is a broad category of services that embrace emerging technologies to reinvent the wealth management sector.

The world of wealth management is changing fast, with an increasing number of people – especially the young who have not traditionally been clients of wealth managers – looking to get involved, and drawn to new kinds of assets, eg, cryptocurrencies.

WealthTech platforms give their users the tools to deal with their financial matters in a much more direct way. With smartphones, tablets and personal computers, they are able to connect directly to online platforms which execute the services they require in an automated way, and with little or no human interaction.

The US has led the WealthTech development, from Wealthfront and Betterment, two market leaders in robo-advisory allowing people to invest in financial products using a smart, automated, and low-cost model, to digital broker Robinhood, which went public in July 2021.

Europe may be a few years behind the US, but its WealthTech start-ups, from robo-advisers to software innovators, are helping the wealth management industry change.

The UK and Germany are both major European WealthTech hubs. The eurozone in theory, has a great potential, but its markets have different savings and investment characteristics – there is not a pan-European WealthTech champion yet.

8.1.1 Robo-Advice

Arguably, **robo-advice** may be regarded as the main subgroup of WealthTech. In fact, often the two terms seem to be used interchangeably. Robo-advisers are digital platforms that provide automated, algorithm-driven wealth management services with little to no human supervision. They:

- require a low initial investment (often as little as $1 or less – also known as 'micro-investing')
- charge low fees (below 50 basis points of AUM, whereas traditional financial advisers charge 100 or more basis points), and
- they allow more people to enter the market, particularly young people with a good understanding of new technologies.

The low interest rates and low yields which we have seen, post-financial crisis of 2008, are bringing all sorts of investors into the fold.

In the UK, Nutmeg, founded in 2011, was an early pioneer of the online investment model and is said to have over £4.5 billion of AUM. There are many other new entrants to this market. Wealthfront, an automated investment platform, and Betterment, an online investment adviser, were both formed in 2008. Wealthfront has $25.3 billion of AUM, Betterment $36.6 billion[29].

Meanwhile, traditional institutions are buying, funding or partnering with robo-advice start-ups, or developing their own offerings. Some have greater success than others. For example, Deutsche Bank initially developed AnlageFinder, in cooperation with the Fintech company, Fincite, but the initiative did not take off. Similarly, UBS shut down their own robo-advisory unit only approximately one year after launch.

According to one study, only 8% of surveyed individuals believe that a robo-adviser could deliver the best returns on their money. In spite of pessimism in the sector, some players have begun to tweak their offerings to remain attractive to retail investors. For example, the Singaporean banking group DBS launched a 'hybrid human-robo' investment service, which is said to utilise robo-advisory technology to offer access to investment services traditionally only available to high-net-worth clients.

8.1.2 Digitalisation

Two-thirds of people aged over 50 prefer face-to-face meetings as a method of getting financial advice, research by ComPeer found. Among younger people, the proportion was only slightly lower at 58%. Just 5% in the younger category and 1% in the older preferred an online service.

WealthTech is unlikely to replace all financial advisers and wealth managers, as some entrepreneurs in the area envisage. However, an increasing number of emerging Fintechs in the space see significant potential in developing the back-end technology solutions used by the traditional wealth managers, who spend a lot of their time doing administrative tasks.

For example, developer-friendly, 'open banking' software can help wealth managers handle their operations more efficiently, including tracking what their clients need and want. People are now used to the tech giants experience and want personalised services. If wealth managers do not change, they will lose clients who are more willing to switch than before.

TrueLayer and Fund Sense are just two of many low-code solution providers that are building application programming interfaces (APIs) that connect the legacy backend systems used by wealth managers enabling digitalisation of processes.

8.1.3 WealthTech Risks

WealthTech platforms claim to be democratising trading and investing, but this carries risks. Money can be lost just as easily as it can be earned through these platforms, which often offer crypto assets. In 2021, the UK's Financial Conduct Authority (FCA) said that it was unable to oversee the UK arm of cryptocurrency exchange Binance, one of the largest in the world, highlighting the 'significant risk' to investors caused by the complex and risky products offered by the exchange. The FCA also banned the sale of cryptocurrency derivatives to retail investors in the UK, while continuing to allow their spot trade.

29 Investing in the Web, September 2024. The largest Robo-Advisors by AUM in 2024. Retrieved from https://investingintheweb.com/brokers/the-largest-robo-advisors-by-aum/ (Accessed: September 2024)

WealthTechs often use gamification – the application of game design concepts in the user experience of a non-game environment – to simplify the complex world of finance and therefore attract and better engage with primarily younger users. Robinhood, eToro and Trading 212 are some of the most well-known WealthTechs that have been using gamification to encourage clients to sign up and to trade more.

However, regulators and finance professionals raised questions about whether it is actually a good thing to make financial instruments easier to trade. This is particularly so in the case of Robinhood, after the GameStop episode in early 2021, where retail traders members of the Reddit's WallStreetBets forum pushed up the stock price of GameStop (a struggling videogame retailer) from less than $20 per share to near $500 in a short period of time, causing significant losses at some hedge funds who had shorted the position.

The FCA had to launch a campaign, called InvestSmart, to prevent investment harm of this kind. It targets people online with the InvestSmart website[30], which includes information to help people make smarter investments and suggests that they ask themselves five questions before investing:

- Am I comfortable with the level of risk? Can I afford to lose my money?
- Do I understand the investment and could I get my money out easily?
- Are my investments regulated?
- Am I protected if the investment provider or my adviser goes out of business?
- Should I get financial advice?

8.1.4 Cybercrime

The financial services sector handles a great deal of sensitive information, and FinTechs, in particular, make more data available in digital formats. While this does make it easier to analyse and generate insights, it also makes the data more susceptible to security breaches. This can be challenging for a small start-up to devote resources to, especially against well-organised crime syndicates, some of which are state-sponsored. An example would be North Korean hackers stealing Bitcoins as a means to bypass economic sanctions.

On the other hand, some may also argue that large traditional players with legacy systems are no less susceptible to cybercrime. An example would be Travelex, the international currency exchange firm, whose computer system and customer data were held to ransom by a group of hackers in early 2020.

From the consumer's point of view, security is an integral part of any solution, the onus for which lies with the provider, whether it is a Fintech firm or a traditional financial institution. Moving forward, security and data privacy are going to play a key role in winning consumer confidence and catalysing the far-reaching adoption of new solutions.

Research by global law firm Simmons & Simmons also found that 71% of large financial services firms believe better visibility of cyber-security controls within Fintech firms would improve partnering prospects.

30 Financial Conduct Authority, 2024. InvestSmart. Retrieved from https://www.fca.org.uk/investsmart (Accessed: September 2024)

8.1.5 Tech-Enabled Wealth Managers

WealthTech entrepreneurs seem to agree that there is still very little tech in wealth management today. WealthTech will grow, with an increasing focus on technologies and start-ups that are able to curate investment opportunities and offer user-friendly platforms that use AI to help both retail and institutional investors manage their portfolios. There is also going to be a strong demand for access to alternative asset classes like cryptocurrencies.

The ultimate impact of the rise of these new platforms is yet to be seen. However, these platforms will likely impact wealth managers. There will be a need for both DIY and adviser-led investing. More people are expected to make their savings work harder and the younger generations are expected to migrate to a tech-enabled advised service as their wealth grows.

8.1.6 Environmental, Social and Governance (ESG) WealthTech

Wealth managers are increasingly managing younger people's money. Younger investors seem to value sustainability substantially more. According to a May 2021 survey by The Harris Poll, 30% of millennials often, or exclusively, want to invest in companies that consider **environmental, social, and governance (ESG) factors**. That compares with 19% of Generation Z, 16% of Generation X and 2% of baby boomers. Younger investors also seem to demand to be given more opportunities to invest not only in responsible companies, but also in those whose main purpose is to help resolve the natural world and societal challenges. Some robo-advisors build socially conscious portfolios and help investors manage them. Clim8 Invest offers solutions that allow investors to gain exposure to green energy, clean mobility and another four themes which support the UN Sustainable Development Goals (SDGs)[31].

Source: https://content.sifted.eu/wp-content/uploads/2021/10/10210240/Wealthtech-Sifted.pdf

In October 2018, the FCA launched the Green Fintech Challenge. The FCA stated that it wants a financial services market that responds well to the challenges and opportunities of climate change. The FCA also wants to protect investors from 'greenwashing', ie, it wants to ensure that the products labelled sustainable by green Fintechs are genuinely green. However, it acknowledged that assessing this is complex. In 2019, the initiative has accepted nine firms developing innovative products and services to assist in the UK's transition to a greener economy.

8.2 Crypto Assets

The first investment many younger investors make is in crypto assets, using specialist platforms such as Coinbase or Binance as some of them do not even have a bank account.

Recent regulatory developments in the UK have led to tighter oversight of the cryptoasset market. The UK government is progressing legislation aimed at regulating stablecoins and tokens within the broader financial regulatory framework. Furthermore, the FCA continues to enforce its ban on the sale of cryptocurrency derivatives to retail investors and has increased scrutiny of crypto exchanges, including clarifications on the regulatory status of platforms such as Binance.

31 Sifted, October 2021. Wealthtech: the new app-driven world of investment. Retrieved from https://content.sifted.eu/wp-content/uploads/2021/10/10210240/Wealthtech-Sifted.pdf (Accessed: September 2024)

8.2.1 Cryptocurrencies

The wake of the global financial crisis saw the creation of cryptocurrencies as a way for individuals to control their own money without having to rely on companies, banks or governments. At the time, blame for the crisis was primarily attributed to the imprudent actions of bankers and politicians. Many individuals were upset, therefore, by the way in which they had to implicitly trust banks and governments with their hard-earned money. In 2009, the first established cryptocurrency, Bitcoin, was created. Today, there are over 12,000 other cryptocurrencies (sometimes also referred to as altcoins, ie, alternatives to Bitcoin) in the $1.8 trillion crypto market, according to one estimate.

Bitcoin and many altcoins have many limitations that prevent them from becoming major peer-to-peer (P2P) payment systems. For one thing, scalability is a major bottleneck for mass market payments. By 2016, the speed of processing transactions on the Bitcoin network had become so slow that users had to make fee payments to miners to increase their chances of having their transactions included in a block for swifter processing.

Mining is an energy-intensive process – it is said that:

> '*if the blockchain could be scaled to reach the transaction number of Visa, the energy requirement will be the equivalent of 5,000 nuclear reactors, or the entire energy consumption in the world*'.

Moreover, mining is a slow process that results in delays to payment processing. Although estimates vary, it is said that a blockchain can only process four to seven transactions per second, whereas the Visa network can currently process 40,000 to 50,000 transactions per second – a Bitcoin transaction can take days rather than minutes to complete.

Mining also demands high computational power – miners utilising the greatest computing power stand a far greater chance of being rewarded with newly minted Bitcoins. With the meteoric rise of Bitcoin's trading price – from around US $300 in 2015 to over US $60,000 at its peak in November 2021 – mining became a profitable enterprise where miners use dedicated machines, known as application-specific integrated circuits (ASICs).

8.2.2 Security Token Offerings (STOs)

Regulator-compliant security token offerings (STOs) first appeared after the 'death' of initial coin offerings (ICOs) in late 2018 to restore confidence in crypto and accelerate the pace of transformational change in the world of finance.

The adoption of STOs has faced several challenges. One of the main ones has been the lack of good publicly available data, making them unattractive to most investors. Another one has been their quality. But now it seems that the demand for STOs is finally soaring.

Clifford Chance, a multinational law firm headquartered in London, published a report in October 2020 that says STOs are increasingly being seen as an alternative to mainstream debt and equity fundraisings. The report also says that STOs are typically structured to sit within securities law frameworks. This means much greater certainty for both fundraisers and investors, resulting in enhanced liquidity.

Meanwhile, Sumitomo Mitsui Trust Bank, one of Japan's largest banks, has completed its first asset-backed security token issuance pilot. The bank has converted Japan's first certificates of ownership backed by securities into security tokens and is conducting a trial on the digital asset issuance platform Securitize Japan, a unit of Securitize Inc, a US-based digital securities issuance platform, according to CoinDesk.

Ethereum is the preferred blockchain to issue security tokens (as it was for ICOs).

Security tokens can enable fractional access to assets such as prime property and private equity (including venture capital), which have been closed to retail investors in the past.

8.2.3 Cryptocurrency Exchanges

A cryptocurrency exchange is a trading platform for traders to buy, sell and trade cryptocurrencies. They have emerged around the world to provide users, who are less tech-savvy or do not want to mine Bitcoins on their own, with a convenient way to purchase Bitcoins for fiat currency, hold them in digital wallets and execute trades. Cryptocurrencies have corresponding trading symbols similar to stock ticker symbols for a stock.

Exchanges tend to have differing capacities in terms of the types of cryptocurrencies that users can trade in – some with a greater range, some with fewer. The decision on which cryptocurrency and auxiliary service is, or is not, offered may be partly commercial and partly due to the exchange's own tolerance for regulatory risks. For example, the New York-based exchange Gemini, which is regulated by the New York State Department of Financial Services (DFS), surprised some in October 2020 by announcing that users can withdraw Zcash, a privacy coin, confidentially.

The level of user-friendliness also differs between cryptocurrency exchanges. For example, US-based Coinbase is said to be geared towards the beginner as it allows the user to buy a cryptocurrency with a fiat currency, at the cost of higher transaction fees. Meanwhile, Binance, another prominent exchange, is said to be geared towards a more advanced user. In the past, a user on Binance could only fund their account with cryptocurrency – which they have either mined themselves or purchased with fiat currency elsewhere. However, since late 2019, the exchange began to support purchases with some fiat currencies, including the Russian ruble, the Turkish lira and the Vietnamese dong. Binance is said to levy lower transaction costs.

Exchanges, such as Gemini, Coinbase and Binance, are considered to be centralised cryptocurrency exchanges, meaning that there is a corporate entity and identifiable senior management behind the operations. However, some of these exchanges may be more opaque than others. Some exchanges clearly operate under regulatory regimes, while others do not. For example, the Malta Financial Services Authority (MFSA) issued an announcement that it has never approved Binance to operate in the country, in order to dispel mass media portrayal that the exchange is indeed authorised there. To date, it is unclear under which regulatory regime Binance operates, or where its corporate headquarters is based.

In 2025, the UK government published draft legislation – the Financial Services and Markets Act 2000 (Regulated Activities and Miscellaneous Provisions) (Cryptoassets) Order 2025[32] – to bring crypto exchanges, dealers and agents into the regulatory perimeter. The FCA now requires crypto firms serving UK customers to meet transparency, consumer protection and operational resilience standards similar to those applied to traditional financial firms. Non-UK firms offering crypto trading services to UK retail clients must obtain FCA authorisation and establish a UK presence.

The increasingly competitive landscape of cryptocurrency trading also created cryptocurrency exchange aggregators, which aggregate multiple exchanges and enable users to compare prices across different exchanges. CoinSwitch, based in India, is an example of this.

8.2.4 Crypto Exchange-Traded Products (ETPs)

The market for Crypto ETPs, including ETFs and Exchange-Traded Notes (ETNs), has seen significant growth in 2025 due to increasing investor appetite and evolving regulatory clarity. Crypto ETPs allow investors to gain exposure to the performance of underlying cryptocurrencies, such as Bitcoin and Ethereum, without needing to hold the digital assets directly. These products trade on traditional regulated exchanges, such as the LSE, NYSE and Nasdaq, providing the benefits of brokerage accessibility, liquidity and regulatory oversight akin to conventional securities.

Notable examples include the Valour Bitcoin Staking ETP listed on the LSE and several Bitwise crypto ETPs on the LSE and other exchanges. In the US, the US Securities and Exchange Commission (SEC) has softened its stance by approving in-kind creation and redemption mechanisms for crypto ETPs[33], aligning them with traditional asset products and facilitating efficient market functioning. In the UK, the FCA announced the lifting of its retail ban on crypto ETNs effective 8 October 2025[34], reflecting growing acceptance and regulatory evolution in the sector.

This broadening availability and formalisation of Crypto ETPs signifies a maturing investment landscape and enhanced incorporation of digital assets within mainstream financial markets.

8.2.5 Decentralised Finance (DeFi)

Unlike traditional securities, such as bonds or stocks, a crypto asset typically does not offer income streams (coupon or dividend payments). Having recognised a demand among owners of crypto assets to put their assets to work, some operators have set up DeFi schemes to enable owners to lend out their assets in return for renumeration. Making money through DeFi is called yield farming by its proponents.

The concept is similar to securities lending in the traditional asset management world, where fund managers may loan out their securities holdings for the short term to a borrower in return for a borrowing fee. Typically, the borrower would have put up some form of collateral.

32 UK Government, April 2025. Regulatory regime for cryptoassets (regulated activities) draft SI and policy note. Retrieved from: https://www.gov.uk/government/publications/regulatory-regime-for-cryptoassets-regulated-activities-draft-si-and-policy

33 Securities and Exchange Commission, July, 2025. SEC Permits In-Kind Creations and Redemptions for Crypto Exchange-Traded Products. Retrieved from: https://www.mofo.com/resources/insights/250801-sec-permits-in-kind-creations-and-redemptions-for-crypto-etps (Accessed 22 September 2025).

34 Financial Conduct Authority, July 2025. FCA opens retail access to crypto ETNs. Retrieved from: https://www.fca.org.uk/news/press-releases/fca-opens-retail-access-crypto-etns (Accessed 22 September 2025).

However, DeFi is different in many ways from traditional securities lending. DeFi operations usually take place in decentralised exchanges, such as Uniswap, which are unregulated and may exist as no more than codes written to create such a marketplace. The backers of these decentralised exchanges are not always known to the public. Moreover, the underlying codes may, or may not, be audited, and could have security vulnerabilities. According to Chainalysis's 2021 *Crypto Crime Report*, 73% of crypto thefts in 2021 took place on DeFi platforms. Uniswap, for one, has been targeted by hackers for theft many times.

In addition, proponents of DeFi claim that such a marketplace enables 'frictionless' lending and borrowing – which may be true in the sense that anyone, without proper KYC/AML procedures, can engage in such transactions – and this is likely to be frowned upon by regulators. Also, borrowers do not have to explain the reasons for borrowing a crypto asset, although it is presumed to be for speculative purposes, which is likely to add to the already volatile crypto markets.

The most incredible part is that some DeFI transactions promise interest yields in the double digits, which seem to be too good to be true. The reality and profit mechanism behind DeFi platforms is often hard to penetrate due to the euphoric rhetoric and lack of truthful information. These developments have not escaped the attention of regulators. Two DeFi platforms, Celsius and BlockFi, have come under the scrutiny of US state regulators in 2021. The regulators regard the DeFi products marketed as 'interest-bearing accounts' by these two outfits as 'unregistered securities' offered unlawfully.

The FCA recognises the significant risks associated with decentralised finance (DeFi) activities, including operational vulnerabilities and the lack of clearly identifiable responsible parties. It has stated that truly decentralised DeFi falls outside the current regulatory perimeter but intends to develop further guidance and engage market participants to better understand and manage the risks.

8.2.6 Non-Fungible Tokens

NFTs are encoded with the same software of cryptocurrencies and are becoming an increasingly popular way to buy and sell digital artwork. NFTs have been around since 2014, but the market exploded in 2021. By the end of 2021 nearly $41 billion had been spent on NFTs, making the market for digital artwork and collectibles almost as valuable as the global art market.

In October 2021 *The Economist* newspaper invited bids for a non-fungible token (NFT) of an image of their recent cover on decentralised finance. NFTs are digital ownership certificates registered on a blockchain – an immutable record that cannot be changed. The winner paid 99.9 ether – which was then worth around $420,000.[35]

8.2.7 Stablecoins and Central Bank Digital Currencies (CBDCs)

Stablecoins are cryptocurrencies primarily pegged to stable fiat currencies, with some linked to commodities such as gold or silver. They offer price stability, fast, low-cost digital payments and are popular for everyday and cross-border transactions, although they face increasing regulatory scrutiny and competition from emerging CBDCs. Financial advisers should carefully assess the legal and regulatory status of gold-linked digital assets before recommendation.

35 https://www.ft.com/content/e95f5ac2-0476-41f4-abd4-8a99faa7737d

CBDCs are reshaping digital payments, with China leading through its digital yuan (e-CNY), offering real-world application and expanding internationally. The European Central Bank (RCB) is advancing its digital euro, aiming for rollout soon after completing key development phases in late 2025. The Bank of England (BoE) is designing a digital pound but has not yet set a launch date. Other central banks, including those of Brazil and India, are also pursuing CBDC initiatives to enhance financial inclusion and reduce informal economies.

While CBDCs may compete with stablecoins, especially in retail and cross-border payments, stablecoins are unlikely to become obsolete due to their essential roles in global accessibility, integration with decentralised finance and privacy features. However, rising regulatory scrutiny and CBDC adoption will likely reshape the stablecoin market in jurisdictions with advanced digital currency infrastructures.

8.3 Crowdfunding

Following the 2008 global financial crisis, online crowdfunding has become a way of financing a project or business by raising money from a large number of people.

The FCA regulates the following types of crowdfunding:

- loan-based crowdfunding: also known as 'peer-to-peer lending', consumers lend money to businesses in return for interest payments and a repayment of capital over time, and
- investment-based crowdfunding: consumers invest directly or indirectly in businesses by buying investments such as shares or debentures, which act like bonds.

Loan-based crowdfunding platforms allow for the lending of money while bypassing traditional banks; returns are financial, but investors also benefit from having contributed to the success of an idea they believe in. This finance option is primarily for SMEs that have been in business for a while and are profitable.

The main loan-based crowdfunding platforms include Funding Circle in the UK and Lending Club in the US. Funding Circle is also one of the oldest peer-to-peer crowdfunding platforms in the UK. It was launched in 2010, and grew rapidly to be listed on the London Stock Exchange (LSE) in 2018, with a valuation of £1.5 billion. The platform enables investors to lend to small companies, but its lending mechanisms have changed over time. For example, it used to allow retail investors to pick and choose which particular company to lend to, but in 2017 it suspended this function, citing lack of diversification as a risk to retail investors. It is also known to have closed down its Funding Circle SME Income Fund, which holds a portfolio of small business loans. The company said the fund is a '*declining part of its overall funding mix*' and initiated a winding-down process to return funds to investors. The company has operations in UK, the US, Germany and the Netherlands.

As far as debt is concerned, investment-based crowdfunding refers to mini-bonds (or crowd bonds), a way for investors to lend money directly to businesses. They became quite popular a few years ago, but after the FCA banned the sale of mini-bonds to retail investors in 2020, their popularity substantially reduced. Mini-bonds typically used to have terms of three to five years and investors were rewarded in the form of either regular interest payments (eg, annually) or a lump sum at the end of the term, alongside their initial investment.

The FCA faced increased scrutiny in this market after several mini-bond scandals. The collapse of mini-bond provider London Capital & Finance, which promised clients 8 per cent interest, put at risk more than £200 million invested by over 10,000 people.

The FCA found that different platforms and loans carry different levels of risk:

8.3.1 Loan-Based Crowdfunding

Consumers who invest via loan-based crowdfunding platforms need to be aware that:

- you will not have access to the Financial Services Compensation Scheme (FSCS)
- although some platforms have a way of cashing in your investment (a secondary market), you may not always be able to cash it in quickly or for as much money as you paid – you may get back less than what you put in
- it is higher risk than holding money in a savings account, and
- you may lose some or all of the money that you invest.

8.3.2 Investment-based Crowdfunding

Due to the potential for losses, we regard investment-based crowdfunding as a high-risk investment activity. As well as the risks associated with loan-based crowdfunding, for investment-based crowdfunding it is very likely that you will lose all your money.

- Most investments are in shares or debt securities in start-up companies and will often result in a 100% loss of capital as most start-up businesses fail.
- You will not be repaid and/or dividends will not be paid if the company you invest in fails or there is a fraud.
- If you hold shares in a business or project, it is unlikely that income in the form of dividends will be paid. The value of your investment may be diluted if more shares are issued, and this is likely as many start-up businesses undergo multiple rounds of funding.
- You should be prepared to wait for a return on your investment, as even successful start-up businesses tend to take time to generate income.
- If firms do handle clients' money without our permission or authorisation, there will be no protection for investors in place. This is a particular risk if a platform fails and becomes insolvent.
- Most platforms do not have a way you can cash in your investment (a secondary market).

For debt security crowdfunding, it is likely that you will lose some or all of your money. Most debt securities on offer are issued by start-up companies and can result in capital loss if the businesses fail.

- Your money will not be repaid and/or expected coupon payments will not be paid if the company you invest in fails or there is fraud.
- The company can become more likely to fail over time, increasing the risk of the investment.
- If firms do handle clients' money without our permission or authorisation, there won't be protection for investors. This is a particular risk if a platform fails and becomes insolvent.
- Securities offered on such platforms are not usually traded on a secondary market and most are not transferable. This means you may be unable to cash in your investment. You should be prepared to hold any securities you buy until maturity.

Source: https://www.fca.org.uk/consumers/crowdfunding

8.3.3 Equity Crowdfunding

Equity crowdfunding online platforms like Republic Europe (formerly Seedrs) and Crowdcube allow people to invest in an opportunity in exchange for equity. Money is exchanged for shares or a small stake in a business, project or venture. As with other types of shares (apart from community shares), their value rises or falls depending on the success of the project.

Most sectors are now using crowdfunding, from food and drink to cleantech, from real estate to FinTech. Equity crowdfunding also provides investment opportunities not available at mainstream financial institutions. One example is Yielders, a UK Sharia-compliant platform that enables Muslims to invest in real estate via special purpose vehicles (SPVs).

There are many other crowdfunding platforms in the UK. The fees they charge vary enormously, which makes deciding which one to choose for raising funds quite challenging.

Chapter Four

Retirement Planning

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Retirement planning is a critical part of wealth management that focuses on preparing clients for life after their working years. It involves setting clear retirement income goals and executing strategies to achieve these objectives. Key elements include identifying income sources, estimating future expenses, implementing a robust savings programme, and effectively managing assets and risks. Ideally, retirement planning should commence early in a client's career and continue throughout their retirement.

In this chapter, we will cover the essential concepts of retirement planning, explore the various types of pensions available, delve into the specific regulations governing them and provide insights into the regulatory framework that shapes pension policies.

1. Pensions

Studies indicate that people perceive 'pension' to be an uninteresting word, that a significant lack of trust persists because of the negative view of the financial sector and that it is hard for people to prioritise saving for tomorrow versus spending money today.

There is also a good body of research that strongly indicates retirement planning requires quite different abilities from those needed to manage money well day to day (although the two are complementary); and that it stretches many people's ability to the limits. It shows that people can struggle to engage at all with aspects of retirement planning, such as thinking about their pension or thinking about long-term care; and they either put off making decisions or make decisions that are not fully thought through.

1.1 Participation in Pension Schemes

A string of initiatives since the mid-1990s, aimed at increasing public participation in pensions, have largely failed.

People who were in money purchase (**defined contribution (DC)**) schemes experienced fluctuating pension fund values during the first decade of the millennium, with significant falls during the 2000–02 dotcom crash and the 2007–09 Global Financial Crisis, offset by strong returns, particularly from 2003 to 2008 and a rebound post-2009. This led to a misconception that pensions themselves were at fault, rather than the underlying investment strategies; confidence in private pensions is low. State second and third pensions have either been too complex or have had relatively low uptake or have proved too costly to the public purse and been dropped. Stakeholder pensions have also had a disappointing uptake and have been unprofitable for those insurance companies who offered them. The National Employment Savings Trust (NEST) is a compulsory default membership scheme for employees run by employers and represents just one thread in an increasingly complex web of legislation and regulation of pensions in the UK.

Growing apathy towards markets long term has seen voluntary contributions dwindle versus inflation, and this has been borne out in consumer research and in the statistics for savings as a percentage of earnings (the savings ratio). This is probably the biggest problem for the post-baby boomer generation: a growing pension apathy, an ageing population and a pension deficit in the UK and much of the West.

1.2 Pension Planning Environment

Existing pension plans may also fall short of providing the funds needed in retirement.

Defined benefit (DB) schemes (also known as final salary schemes) that were supposed to offer employees a secure retirement income have been withdrawn by many companies and, for those remaining in such schemes, their companies are sometimes reducing the benefits payable and/or deferring the retirement age at which they are payable.

Instead, the increased liabilities and expenses associated with such schemes have made many companies switch to only offering DC schemes. This has transferred the risk and uncertainties of the financing of retirement from employers to individuals, leaving them with no choice but to take their retirement planning into their own hands.

The concept of choice has accelerated following the 2014 Budget, which initiated certain pension flexibilities referred to as 'pension freedoms' effective from 2015 (Pension Schemes Act 2015). Today's UK retirees no longer have to accept an annuity from an insurance company and can access their pension pot from age 55 (this is increasing to 57 from 2028, and with the state pension age thereafter).

As well as having greater choice, individuals are faced with increasing longevity meaning that they need to fund retirement income for even longer than before. Recent figures from the Office for National Statistics (ONS) estimates that, by 2039, the average life expectancy will be 91 and 89 for women and men respectively. Apart from this, we need to remember that old age typically brings medical problems and increased healthcare expenses. Individuals need, therefore, to consider how they should plan for unforeseen illness and whether their retirement savings will be sufficient, or whether they need to take out medical insurance or long-term care protection policies.

1.3 Importance of Retirement Planning

Increased average life expectancy means, among other things, that it is more important than ever for people to plan and take actions to enjoy rather than endure retirement and to start planning as early in their lives as possible.

Many people may be in retirement for 20 years or more, so planning for a comfortable retirement must be a key financial objective. Increasing flexibility and access to retirement savings adds further challenges to balancing client needs and planning a sustainable retirement. Planning a retirement in which a person can have financial security requires a structured approach. Even when retirement is reached, the need for ongoing financial planning remains and is a continuing activity well into later years.

Before looking at the process, it is essential to understand why planning for retirement is so important:

- Changing demographics and the increasing cost of state pension provision will most probably see this source of retirement income decline and become, at best, a modestly adequate source of income.
- The increasing costs of providing state pensions are forcing governments to reassess how much they pay.

In late 2016, the Schroders Global Investor Study analysed the views of 20,000 investors in 28 countries, offering further insight into the balance between state pensions and encouraging self-reliance in terms of savings and investments. The study asked investors, with at least the equivalent of €10,000 invested, what proportion of their retirement income would come (or currently does come, for those already retired) from a state pension. It also asked if investors were keen to improve their understanding of investing. Globally, investors in Asia and South America were most keen to learn more about investing. They also had the lowest expectations that the state would provide for their retirement. By contrast, Europeans put most hope in a good state pension, with the average investor expecting it to constitute 27% of their total retirement income, compared to just 14% in Asia and 12% in the Americas.

Relying on the state to provide a comfortable retirement is not going to be sufficient. In the UK, it is now extremely rare for a person to reach retirement with a gold standard pension of between half and two-thirds of earnings. It appears that, typically, a retiree may have a retirement income of only about 30% of final earnings. This is a result of greatly increased mobility (people often change jobs during their working life, accumulating mismatched elements of pensions), and the restructuring of occupational pension schemes to reduce the future liabilities of employers. This has been happening in both the public and private sectors, and the first decade of the millennium has seen the steady closure of DB schemes to new members, the conversion of some DC schemes, and clear signals that all governments will reduce the benefits of public sector schemes and require higher contributions from employees.

1.4 Pension Rules

Major changes to UK pension legislation became effective on 6 April 2006, known as A-Day, aimed at simplifying a mass of rules surrounding pensions and which replaced the previous eight tax regimes with one universal scheme. These changes were known as pensions simplification, however, the rules are still very detailed and complex.

Potentially greater changes were made in 2015 with the introduction of pension freedoms. The main aim of these changes was to give people greater access to their pensions, and the ability to shop around for different investment opportunities. Today there is no limit on how much income a person after the age of 55 can choose to take from drawdown funds, although there are tax implications.

The 2015 reforms handed control to people to choose how to use their pension savings but research by the FCA, among others, details that while the reforms are still settling in, there is serious concern about the decisions that people are making.

The FCA Retirement Outcomes Review looked at how the retirement income market is evolving since the pension freedoms were introduced in 2015. The following table summarises this, yet candidates will find it valuable to read the material that the FCA has published covering this, as it provides an insight into the current market, the issues that are arising and the regulatory changes that follow.

FCA Retirement Outcomes Review	
Findings: • Accessing pension pots early has become the new norm. • Over half of pension pots accessed have been fully withdrawn. • Most people who fully withdrew had other sources of income, in addition, to the state pension. • Drawdown has become much more popular.	Emerging issues: • People who fully withdrew their pension pots did so partly because they do not trust pensions. • Most people choose the path of least resistance and accept the offer from their existing pension provider rather than shopping around. • Most people buy drawdown without advice but may need further protection to manage drawdown effectively. • Annuity providers are leaving the open annuity market. • Product innovation has been limited.

Following consultation, the FCA issued policy statements that set out regulatory changes:

- 'Wake-up' packs are to be sent to consumers before deciding on how to access pension savings, risk warnings that must be provided once consumers decide how to access their pension savings, more information about annuity options and making cost comparisons for drawdown products clearer.
- Separate rules on investment pathways for non-advised consumers entering drawdown or transferring-in assets already in drawdown.

Additionally, the Mansion House Accord – covered in detail later in section 6 of this chapter – is a significant initiative aiming to increase pension fund investment in private markets, supporting better saver outcomes and UK economic growth.

1.5 Summary

With any change such as pension freedoms comes greater choice and greater uncertainty. Individuals have to consider issues such as complex options, longevity, tax, investment performance and charges, with many being ill-equipped to do so. People need help to learn new skills and receive guidance about the consequence of their financial choices.

With so many rules surrounding pensions, it is easy to forget what a pension is there to do.

A pension is a form of long-term saving, typically encouraged by governments with tax advantages, and is the most common way of providing income to fund one's lifestyle when occupational earnings (or state benefits) cease. Pensions are about making and reviewing long-term decisions, with an explicit or implicit glide-path to get them to a target retirement date and expected level of accumulated wealth or income.

The 2015 reforms handed control to people to choose how to use their pension savings. This is the challenge for the wealth manager: to simultaneously engage their clients and make sure that pension planning is as disciplined as it is for financial planning and investment management.

2. Retirement Planning

As with every other aspect of financial planning, preparation for retirement is assisted by following a structured process, similar to the financial planning one we have seen in chapter 2. The key stages of the process are as follows:

- Establishing the client's current financial position and what assets are to be used to achieve the retirement goal – be it lump sum or regular contribution investing.
- Establishing the client's health and medical condition in case the adviser needs to consider whether the client can benefit from an impaired or enhanced annuity for certain medical conditions and would get more income.
- Establishing the client's aspirations for retirement.
- Determining what capital will need to be available at retirement to fund their plans.
- Determining how much income will be needed in retirement to fund their intended lifestyle.
- Assessing the client's existing retirement plans along with their assets, liabilities and protection products.
- Developing an investment and protection strategy to meet their needs.
- Identifying appropriate solutions.
- Implementing that strategy and keeping it under regular review.

2.1 Establishing Information

As part of the meeting with the client, the adviser will need to collect all of their basic factual information.

The core information that will be needed includes:

- **Personal information** – this will include age, marital status and employment information.
- **Dependants** – details of children and any other dependants whose needs will require to be taken care of.
- **Health** – information about the client's health, their job and whether they engage in any potentially dangerous or hazardous activities.
- **Assets** – the extent of their assets and savings and any expected inheritances.
- **Liabilities** – what debts must be serviced and how they would continue to be met or repaid in the event of illness or death.
- **Income and expenditure** – details of the client's income and expenditure, so that their potential income needs in retirement can be established in order to maintain their expected standard of living. It will also be necessary to determine the client's tax rate.
- **Inclusion of inflation rate** – An option to allow the inclusion of an assumed inflation rate.
- **One-off payments** – any planned payments that may fall due, eg, special one-off retirement holiday or purchase, a child's wedding or deposit for a house.
- **Protection** – details of any protection policies in place that are relevant to the retirement planning process.

While the basic information needed is the same as for other types of financial planning, where the process for collecting the information differs is that the emphasis is on analysing where the client is now and where they expect to be at retirement.

The additional information that is needed will, therefore, include:

- anticipated retirement date
- any medical conditions that may be relevant
- current assets and investments
- expected lump sum payments from any existing pension arrangements
- estimates of the income they can expect from any existing pension arrangements
- the amount of any state pension that might be payable, and
- what level of cash reserves the client will need for emergencies and the unexpected.

In order to develop a strategy from this information, advisers will, therefore, need to understand in detail, their expectations and will need to consider, among other things, the following:

- An estimate of any lump sum (after income tax) that may be needed at retirement to repay items, such as mortgages, or to fund activities such as special holidays.
- An estimate of the income they will need in retirement, taking into account inflation and income tax.

The next stage is, therefore, to quantify what the client's aspirations and needs are.

2.2 Intended Retirement Age

Once an individual finishes work, they will clearly cease to generate earned income, yet they will still have to meet their living expenses and other commitments. This presents a major financial planning need.

When retirement occurs will vary considerably, from those who plan to retire from work at the traditional retirement age, say, 65, to those who aspire to finish earlier, say, in their 50s, to make the most of the opportunities it presents. Whichever, they are likely to have to fund at least 20 years of living and leisure expenses, with 30–40 years in retirement set to become increasingly common. This always assumes the individual enjoys good health and fortune and is not forced to finish work earlier through either ill health or job loss. It is also worthwhile noting that people are working for longer, helped by anti-age discrimination laws and the abolition of a compulsory upper retirement age.

The global trend of an ageing population cannot be underestimated. In the UK, for example, one in four people are projected to be aged over 65 years by 2050 according to the ONS, creating significant implications for economic policy and personal pension planning decisions.

Consequently, planning for long-term income has become, and is set to continue to be, a core area of retirement planning, as well as providing strategies that encompass income and growth to support phased retirement.

An individual may be fortunate enough to have, through their employer, good pension arrangements which can supplement savings made during their working life; or they may make their own arrangements in any of a variety of ways, from saving to investment in property or business assets.

Retirement planning, therefore, needs to be based upon a broad approach and one that is flexible enough to accommodate a wide range of strategies and a horizon that is potentially longer than what the client expects.

2.3 Quantifying Needs

Peoples' expectations of retirement have changed markedly over the last few decades and the adviser will need to understand the changing factors that may affect a client's circumstances and their retirement aspirations.

After establishing the client's intended retirement age, the next stage is to make an estimate of both the lump sum and income requirements that will be needed. This should take account of long-term needs, as well as any immediate requirements, and factor in the possible need for medical treatment and long-term care.

An adviser will need to investigate with the client what income they will need in retirement. One way of achieving that is for the client to complete an expenditure plan such as the following:

Outgoings	Pre-Retirement	Post-Retirement	Difference
Rent or mortgage payments			
Other loan repayments			
Credit card repayments			
Local taxes			
Food			
Clothing			
Gas, electricity and water			
Schooling costs			
Telephone and internet connections			
Car costs including petrol, servicing and insurance			
Socialising			
Holidays and breaks			
Other			
Total			

The client can use this to record their current expenditure and then make an estimate of what they expect it to be post-retirement taking account of inflation. Retirement will generally bring about a lowering of many items of expenditure such as travel costs as there is no need to travel to work but increase others such as holidays and breaks.

Establishing that, however, can be difficult. If the client is not able to make a realistic assessment, then as a rule of thumb it is generally reckoned that an individual will need about three-quarters of their net income to maintain a similar lifestyle in retirement. However, advisers should recognise that there is no universally accepted fraction, and some people will find their expenditure increases as they indulge in travel, hobbies and pastimes. It is key to tease out from clients a realistic figure and make a judgement as to their capacity to stay within a calculated budget.

This assessment is also, however, made in today's money, and the adviser will therefore need to make an estimate of the effect of compound growth which tends to enhance the overall return, countered by an allowance for inflation, which reduces the purchasing power of the growth rate (final sum/income) in real terms. The long-term impact of charges is also cumulative and should not be underestimated. In pension and actuarial terms, the reduction in growth caused by charges is sometimes referred to as the reduction in yield (RIY).

To calculate the impact of inflation, we need to know the client's intended retirement age and use an estimate of what inflation might be over that period. Predicting what inflation might average over a period of time is fraught with problems, but the adviser should look at what the trend rate of inflation is and then select a figure that will provide a conservative estimate for the client, such as historical average **consumer price index (CPI)**, Bank of England (BoE) inflation outlook, or its target or core inflation. Also, the adviser might try to determine the client's personal inflation rate where they have expenditure likely to rise significantly faster than general inflation.

This assessment will give an indication of how much net annual income will be needed in retirement to finance the client's hoped-for lifestyle. The next steps are to determine how much of this the client needs to fund themselves and how much they can expect to be funded from any existing pension arrangements that they have and from any state pension payments they might receive.

Having established this, the adviser can then look at what other lump sums will need to be generated to meet the client's plans and aspirations. In doing so, they will clearly take into account any expected lump sums that the client may reasonably expect to receive from any protection policies they may have, from any pension plans or from any inheritances.

This will leave a net amount of capital that needs to be generated. Again, this will need to be adjusted for inflation and the same calculation as above can be used to determine this figure.

Having established when the client wishes to retire and what income and capital sum, they will need to achieve this, we can move on to assess whether their existing retirement plans are suitable for their objectives.

2.4 Existing Retirement Arrangements

Pension schemes tend to receive favourable tax treatment from governments so that they encourage individuals to make their own retirement provision and thus relieve the state of the need to fund it. The tax benefits tend to be twofold: tax relief on contributions made into the scheme, and either exemption or additional allowances against tax on gains and dividend income, but only while the fund remains within the tax-exempt pension wrapper. For this reason, pension arrangements continue to provide a useful tax-efficient investment vehicle for meeting clients' needs.

The adviser will clearly need to determine the detail of any scheme that a client is part of or has the option to join. In doing so, they will also need to establish the availability of benefits from the arrangements. The adviser will need to establish at what age the client can retire and take benefits, which will usually be available in the form of a lump sum, with the remainder as an ongoing income. For the latter, it should also be established whether there is an ongoing pension for the surviving spouse/civil partner following death.

The extent of any death benefits which may be provided should also be identified. It is usual to provide for a lump sum to be paid in the event of death before retirement by either a return of part of the fund or by life assurance.

The adviser will need to determine what type of pension plan the client has and what retirement benefits it will generate.

It will, therefore, be necessary to identify:

- the age at which benefits can be taken
- the expected amount of any state pension
- the expected amount of income that will be payable, if it is a defined benefit (DB) scheme and how future increases to the pension are calculated
- if it is a defined contribution (DC) scheme, the value of the pension fund and what funds it is invested in
- any penalties, such as actuarial reductions that may be made for taking retirement benefits early, and
- the lump sum that can be taken at retirement.

All the above facts should be available from the scheme booklet.

As well as establishing what type of scheme the client may be a member of, the adviser should also look at whether additional contributions can be made. The client may be able to make extra contributions to the pension scheme. Although the provision of additional voluntary contributions (AVCs) is no longer compulsory, some occupational schemes still offer them. They may be DC arrangements or, now extremely rarely, the ability to buy added years in a DB scheme. Public sector schemes in particular still usually offer some benefit-enhancement opportunities.

Where such opportunities do not exist, a stand-alone personal pension could be set up, always remembering the annual allowance limits. If the client's main pension is through a DB occupational scheme, the annual increase in benefits counts towards the available annual allowance on a ratio of 16:1 (using the valuation factor for the Annual Allowance test).

2.5 Retirement Planning Strategy

The analysis undertaken up to this point will show the capital and income the client will need in retirement and what gap needs to be financed. The adviser can now turn to developing a strategy to meet those needs.

2.5.1 Sources of Capital and Income in Retirement

Pension arrangements may represent a major part of the client's assets that will be used in retirement, but they are not the only solution, and a wide range of other assets will need to be taken into consideration.

The rest of the client's assets will also contribute towards the funds that are needed to finance retirement.

This will include:

- Their home which, although still required in retirement, offers the opportunity for them to sell and purchase something less expensive and thus free up capital for investment.
- They may own property which is rented out and which can either provide a lump sum for investment or a continuing income source.

- They may have their own business and there may be the opportunity to sell this as a going concern, realise assets or for the business to be continued by others and still receive income via a reduced involvement, consultancy arrangement or dividends.
- There will also be the whole range of other assets that the client builds up during their life, including cash deposits, collective investment funds and other investment products.

In almost all cases, a mix of asset types is likely to be necessary to meet the client's retirement planning objectives, along with appropriate protection products.

2.5.2 Main Aims and Strategies

It is worth reflecting on investment strategy and asset allocation and how these might change during an individual's lifetime from a retirement planning viewpoint.

During a client's life, even though they will be investing for retirement and their attitude to risk may not change dramatically, their investment strategy may need to. This gives rise to lifestyling and underlines the importance of regular reviews (eg, annual).

As retirement approaches, there will come a point when the priority switches to securing gains. When this is done will be determined not only by the client's anticipated retirement date but by their attitude to risk. A more cautious individual will want to remove the risk of stock market volatility earlier and switch into more secure investments, while someone who is adventurous, and maybe has greater financial resources, may be prepared to delay this in order to secure greater gains if income is not an immediate concern.

2.5.3 Lifestyling and Glide Paths

The approach to automatically switching a portion every year from more high-risk securities, such as equities, into low-risk assets, such as **gilts**, is called lifestyling.

However, while this strategy may make sense when conventional annuitisation is planned, a large fund and low annuity rates may combine to make drawdown attractive, at least *pro tem*. If income drawdown is being considered, then the strategy will almost certainly require the inclusion of risky assets in the portfolio; low-risk assets will probably result in rapid capital erosion as income is withdrawn, although this does depend on the agreed risk level and mandate signed by the client.

As the client approaches the retirement period, a change in risk levels and strategy is needed; between five to ten years before retirement, the adviser should be initiating an annual review with the client to discuss the options and risks. Alternatively, at the outset of their investment in a pension, the client may agree to lifestyling management. It is important to note that wealth managers must not take it upon themselves to change the mandate strategy without the client's full consent.

Sometimes referred to as de-risking, lifestyle strategies follow a glide path based on a client's normal retirement date. This can be adjusted by the wealth manager through the course of a client's pension planning. Lifestyling generally applies to portfolios made up of a basket of direct or indirect assets and normally involves rotating assets from riskier assets to lower-risk assets in the last few years before

retirement. The conventional rotation is to move from equities and other risky assets into lower-volatility bonds, then gilts and finally cash.

The asset allocation is often based on long-term actuarial models (eg, the Wilkie Investment Model) or through more active asset allocation processes. Strategies are often rebalanced monthly or quarterly to adjust for market movements, and thereby crystallise losses or gains to put the strategy back on the intended glide path. Without rebalancing, a strategy can drift and so alter its risk profile.

This area has been further complicated by pension freedoms, which challenge the presumption that a pension client will purchase an annuity. Sequencing risk is the term given to a portfolio running out of capital sooner than expected, or not providing sufficient steady cash flow because of the double effect of drawing down income coupled to any volatility or drawdowns in the underlying portfolio.

Target date funds are similar but have a pre-set target date that the investor usually invests singularly. These are indirect investments, whereby the glide path is already pre-programmed and run by a fund manager. If the investor wants to change their selected target date (or glide path), then they have to switch out of that fund into another with the correct target date or risk profile. Target date funds benefit from the skill of the fund manager in exchange for some loss of control and flexibility for the wealth manager and client.

Over recent years, interest rates have increased, and gilts have become an increasingly popular choice for wealth managers, particularly short-dated gilts. This is, of course, a lower-risk strategy compared to approaches used during the years that followed the Global Financial Crisis, when some wealth managers even used derivatives and structured products as part of a lifestyle strategy to enhance return. Now interest rates are no longer at record lows. The 10-year gilt is yielding around 4% – this should reduce the use of riskier plans in the future.

It needs to be remembered, though, that retirement planning will be just one of the client's objectives and the investment strategy adopted will have to be balanced against the client's other objectives. At retirement, their objectives will clearly change. They will need to replace any earned income with an alternative source, namely income from any pension arrangements and from the capital that has been accumulated or revise their future income expectations so as not to increase the risk of their present investment strategy. The client's attitude and feelings about risk and loss may change, as most individuals will be reluctant to put all their hard work at risk, but this requires a sensitive discussion with the client and spouse (if any).

It is important to accept that there may be limits to planning. Ideally, the required future income (in real terms) will be determined early, and this target is effectively the pension liability. If the fund is large enough, and the liability can be covered by a portfolio of gilts or by buying an indexed lifetime annuity, this liability matching should almost certainly be done. However, in practice, such occasions are rare, and most clients do not have a sufficiently large pension pot to guarantee their required income. The probability of this can be judged over time, by monitoring the investment performance at annual review meetings. If it appears that a risk-free annuity will not meet the target income, a very careful decision needs to be made on investment strategy.

As can be seen, there is no single solution and it is the individual circumstances of the client, their objectives and their attitude to risk that will determine the strategy that is adopted.

2.5.4 Criteria for Matching Solutions to Client Needs

As retirement planning is essentially concerned with long-term investments, it is really only one element of lifelong investment planning. Applying holistic financial advice may generate different investment strategies. For example, to pay for a child's school or university fees, a client could have a low risk, income-producing strategy. By comparison, for a long-term pension strategy, the same client would go for a high-risk, high-growth strategy. The difference between the two is time horizon, income yield, liquidity needs and level of risk.

For investment products, the criteria used to assess these factors will be the same as considered in the chapter on Investment Planning.

For pension products, although there is little to differentiate the mechanics of the product itself, there are other differentiators, such as charges, wrappers, investment options, lifestyling, retirement income options, quality of communication, governance and quality of service. The adviser should check that features such as tax treatment, eligibility and maximum contributions are the same.

The key factors the adviser will want to consider include the following:

- The range of funds that the investor will have access to and whether this matches the required asset allocation.
- Whether there is a diversified choice of funds provided by other investment houses.
- Whether the provider has an active and visible fund governance process.
- The regulatory history and reputation of the provider.
- The past performance and risk metrics of the funds.
- The investment style and strategies adopted by the fund managers.
- The terms for switching between funds.
- Waiver of contributions.
- The level of minimum contributions.
- Retirement benefit and drawdown options.
- Charges and exit penalties.

They will also need to take into account financial strength and service quality in the selection of the provider.

Where pure investment or protection products have a part to play in the solution, the approach will be the same as covered above.

2.5.5 Presenting Recommendations

The recommendations made should be presented to the client in a suitability report so that they have the time to consider the detail of what is being suggested and so that there is a documented plan that can be referred to at a later date, when progress is being reviewed.

The report will need to summarise the details obtained from the client and their current position. It should then list the objectives and priorities that have been agreed and then go on to detail how the recommendations that are being made have been arrived at. The report should be fair, clear and not misleading.

The report will need to set out the results of the analysis that have been undertaken:

- **Income**
  - The level of income needed in retirement adjusted for inflation.
  - The proportion of income to be met from existing pension arrangements. Whether additional pension contributions can or should be made.
  - Whether the existing pension arrangements are suitable or should be switched to an alternative provider.
  - The amount of additional income that will need to be generated in retirement over and above that received from state, company and personal pensions.
- **Capital**
  - The amount of capital needed at retirement in order to provide an investment fund to generate the additional income needed in retirement.
  - The amount of capital needed to meet other plans of the client at retirement and provide a cash reserve into retirement.
  - The value of any existing assets and the extent to which they can be utilised and invested to meet these needs.
  - The extent of any funds that are expected to be received from other sources, such as insurance policies or inheritances.
  - The growth rate that needs to be achieved to generate the lump sum needed.
- **Protection**
  - The extent of any existing protection policies that are in place to address areas such as income protection, medical insurance and life cover.
  - Essential gaps in protection cover that need to be dealt with.

As part of your recommendation, an estimate will need to be made about charges, which can have an effect on long-term returns. It will then set out the recommendations that are being made, how they relate to priorities and objectives and an explanation of the choice of provider.

The report will be accompanied by any supporting product brochures, charges, illustrations, key features documents (KFDs), a key information document (KID) if the product falls under PRIIPs rules, and key investor information documents (KIIDs). It will also note the action needed to implement the requirements.

3. Types of Pensions

There are many ways of categorising the various types of pension schemes found in the UK but for simplicity, it is possible to break them down into three types:

1. State pension.
2. Defined benefit (DB) schemes.
3. Defined contribution (DC) schemes.

There are then several different types of DC schemes from occupational ones to personal pensions. In the following section, we will look at some of the main types encountered.

3.1 State Pensions

The UK state pension system was first introduced in 1909 and was paid to people aged 70 or more; at the time, this was around 500,000 people as only one in four reached that age and life expectancy post-retirement was about nine years.

Since then, it has undergone numerous changes over the years. Often when new systems and rules were introduced, entitlements under the previous systems were preserved resulting in a complicated nature of entitlements. This was one of the reasons for the introduction of the new state single-tier pension in 2016.

The state pension in the UK is based on a pay-as-you-go basis where contributions from working-age individuals are used to finance the pensions payable to those eligible for the state pension. It is essentially an unfunded scheme and spending on state pensions in the UK represents the largest single element of public spending.

Advisers are likely to encounter clients whose entitlements are based on the old rules and ones who will receive the new state pension and so need to be aware of the general terms of each.

3.1.1 New State Pension

The new state pension was introduced with the stated government intention of streamlining the old system, making it easier to understand and to provide a more comprehensive basic level of retirement income.

It is a single tier or flat rate pension payable once an individual reaches state pension age (SPA) so that individuals will receive the same level of benefit provided they have the necessary number of years of qualifying National Insurance (NI) contributions.

National Insurance (NI) Contributions

The entitlement to the new state pension is based on an individual's NI contribution record. Any year in which the individual pays NI contributions or is credited with NI contributions is known as a qualifying year. NI contribution rules are complex and there are several activities that count as credit towards the total number of years contributions.

An individual needs 35 years or more of NI contributions to qualify for the full new state pension. A minimum of ten qualifying years are necessary to get any new state pension.

State Pension Age

State pension age (SPA) is the minimum age at which an individual can claim the state pension and depends on their date of birth as gradual increases in the SPA are underway.

The SPA is currently 66. It is due to rise to age 67 between 2026 and 2028, and to age 68 thereafter.

The Pensions Act 2014 provides a regular review of the SPA, at least once every five years.

State Pension Age Review 2023

The government's 2023 review of the state pension has concluded that it aims to maintain the pension as a reliable and fair source of retirement income for future generations. The review considered various evidence, including the findings from the Government Actuary and Baroness Neville-Rolfe's Independent Report, which highlighted challenges related to life expectancy and fiscal sustainability. Based on the report's conclusions, the government agrees that raising the State Pension age from 66 to 67 is appropriate, scheduled to take place between 2026 and 2028. However, the report did not consider the long-term impacts of recent economic changes, such as COVID-19 and the global energy crisis, leading to uncertainty regarding future increases. A further review is planned within two years to assess age 68, considering updated information on life expectancy, demographics, the economy, and labour market conditions. The government is committed to providing a 10-year notice for any changes to the state pension age.

Amount Payable

An individual pensioner with a complete NI contribution record of 35 years, who is entitled to the full new state pension, will receive £230.25 a week from April 2025. Anyone who contracted out under the old state pension may receive a reduced amount. Individuals can choose to defer the commencement of their new state pension in return for an increase in the amount payable known as an enhanced pension. For each nine weeks of deferral, they can receive an increase of 1% in their pension which is an equivalent of around 5.8% for each year people defer.

Uprating of the State Pension

There have been varying systems in place to uplift the amount of state pension payable.

From April 2011, the basic state pension and the new state pension have increased by the higher of 2.5%, the increase in average earnings and the rate of inflation as measured by CPI. This is known as the 'triple lock' but is not enshrined in legislation. The triple lock was suspended in 2022–23 due to distorted wage growth figures because of COVID-19. In 2023–24, it will rise by 10.1%. The table below shows the weekly amounts payable under the basic state pension and the new state pension and how they have increased in recent years.

State Pension Weekly Amount		
Year	**Basic State Pension**	**New State Pension**
April 2016	£119.30	£155.65
April 2017	£122.30	£159.55
April 2018	£125.95	£164.35
April 2019	£129.20	£168.60
April 2020	£134.25	£175.20
April 2021	£137.60	£179.60
April 2022	£141.85	£185.15
April 2023	£156.20	£203.85
April 2024	£169.50	£221.20
April 2025	£176.45	£230.25

3.1.2 'Old' State Pension

The 'old' state pension consists of two tiers:

- the basic state pension which is a flat-rate benefit, and
- the additional state pension which is earnings related.

The first tier is the basic state pension which is based on the number of qualifying years of NI contribution. People retiring between 6 April 2010 and 5 April 2016 needed 30 qualifying years to receive the full basic state pension, which is £176.45 per week from April 2025. There was no minimum number of qualifying years required before 2010. Pensioners with relatively low incomes may also qualify for means-tested support through, for example, the Pension Credit.

Before April 2016, some people received a state pension based on their partner's NI contributions. These included individuals who were expecting to receive a pension based on their spouse or civil partner's NI contributions and married women who paid reduced rates of NI on the assumption that they would receive a pension based on their husband's contributions.

The second tier is the additional state pension which, as mentioned above, is earnings related and was intended to provide further pension income that was more closely related to the individual's earnings level although over time it became less earnings-related and more flat rate.

The additional state pension has existed in three different guises:

- a compulsory graduated retirement benefit scheme from 1961 to 1975
- the state earnings related pension scheme (SERPS) which operated between 1978 and 2002 and
- the state second pension (S2P) which replaced SERPS from 2002 until 2016.

Contributions were made in proportion to earnings so the amount payable depends on the level of contribution and varies from individual to individual.

3.1.3 Contracting Out

From 1978, it was possible to 'contract out' of the additional state pension into a private pension scheme that met certain requirements. Where an individual was contracted out into a salary-related scheme, they and their employer paid lower NI contributions, reduced by the amount of the 'contracted-out rebate'.

From April 2012, the contracting-out option was removed for DC schemes and people were contracted back into the additional state pension. Members of DB schemes were able to continue to contract out until 2016 as their employer was responsible for providing an actuarially-assessed equivalent value of private pension.

Contracting out was removed with the introduction of the new state pension in 2016 and has led to a confusing picture for individuals approaching SPA as to whether they have built up the required number of years' worth of contributions.

Most people were contracted out at some time during their working life. Under the new state pension, people who contracted out of SERPS and/or S2P are treated as having built up less state pension rights than similar individuals who did not contract out.

- When calculating the amount payable under the new state pension, a 'starting amount' is calculated based on the individual's NI record at 6 April each year.
- The calculation compares the amount of state pension they would have received under the old state pension rules with that under the new state pension rules. The higher of these amounts is the starting amount for the new state pension system.
- If they were contracted out, they are likely to have a lower starting amount, and if the individual is close to retirement, they are likely to receive a lower rate of new state pension.
- If they still have some years to go to SPA, they can continue to add further qualifying years to their NI record either until they reach the full new state pension or reach SPA – whichever is the sooner.

Example

Each qualifying year on an individual's National Insurance (NI) record after 5 April 2016 adds to their new State Pension. The value of each qualifying year is calculated by dividing the full new State Pension by 35 (the number of qualifying years of NI contributions needed to receive the full new State Pension). For the 2025-26 tax year, the full new State Pension is £230.25 a week, so each qualifying year adds about £6.58.

If someone had a starting amount of £120 per week at April 2016 and adds another nine qualifying years before their State Pension Age (SPA), this would add £59.22 (9 × £6.58) to their pension, bringing their total to £179.22. (We use nine years assuming nine tax years have passed since the introduction of the new State Pension in April 2016 to April 2025.)

Individuals affected by this should bear in mind that the pension they get from their workplace or personal pension scheme for the periods they were contracted out, should include an amount that, in most cases, will be the equivalent of the additional state pension they would have got if they had not been contracted out.

This is the contracted out pension equivalent (COPE) amount. Individuals can get an estimate of the COPE figure by using the online 'Check your State Pension' service, through their individual self-assessment tax account or by requesting a state pension statement through the post.

In most instances, their private pension will include an amount that is equivalent to the estimated COPE amount. This is not normally identified specifically but is paid by the pension scheme as part of their total private pension. The date when this is payable and the full amount receivable will depend on the rules of that scheme.

DB schemes are required to provide benefits that replace the state pension from which the individual opted out. The private pension built up during the years 1978 to 1997, as a result of being contracted out, is called the guaranteed minimum pension (GMP). If the individual is no longer contributing to this scheme, the scheme is required to revalue the GMP each year and increase it by a fixed rate or the increase in average earnings. If the scheme uses a fixed rate, the GMP should be higher than the additional state pension that the individual would otherwise have got.

3.2 Defined Benefit (DB) Schemes

An occupational pension scheme that takes the form of a DB scheme is where the pension received is related to the number of years of service and the individual's salary. They are more commonly known as final-salary schemes (though the definition of final salary is changing in some cases). Unlike DC schemes, which may be contract-based, DB occupational schemes, whether in the public or private sectors, are invariably trust-based schemes.

A DB scheme essentially promises a given level of income at retirement, usually expressed as a proportion of earnings as defined by the trustees. Contributions to the fund will normally be made by both the employer and the employee, although who contributes what will vary from scheme to scheme.

DB schemes vary from company to company, and the final pension payable is usually expressed as a fraction of the individual's final salary. This is known as an accrual rate and a scheme might provide, for example, one-sixtieth of the employee's final salary for each year of service. Over a 40-year working career, the employee could build up a pension of two-thirds of their final salary. The accrual rate will vary, and some also use an average of the salary received over a period of years leading up to retirement.

The precise terms and conditions will be found in a document called the scheme booklet, and this would be the natural starting point for any advice. All schemes must produce such a booklet. Nearly all occupational schemes, and certainly public sector ones, will have a website. There will also be an employee trustee in nearly all cases, who should be accessible.

DB schemes issue annual benefits statements that show the level of pension benefit expected at retirement based on the individual's current earnings. The members can also request details of the value of their benefits in the form of a transfer value quotation where a transfer to another pension scheme is being considered.

3.2.1 Retirement Benefits

DB schemes will specify the date at which the benefits are expected to be paid, which is known as the normal retirement date or normal pension date.

They will usually have provisions where death occurs before retirement. A death-in-service benefit is usually provided which is generally expressed as a multiple of pensionable pay, and many schemes provide four times pensionable pay, though such benefits are subject to limits under pension law and regulations. In addition, many schemes also provide income benefits for dependants.

At retirement, DB schemes allow part of the member's total benefit to be taken in the form of a lump sum. This is tax-free, providing it does not exceed the HMRC formula for the pension commencement lump sum (PCLS) (see section 4 of this chapter). There are also provisions that permit small pension pots to be taken as cash under the triviality rules.

The remainder of the fund is used to provide retirement income in the form of a pension.

The pension may be payable by the pension fund itself from its internal cash flow. Alternatively, some schemes provide pension benefits, and transfer their own liability, by providing a lump sum that is used to purchase an annuity from an insurance company.

Some DB schemes provide a guarantee for the minimum period for which the pension is paid, so as to ensure that, even if the individual concerned dies shortly after retirement, reasonable value will still have been provided by the scheme. Others will have provisions for a reduced pension to be payable to a surviving spouse/civil partner or dependants, the total package of benefits again being subject to limits.

3.2.2 Scheme Pension

A scheme pension is one payable either from the pension scheme itself or from an insurance company selected by the scheme.

DB schemes can only provide pension income via a scheme pension so if the member wishes to access the flexibiliy offered by pension freedoms, they will have to consider a transfer to a DC scheme.

The rules governing scheme pensions are generally more restrictive than the annuities that can be accessed through a DC scheme. Scheme pensions must:

- be paid at least annually
- not have a guaranteed period of more than ten years
- not reduce unless in specified circumstances (changes to income), and
- be paid by the scheme administrator or an insurance company selected by them.

The law is fairly restrictive on when it allows an amount of scheme pension to change. There is normally no room for variation except in circumstances specified in legislation.

3.2.3 Advantages and Disadvantages of DB Schemes

For the employee, a DB scheme has the advantage of allowing retirement plans to be made with the knowledge of what income will be received. Its potential disadvantages are that, in the final years of working, the employee may not be earning as much as when they were at their peak earning power, and what constitutes the final salary on which the pension will be calculated may be different from total earnings. In assessing such a scheme, consideration needs to be given to the funding position of the scheme and whether it can afford to pay out the promised benefits.

Since about 2000, influenced by several factors, including changes in legislation and economic conditions that made DB schemes increasingly costly for employers, there has been a move to limit the generosity of many DB occupational schemes in the private sector. This includes averaging final salary on a less advantageous basis than previously. Public sector employees, however, have often been able to negotiate retention of the best features of their DB schemes and yet, even here, it is becoming accepted by members and unions that the golden days are probably past.

With a DB scheme, the client can have some reasonable certainty about the amount of income that will be received in retirement, and so the main concerns will be whether this is sufficient, how any annual increases are calculated and the long-term security of the pension fund. Increasingly, DB schemes have been closed to new members, wound up and, in some cases, the value of benefits capped and increased at a nominal rate, such as the CPI. In this case, the end value of benefits may be lower than what the member originally expected.

When assessing such a scheme, the adviser should also establish and take into account any other benefits that are associated with the scheme. These will usually include medical insurance, the possibility of early retirement, death-in-service benefits and spousal or dependant pensions. The scheme or employer will offer incentives to move from the DB scheme by offering an enhanced transfer value (see CETV below in section 3.3.1). This is done to reduce the liabilities of the scheme. Even taking this enhancement into account, it is still often not appropriate to transfer and may result in loss of lifetime allowance protection (see section 4).

As mentioned above, in many cases, a transfer is not appropriate as the benefits available in a DB scheme may be difficult to replicate in a personal pension. A partial transfer could provide the ideal mix of secure DB benefits to provide for core retirement needs, linked with the flexible options offered by DC arrangements. Unfortunately, many schemes do not offer this choice.

3.3 Defined Contribution (DC) Schemes

DC schemes are the other type of pension scheme found in the UK. Most company pension schemes are now defined contribution.

According to the Pension Protection Fund (PPF) in September 2021, almost 2,400 schemes (ie, 45% of all DB schemes) were in deficit by an overall £109.4 billion. Many employers who offered DB schemes have, therefore, closed their schemes, in one of the following three ways:

- **hard freeze or termination** – the scheme is closed to new workers, and existing members are no longer allowed to accrue benefits
- **soft freeze** – the scheme is only closed to new workers, while existing members can continue to accumulate benefits, or
- **partial freeze** – the scheme is frozen for some (but not all) members.

Unlike DB schemes, DC schemes do not guarantee a particular level of retirement income. Instead, the employer and employee agree on a set amount to be contributed to the scheme – these contributions are invested, and the returns from those investments can then be used by the employee to buy an annuity or go into income drawdown. How much the employee receives at retirement depends on the amount paid in, the performance of the investments, any charges that have been deducted and how the benefits are withdrawn.

DC schemes are also known as money purchase schemes. The pension provided is dependent on the contributions made, the investment performance achieved and, ultimately, the size of the accumulated fund when benefits are to be taken. In these types of schemes, the risk lies with the employee rather than the employer, since the employer has not guaranteed a particular level of pension rights.

A company may operate its own pension scheme if it is large enough, but smaller companies will often use a group personal pension arrangement. These are provided by a pension provider, such as an insurance company and although they are employer-sponsored schemes, the legal contract is between the individual and the pension provider. A variation on this approach is a multi-employer pension scheme which offers the same terms to every member regardless of whether they join the scheme as part of a group via their employer or singly as an employee or a self-employed person.

DC schemes can be workplace pensions that are arranged by an employer or a personal pension arranged by an individual. There are many different types including occupational schemes, personal pensions, self-invested personal pensions (SIPPs), small, self-administered schemes (SSASs) and retirement annuity contracts. Until 2012, it was up to a company to determine whether it would offer a pension scheme to its employees and who would be eligible to join. From 2012 onwards, automatic enrolment was introduced requiring all workplaces to enrol their staff into a pension scheme. The Pensions Act 2008 provided the legislation for the introduction of automatic enrolment of employees into private pensions. By 1 February 2018, all employers were required to automatically enrol eligible employees into a pension scheme. To be eligible, workers need to be aged between 22 and the SPA, working in the UK, and earning more than £10,000 a year. Eligible workers can opt out within one month of being enrolled. NEST, which was set up by the UK government to make the process of automatic enrolment easier for employers, has over 13 million members.

Contributions to a DC scheme will be invested either by the pension scheme itself or in funds managed by an insurance company. The eventual value of the pension fund will therefore depend upon the investment performance achieved by the underlying investments. Most insurance-based pension arrangements allow the member to switch between the insurance company's funds, so an individual can switch to more cautious funds as retirement approaches.

The funds will usually be held in a designated trust account for the employee, which gives certainty that they will be available at retirement. The disadvantage is that the actual income that the employee will receive will not be known until retirement, and this makes effective planning significantly more difficult.

At retirement, a tax-free cash lump sum can be taken and the balance used to provide a retirement income. This will be in the form of an annuity or income drawdown depending on the terms of the scheme.

3.3.1 DB to DC Transfers

The pension freedom reforms were aimed at DC schemes as for the majority of members of those schemes, staying in the scheme was likely to be in their best financial interests. However, members of DB schemes have the right to a **cash equivalent transfer value (CETV)** allowing them to transfer to any other scheme, subject to certain conditions.

If an individual is in a private sector DB pension scheme or a funded public sector scheme (such as a local government pension), they can transfer to a DC pension as long as they are not already taking their pension. If they are in an unfunded DB pension scheme (these are mainly public sector schemes), they are not able to transfer to a DC pension scheme.

DC pensions can be accessed flexibly from age 55 (changing to 57 from 2028), but a transfer from a DB pension scheme means giving up valuable benefits and the individual might find themselves worse off. If an individual's pension savings are worth £30,000 or more, they are required to take financial advice on a transfer (see section 5.2 for more details).

Staying in a DB scheme is not risk-free as the employer may become insolvent, leaving the scheme without enough pension funds. On the converse side, any potential advantages of transferring are often outweighed by the costs, risks and loss of benefits involved. The table below highlights some of the advantages and disadvantages of a DB to DC transfer.

Advantages

- The ability to take benefits earlier than the rules of a DB scheme may permit, such as retiring at 60 compared to waiting for the scheme retirement age of 65. Some DB schemes permit this but apply a significant actuarial reduction to the amount of pension payable.
- Choice of when to take the cash-free lump sum available at retirement by phasing the payment, whereas a DB scheme only permits it to be taken in full or not at all. Phasing can help in determining how much income tax the client pays, managing any potential lifetime allowance charge.
- Greater choice of pension annuity options such as enhanced or impaired life annuities.
- Flexibility such as income drawdown which is not an option under a DB scheme. Income drawdown allows the individual to select the level of income they draw from their pension and adjust this to meet their changing requirements.
- Greater flexibility about the range of death benefits and how these are dealt with.

Disadvantages

- With greater flexibility comes greater complexity and the individual needs to be able to fully understand all of the options that are available both at the time of transfer and during their retirement.
- The individual takes on the risk of investing the funds and managing the risks associated with it.
- If they select income drawdown, the individual needs to understand longevity risk and how to effectively manage this to ensure certainty of income during their whole retirement.
- The individual needs to exercise management of their income withdrawals and be in a position to judge what constitutes a practical level of withdrawal and then adjust it based on fund performance during the decumulation phase.
- The protection of the Pension Protection Fund is lost.

In some cases, an existing scheme or employer will offer incentives to move from the DB scheme by offering an enhanced transfer value (see CETV below). This is done to reduce the liabilities of the scheme. Even taking this enhancement into account, it is still often not appropriate to transfer and may result in loss of lifetime allowance protection (see section 4).

As mentioned above, in many cases, a transfer is not appropriate as the benefits available in a DB scheme may be difficult to replicate in a personal pension. A partial transfer could provide the ideal mix of secure DB benefits to provide for core retirement needs, linked with the flexible options offered by DC arrangements. Unfortunately, many schemes do not offer this choice.

Cash Equivalent Transfer Value (CETV)

A transfer value or, to give it its full name, a cash equivalent transfer value (CETV), is the capitalised value of a DB pension scheme member's benefit which they can transfer to an alternative pension scheme. This could be to another DB scheme, a UK DC scheme, or an overseas pension scheme, in certain circumstances.

Transfer values are calculated by the DB scheme actuary using a set of assumptions that they will have agreed with the scheme actuary. These will be similar to, but not necessarily the same as, those used to determine scheme funding and contribution levels. The calculation of transfer values must take into account the nature of members' benefits, the assumed returns on scheme investments, member-specific and population-wide mortality assumptions. If the scheme is significantly underfunded, the

scheme actuary is also allowed to recommend a discount against the CETV to avoid disadvantaging other scheme members. In common with scheme funding, trustees and actuaries must adhere to rules and guidance issued by TPR. TPR specifies a best estimate method which calculates an initial cash equivalent which is the baseline CETV, but it also allows for an alternative method which can result in the CETV being uplifted if the trustees consider it prudent given the funding position of the DB scheme.

Transfer values are typically made up of a number of components which are based on different periods of a scheme member's service. These usually relate to different pensions regulatory regimes or alterations by the scheme trustees of members' entitlements. Some schemes permit partial transfers to be undertaken, and this is an option that advisers should always enquire about and consider when determining how to advise scheme members.

3.3.2 The Rise of DB Pension Transfers

According to a paper published by LCP, a consultancy firm, DB pension schemes were expensive to finance due to ultra-low interest rates and, therefore, offered higher transfer values, reaching record levels.

High transfer values were an important factor in the surge in DB pension transfer activity that took place in the second half of that decade, peaking in 2017. Transfer values have stayed at very high levels for several years, but recently have started to decline, influenced by increasing interest rates. LCP suggests that the typical transfer value quotation in the first quarter of 2022 was just under £300,000, compared with a peak of just over £400,000 in the final quarter of 2021. However, their research shows that there is a variety of factors which can influence the generosity of transfer values, and some could lead to higher values in the future.

The research also points out that pension schemes have discretion over how they set their transfer values, and that there can be a large variation from one scheme to the next in the transfer value offered for an identical pension. For those ten years out from retirement, the amount offered by some schemes can be double that offered by others. Factors which can affect the generosity of transfer values include the age of the member, the longevity of members, the number of members in the scheme, the investment strategy, and the funding level.

The number of people transferring their pension has increased in 2022, but remained below the volume of recent years, according to pension age. This could be due to the current high inflation squeezing people's budgets, in part. It could also be due to people trying to time the market (expecting the values to keep falling for a long time).

Financial advisers who also provide DB pension transfer advice need to understand the particular circumstances of their clients and how ongoing high inflation and rising interest rates will likely impact them in the short and longer term. Bearing in mind the FCA stance on this, most savers are better off staying in their existing DB pension schemes.

3.3.3 Personal Pensions

There are several types of individual arrangements that people can make for their own pensions, including stakeholder pensions and personal pensions. These work with the same underlying principles

as other DC schemes, but charges may be higher due to the provider running the scheme for one person rather than a group of employees.

As the name suggests, personal pensions are pension arrangements made by an individual in order to provide retirement benefits.

They are individual contracts with a pension provider. The provider will usually be a life company but could be a friendly society, a bank, a building society or a unit trust group. They will usually be structured as an insurance contract and may be either with profits, unit linked or invested in unit trusts. That said, SIPPs are also classified as personal pensions, and they are structured as trusts and run by specialist trustee companies.

Personal pensions are a form of DC scheme and so the retirement benefits will depend upon the contributions made, the investment performance of the fund and annuity rates at the time of retirement. At retirement, a tax-free lump sum can be taken and the balance used to provide retirement income through the purchase of an annuity, or the personal pension can remain invested and the client can elect to take income withdrawal.

Personal pensions will tend to have more flexibility than many occupational schemes, which choose not to take on the complexities that the full range of investment and benefit options would entail.

A number of life offices offer group personal pensions (GPPs), where an employer can facilitate the provision of personal pensions to their employees and collect pension contributions through their payroll. A GPP is a collection of individual pension contracts with each member and, because of the cost savings that this type of arrangement can provide, charges can be lower or the benefits better compared to standard personal pensions.

Stakeholder pensions are a type of legacy personal pension and have the same rules for eligibility, transfers, benefits, contributions and taxation. They were introduced in 2001 to provide a relatively simple, low-cost arrangement to encourage more people to save for retirement. Stakeholder pensions are intended to be simple enough not to require regulated financial advice, and the FCA permits this product to be sold with the use of decision trees. However, the number of new stakeholder schemes has been in decline as employers focus on their auto enrolment requirements.

When a firm prepares a suitability report that recommends a personal pension scheme, the rules in COBS 19 require firms to explain why they consider the personal pension scheme to be at least as suitable as a stakeholder pension. It also requires that the firm explains where a personal pension, stakeholder pension or free-standing additional voluntary contribution arrangement (FSAVC) is at least as suitable as any facility to make additional contributions to an existing occupational scheme.

3.3.4 Buyout Policies

Buyout policies were introduced in the early 1980s and were largely superseded by personal pensions.

This is a policy or contract bought from an insurance company using funds from a registered pension scheme. It is referred to as a 'buyout' policy, as the member's benefits rights have been 'bought out' of the registered pension scheme. It is called a **Section 32** policy as this was the Section in the Finance Act 1981 that referred to deferred annuity contracts.

The policy provides for an annuity at some point in the future – a deferred annuity contract. Section 32 policies could be used if:

- the occupational scheme is about to wind up, and/or
- the member has left the employment of the employer running the occupational scheme and they wish to transfer to a deferred annuity contract rather than another employer's scheme, personal pension, or stakeholder pension.

A Section 32 policy cannot receive any further contributions or separate transfer value payments once it is set up.

3.3.5 Self-Invested Personal Pensions (SIPPs)

A self-invested personal pension (SIPP) is a type of personal pension plan aimed at relatively sophisticated investors who wish to have greater control over the investment of the funds within their pension plan.

A SIPP is essentially a pension wrapper that is capable of holding investments in a tax-efficient manner. As a type of personal pension scheme, they have the same rules on contributions, allowances and benefits as discussed above.

SIPPs can be established for one individual or for many members and each scheme will have a scheme provider, a scheme administrator, a scheme trustee, a pension adviser, an investment adviser and an investment manager. Often, more than one of these functions is provided by the same entity. SIPPs can be provided by insurance companies, banks and building societies, unit trusts and friendly societies, but specialist SIPP providers are now increasingly common. The scheme administrator is responsible for ensuring that the scheme is operated in accordance with HMRC rules, and the trustee is responsible for holding and safeguarding the fund's assets.

Charges vary significantly from provider to provider and will encompass an initial set-up fee, annual administration fees and dealing fees. SIPPs are likely, therefore, to have higher charges than other personal pensions or stakeholder pensions, meaning they are more suitable for large funds and for people who are experienced with investing. SIPPs are often categorised as 'low cost' or 'full'. With low-cost SIPPs, the platform does not provide advice, and so the investor makes their own investment choices; a full SIPP offers a wider choice of investments, including commercial property, but typically comes with higher charges.

As well as managing the funds themselves, individuals can use an authorised investment manager to make the decisions for them. The types of investments permitted within a SIPP were standardised from A-Day and are the same for all registered pension schemes. However, the investments offered will depend on the rules of each scheme, and SIPPs generally offer most, or all, of those permitted.

Most esoteric assets (eg, direct residential property, art, classic cars and wine) were technically permitted, but can no longer be used through SIPPs following changes in the Pensions Act 2006. Loans are not permitted, and a SIPP can borrow up to 50% of its value to purchase a commercial property.

Advisers need to be aware that, if they recommend a SIPP, they also have responsibility for the underlying investments. Due diligence on investments is a recurring theme in FCA reviews of the SIPP sector and, in 2014, the FCA wrote to SIPP firms after it found 'unacceptable' and 'significant' failings in firms' due diligence on non-standard investments.

Successful claims against the Financial Services Compensation Scheme (FSCS) and Financial Ombudsman Service (FOS) decisions have confirmed that SIPP providers were deficient in the asset acceptance process, by accepting non-standard investments that were high risk and made by clients with little investment experience and modest funds to invest. Examples of failings by SIPP providers quoted by the FCSC include the following:

- Failing to carry out any due diligence on the underlying investment held in the SIPP.
- Receiving information that indicated that the non-advised investor did not understand the SIPP investment and/or that they were not receiving any advice, but still failed to seek clarification of the investor's understanding.
- Failing to check that advisers who advised investors had the necessary FCA permissions.
- The adviser did not have the necessary authority from the investor to authorise the underlying investment being made via the SIPP.

Since 2015, the Financial Conduct Authority (FCA) has been conducting regular surveys of Self-Invested Personal Pension (SIPP) operators to assess their holdings of non-standard assets. However, in 2022, the FCA expanded its data request to include standard assets due to concerns that non-standard assets were being wrongly categorised as standard. This misclassification led to inaccurate information provided by firms and inadequate financial resources.

Although the 2022 data request was more comprehensive, the FCA has expressed concerns about the quality of data and information received from some firms. These concerns include incomplete or inconsistent returns, with over £4.1 billion of unclassified assets and numerous instances of incorrect asset classification. These data quality issues hinder the FCA's ability to fully assess the risks associated with the dataset.

While the FCA acknowledges that SIPP operators often rely on third parties for data, the regulatory strategy is increasingly reliant on data analysis. The FCA is worried that some firms have not invested enough in their IT systems. The FCA will collaborate with firms and trade bodies on these requests, emphasising the importance of high-quality data to demonstrate effective control. High-quality data will also help firms meet the requirements of the Consumer Duty.

It is worth noting that the most SIPP customers do not take advantage of additional facilities and thus operate like standard personal pensions. This is because the needs of mass affluent clients, generally defined as those with investable assets between £50,000 and £1 million, have often been found to be straightforward, and such price competition has encouraged providers to offer simpler lower-cost SIPPs.

In respect of benefits, SIPPs are no different from other personal pensions and all the usual options are available.

3.3.6 Small Self-Administered Schemes (SSASs)

A **small self-administered scheme (SSAS)** is a form of defined contribution scheme whose members are typically directors within a company. They are occupational schemes that are normally used for small family businesses, due to the requirement for one or more parties to be connected. There can only be one SSAS per company.

A SSAS differs from a standard DC occupational scheme as members are limited to no more than 11, and it allows a much wider investment choice, such as investment in direct commercial property and loan backs, unlike insurance-based schemes, which predominantly invest in funds. At retirement, benefits can be used to provide a tax-free cash lump sum with an annuity purchase or staged income withdrawals. If commercial property is held under a SSAS, rental payments can be paid direct to the member as a form of income.

Since 6 April 2016, there are no longer as many differences between SIPPs and SSASs as previously. Both have a wide range of investment powers and are classed as investment-regulated pension schemes. The main difference is that a SSAS is not an FCA-regulated product and, therefore, has an impact on how advice needs to be given. A SIPP cannot make a loan to a sponsoring employer and, within a SSAS, there are limits to share ownership in a sponsoring employer that do not apply to a SIPP. However, with a SIPP, any purchase of shares in a company controlled by a member may be taxable.

3.3.7 Hybrid Schemes

A cash balance arrangement is a type of DC scheme, with the major difference being that the member's pension pot will grow at a promised fixed rate. The growth of the pension contributions is therefore known, rather than depending on investment performance, but the amount of pension benefits payable are unknown, and depend on market circumstances at the time of retirement.

Other types of hybrid schemes can now be established following the Pension Schemes Act 2015 which introduced legislation to facilitate the development of shared risk and collective benefit schemes in the UK. The Act defines three different categories of pension scheme based on the type of promise offered to members during the accumulation phase about the level or amount of pension benefits. This promise will either refer to all of the retirement income payable from the scheme (ie, a DB-type arrangement), some of the retirement income or some, or all, of the pot (shared risk), or no promise (ie, a DC type arrangement).

Note that the Pension Schemes Act 2021 has introduced an alternative pension scheme design, known as a collective money purchase scheme, in response to a request by the Royal Mail pension scheme. In such schemes, risks are shared collectively by members in contrast to traditional money purchase schemes where the individual member bears the investment risk. These schemes can provide a target level of benefits (eg, the Royal Mail scheme has a target of 1/80th of pensionable pay for each year of service), but the benefits can be adjusted periodically depending on the scheme assets available. These types of schemes are available in other countries, such as Canada, Denmark and the Netherlands, and merge some of the elements of defined benefit schemes with those of DC schemes.

3.3.8 Trust-Based and Contract-Based Schemes

Two main structures are used for occupational pension schemes.

- **Trust-based schemes** are run by a board of trustees that oversees the management and investments in the pension fund. The trustees choose the professionals who look after the money and have a duty to the member of the scheme to get the best deal on their behalf.
- **Contract-based schemes** are where the employer has appointed a pension provider, such as an insurance company, to run the pension scheme. These are sometimes called 'group personal pensions.' The contract is not between the individual and their employer, but between them and the pension provider. These types of schemes often offer a much greater choice in investments than a trust-based scheme.

Since A-Day (6 April 2006), all registered pension schemes must have a registered scheme administrator. The default position is that the scheme trustees will be responsible for this function, but in practice, it is often outsourced to professional administrators.

Where an occupational scheme is established under trust, the scheme's property is held by trustees for the benefit of its members. A trust-based structure ringfences the scheme's assets from the sponsoring employer and protects members' interests in case the employer becomes insolvent. However, increasingly more DC schemes are contract-based, which means the members' interests are serviced by an insurance company. In the last few years, there has been greater regulatory and government focus on how DC schemes are managed, administered and governed for the benefit of customers.

Collective Defined Contribution (CDC) and Master Trusts

CDC schemes pool members' contributions collectively, sharing investment risk and returns to provide a target pension income. They combine features of defined benefit and defined contribution plans and are managed by trustees. Currently, CDC schemes in the UK are available to single employers, though proposals are in place to enable multi-employer CDC schemes. CDCs are regulated by TPR to ensure proper governance and protection of members' interests.

Master Trusts are trust-based schemes serving multiple employers, with separate sections for each. Since the introduction of automatic enrolment in 2012, Master Trusts have grown significantly and now manage the majority of workplace DC pension assets. They operate under strict regulatory oversight by TPR, providing pooled resources, professional management, and enhanced governance to improve member outcomes.

Both CDC schemes and Master Trusts represent key developments in improving pension governance, risk sharing and member outcomes in the UK workplace pension landscape.

3.4 Pension Benefits at Retirement

3.4.1 Retirement Age

The minimum age at which pension benefits can be crystallised is currently 55 years. (Since pension simplification, what used to be known as vesting, retiring or taking benefits is now called pension crystallisation.) The minimum age is due to increase to 57 years from 2028, in line with rises in state pension age.

The only exceptions are the following:

- People who retire due to ill health. Benefits can be taken prior to age 55 where a member is in ill health. To pay benefits in these circumstances, the pension scheme will need a written opinion from a registered medical practitioner that the member is incapable of continuing their current occupation because of physical or mental sickness or disease.
- Members of occupational pension schemes that already have contractual rights to retire early. Any occupational pension scheme member with contractual rights at 9 December 2003 to take benefits from age 50 can retain this right.
- People in special occupations with recognised lower retirement ages, such as sports people, in respect of pension plans established prior to 6 April 2006.

The maximum (otherwise known as default) retirement age has been phased out and most people can now work for as long as they wish.

3.4.2 Tax-Free Lump Sum

A tax-free lump sum may be paid to a member of a registered pension scheme when they start taking benefits from their scheme, known as a pension commencement lump sum (PCLS).

Generally, the tax-free lump sum is 25% of the value of the pension being put into payment but in broad terms it is limited to the lower of 25% of the value of the member's uncrystallised pension rights and 25% of their available lifetime allowance.

Calculating the amount of tax-free cash differs between DB and DC schemes. For DC schemes, it is simply 25% multiplied by the value of the fund. For DB schemes, the calculation is more complex as a **commutation factor** is needed.

The tax-free lump sum is covered further in section 4 (Pension Rules) below.

3.4.3 Small Pension Funds

Individuals with small pension funds can commute them into a one-off lump sum payment under the rules of trivial commutation. As of April 2015, these rules primarily apply to defined benefit (DB) schemes, but defined contribution (DC) schemes are also considered.

The member must be at least 55 years old to access the pension pot as a lump sum. They can take the entire pension pot as a lump sum if their total defined pension benefits (excluding state pension) are valued at £30,000 or less. Additionally, the member may cash in an entire pension as a small pot if its value does not exceed £10,000, without considering other defined benefits.

3.4.4 Benefits Under DB Schemes

At retirement age, a member of a DB scheme usually has a choice of whether to take a tax-free lump sum and an ongoing pension or to take the whole benefits as a pension.

DB schemes will have a normal retirement age that is set out in the scheme booklet following which a scheme pension will be payable. The amount of pension income is usually calculated as:

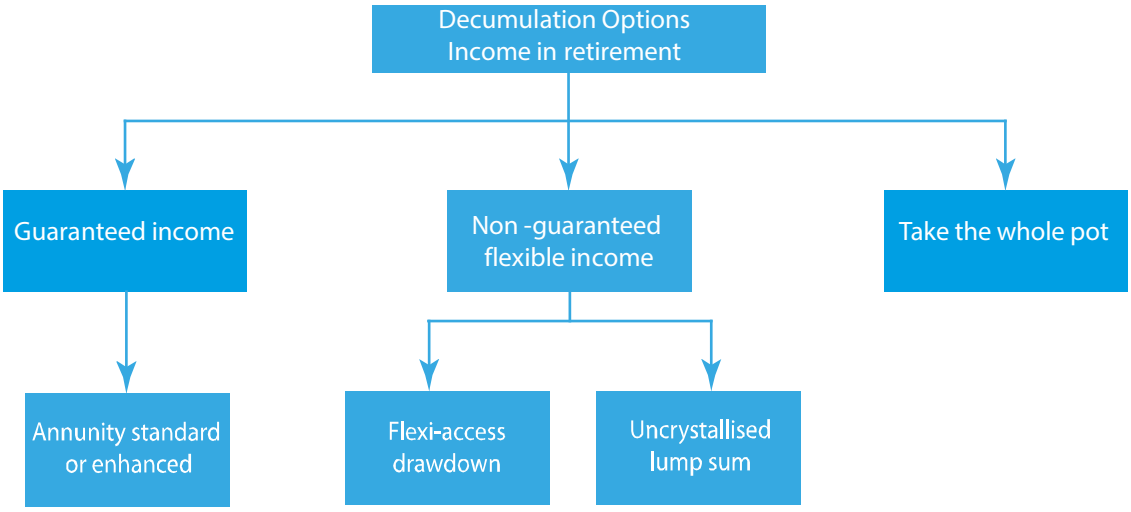
$$\frac{\text{Years in scheme x Pensionable earnings}}{\text{Accrual rate}}$$

The accrual rate will be a figure such as 1/60th or 1/40th or put more simply, the pension will be 1/60th of pensionable earnings for each year in the scheme. For example, if an individual was on a salary of £50,000 when they retire, they have 20 years pensionable service and the accrual rate is 1/40th then they would have a pension of £25,000 per year (20 x £50,000 ÷ 40). The figure would be less if any tax-free cash lump sum is taken.

3.4.5 DC Decumulation Options

The 6 April 2015 Budget saw the most radical changes to private pensions for a generation. The most radical change was allowing people to access their DC scheme as they wish from the point of retirement. Traditionally, at retirement an individual's pension pot was used to buy an annuity to pay a guaranteed income for the rest of their life but the new rules give people more options as to how they access their pension savings.

Essentially, the choices open to individuals when considering what to do with a pension pot are shown in the following diagram.



Not shown above are the options to leave the whole pot untouched or to mix the options. Individuals no longer have to take money from their pension pot when they reach their retirement age and so they could leave it untouched.

Pension Options	
Leave the pot untouched	• It is possible to leave the whole pension pot untouched and allow it to continue to grow. • This may be relevant where someone continues working beyond their pension scheme's retirement age and they do not need the pension income. It may also be a consideration where someone has a long life expectancy and by delaying taking the pension they will have more money to last them once they do take the benefits. • The money remaining in the pension pot continues to grow tax-free and the funds can be passed on tax-free if the person dies before age 75.
Guaranteed income	• The pension pot can be used in the traditional way to buy an annuity to provide a guaranteed income for the rest of an individual's life. • There are many different types of annuity available and the income payable will depend on the amount invested, the type of annuity chosen and an individual's health and lifestyle.
Drawdown	• There are two types of drawdown – capped drawdown and flexi-access drawdown. Capped drawdown pensions limit the amount that can be drawn as income during a year. Flexi-access drawdown pensions allow members to take as much or as little income from their pot as they wish. Capped drawdown pensions were ended in 2015 but can be converted to flexi-access drawdown ones. • Drawdown is a way to phase pension income while continuing to allow the pension to accumulate. • Drawdown allows the individual to opt for withdrawals from their pension fund, known as pension drawdown or income drawdown, rather than acquiring an annuity. • The pension fund remains invested and allows the member to have more control over their pension. There is no absolute requirement to purchase a lifetime annuity or commence drawdown. • It is possible to take the tax-free cash and leave the entire residue of the fund invested without drawing down any income.
Uncrystallised lump sum	• The 2015 pension changes also introduced an option to leave the money in the current pension fund and take out lump sums when needed. • The technical term for this is uncrystallised funds pension lump sums (UFPLS) – meaning that the individual has yet to 'crystallise' their pension pot by turning it into an income. • Each time money is taken out, 25% is tax-free (up to a max of £268,275, called the lump sum allowance, from tax year 2024–25), and the rest is taxable at the individual's marginal rate.
Take the whole pot	• It is possible to take the whole pension pot in one go as cash. • The first 25% can be taken as a tax-free lump sum but the remaining 75% is taxed as income in the normal way.

Pension Options	
Mix of options	• It is possible to mix the options for example, by using part to buy an annuity to provide a guaranteed income and using the rest to get a flexible income using drawdown. • Not all pension providers, however, offer all of the options. • If someone has multiple pension pots, then they could use different options for each pot. So, for example, they could leave one pot untouched and use one of the other options for the other pots.

3.4.6 Annuities

An **annuity** is a simple way to provide a regular income and as mentioned earlier, lifetime annuities that can be bought with a pension fund have greater flexibility than the scheme pension available under a DB arrangement.

Lifetime annuities are payable by an insurance company where the member has the right to choose the insurance company. The member's right to choose the insurance company is a key difference compared to scheme pensions. It is possible for a DC scheme to provide a scheme pension but only if the member had an opportunity to select a lifetime annuity instead.

An open market option allows the individual to use the funds to buy an annuity from an alternative provider that is offering the best rates and the mix of benefits that are most suitable for them. The amount of pension that the client will be able to generate will depend upon the size of the fund and the prevailing annuity rates at the time of retirement.

FCA rules in COBS 19 also require firms that operate a personal pension, stakeholder pension, FSAVC, retirement annuity contract or a pension buy-out contract to provide an open market option statement and signpost the client to pensions guidance.

- An open market option in this context means the options available to a scheme member to access their savings premium on the open market including a pension annuity, drawdown and UFPLS payments.
- The statement must contain details of the sum of money available in the pension, whether any guarantees apply, any special features of the contract and any other relevant information.
- It must also set out a summary of the retail client's open market options, which is sufficient for the client to be able to make an informed decision about whether to exercise or to decline to exercise open market options.
- It must include the Money Advice Service fact sheet, *Your pension: it's time to choose*, or materially the same information.
- It must contain a clear and prominent statement about the availability of pensions guidance, how it can be accessed and a recommendation that the client seeks appropriate guidance or advice to understand their options at retirement.

Annuity rates are determined by three factors:

1. **Life expectancy** – annuities are a guaranteed income for life, so rates are lower the longer the annuity is payable for. The individual's health will also be a determining factor as this will determine the period the annuity is payable for.
2. **Gilt yields** – annuity providers predominately buy gilts to match their annuity liabilities. Therefore, movement in yields will impact the annuity rates offered; lower gilt yields equate to lower rates and vice versa.
3. **Options chosen** – there are many options available with annuities. The more options are added, the lower the income will be; similarly, the type of option has an impact.

The types of options available are:

- single life or joint life
- guaranteed or not guaranteed
- escalating or non-escalating
- frequency of payments, and
- whether paid in advance or arrears.

All things being equal:

- The highest annuity payment will be where the options chosen are – single life; non-escalating; non-guaranteed; paid annually; and paid in arrears.
- The lowest annuity payment will be where the options chosen are – joint life; guaranteed; escalating; paid monthly; and paid in advance.

There are also other types of annuity that will offer a higher level of income than a standard annuity such as impaired and enhanced annuities.

- An impaired annuity is generally for people with a life expectancy of less than five years.
- An enhanced annuity is where someone has a medical condition that may imply a shorter life expectancy than someone in a better state of health – examples include smokers, people with diabetes, high blood pressure, asthma and high cholesterol.

Where a firm is providing a client with a market-leading quote for a pension annuity, it must provide the client with information that sets out whether the pension annuity it is offering will provide more or less annual income than the market-leading pension annuity quote.

The Pensions Act 2015 changed the rules for lifetime annuities and the table below shows the rules pre- and post-6 April 2015.

Rules on Lifetime Annuities	
Pre 6 April 2015	**Post 6 April 2015**
It must be paid by an insurance company.	Same.
The member can choose the company.	Same.
It is payable at least annually and for life.	Same.

Any minimum guaranteed period cannot exceed ten years.	If there is a minimum guaranteed period, there is no limit on its duration.
The annuity cannot decrease in value or can change only in accordance with specific circumstances.	There is a wider definition of allowed decreases.
The potential survivor of a joint life annuity is limited to a formal dependant (eg, spouse, civil partner, or child under age 23).	The potential survivor can select anyone to become a joint annuitant.
No lump sum can be created on death other than capital protection.	Any unused funds on death can be used to provide death benefits for the dependant or nominee.
It cannot be surrendered or assigned although this is possible through the will for guaranteed periods or to comply with a pensions-sharing order.	Same.

3.4.7 Flexible Income

An alternative to an annuity is to take a flexible income through flexi-access drawdown or use an uncrystallised funds pension lump sum (UFPLS).

Drawdown allows most pension holders to take a tax-free lump sum and invest the remainder to provide an income.

From April 2011 to the introduction of pension freedoms on 6 April 2015, there were two types of drawdown contracts – capped drawdown and flexible drawdown. Capped drawdown contracts can still be retained, but all flexible drawdown contracts have been replaced by flexi-access drawdown.

Drawdown Contracts	
Capped drawdown	• Capped drawdown is no longer available but capped drawdown contracts that were in place before 2015 can continue under their existing rules. If it continues to be used and the drawdown cap is exceeded, tax relief on future pension contributions is reduced. • The pension pot after taking the tax-free lump sum is invested to provide an income. • The maximum amount of income that can be taken (the cap) is worked out using Government Actuary Department (GAD) rates. • The beneficiary retains the ability to contribute to their pension fund using their employed earnings to calculate the allowance available in the normal manner. In the event of the beneficiary withdrawing more than the 'cap', this right is lost, and they are deemed to have entered flexi-access drawdown and are limited to the money purchase annual allowance (MPAA). The MPAA for 2025–26 is £10,000.

Drawdown Contracts	
Flexi-Access drawdown	• As before, the pension pot after taking the tax-free lump sum is invested – these are now crystallised funds. • A pension holder can then choose to draw as much or as little of the crystallised fund as they desire. • Withdrawals can be taken as a regular income stream, or as one or more lump sums. • To help provide certainty of income, a short-term annuity can be used if offered by the provider. The term for the annuity cannot exceed a maximum of five years and it pays a set amount over the set period.

Advantages of Drawdown

Drawdown offers a number of significant advantages:

- After taking the tax-free cash, the residual fund remains fully invested, giving the potential for growth although this is dependent on market performance and still leaves the client in a risk-based product.
- The member may feel that prevailing annuity rates are not attractive and prefer to wait to see if rates improve significantly before opting for a conventional lifetime annuity – which can always be purchased at any time.
- If the member has other income and does not necessarily need to take the maximum drawdown, or indeed anything, the fund retains some very valuable tax concessions.
- Where a joint annuity might have previously been considered, drawdown removes much of the gamble from the decision. This is because, on death, the surviving spouse/civil partner can continue to draw down an income of their own – in effect enabling the fund to generate serial single life maximum pensions.
- Similarly, the guesswork about whether to take level, escalating or indexed benefits can be removed. A member can take, in any year, between zero and the maximum permitted. By starting income at sustainable levels and increasing the amount each year, and by considered changes in the asset allocation, it may be possible to mimic most of the options and characteristics offered by conventional annuity providers.
- The nil income option means a member can effectively take the tax-free cash in isolation, preserving the fund.
- At any point a member may elect to purchase a conventional lifetime annuity.

Critical Yield

If an individual is considering using drawdown, the use of critical yield may arise.

Critical yield is a test by which advisers can gauge if drawdown is more suitable for a customer compared to taking an annuity. This is an important concept, emphasised by the regulator, in relation to any form of pension drawdown, and comes in two forms:

- Critical yield A is the investment growth rate needed in income drawdown to provide and maintain an income equal to that which an annuity could offer (normally based on a single life, level annuity without guarantee).

- If a specific amount of income is being taken, then critical yield B is the investment growth rate required to provide that specified amount of income in drawdown.

Critical yield signals that a member needs to be fully aware of the magnitude of the investment task when using drawdown to fund pension income, potentially for many years. While different methodologies are used to calculate critical yields, the regulator indicates that, in general, they should reflect the effects of charges/expenses and mortality. Some advisers construct a client-specific lifetime cash-flow model comparing drawdown with conventional annuities to demonstrate the effects of various 'what-if' contingencies, including variable investment returns.

However, there are limitations to the critical yield, as achieving it provides no guarantee that the comparable income will be maintained. As such, critical yields should only be used as part of an overall assessment of suitability of drawdown.

Critical yield should be considered along with all the other factors, such as gilt yields and annuity rates, as together these have implications for investment selection and whether drawdown is a suitable vehicle for the client. Another important factor to consider here is the client's expected longevity profile and sequencing risk.

Sequencing Risk

In theory, a member might achieve a level of investment return which could allow them to drawdown the level of income required, while still allowing the fund to grow. In practice, however, this is more difficult.

Unless the levels of income withdrawn are modest, an individual using drawdown faces the risk of fund erosion (sometimes referred to as burn rate or sequencing risk). Mathematically, if the rate of withdrawal exceeds the rate of investment return, some loss of capital is certain and, over time, the rate of burn will accelerate.

Depending on the chosen investment strategy, a member may well be exposed to market risk as well as the loss of capital from income. For example, by adding increased risk to enhance the income yield (eg, high yield debt, emerging market debt, property, high dividend equities), an investor may introduce more volatility into the portfolio. If the market value of the portfolio falls sharply while the investor is drawing down an income, this creates a double-down situation from which a portfolio is unlikely to recover.

To increase the income yield, a member needs to be willing to accept investment risk, and there is no guarantee a member will achieve a better outcome than a conventional annuity. It is for these reasons that drawdown may be unsuitable for some clients, such as those who seek a predictable income or have a high level of risk aversion.

The other factor here is whether the client invests in natural income-producing assets (that tend to have variable yield and higher capital volatility) or in total return and drawdown strategies that may risk running out of capital to support a level of income.

Research by Abraham Okusanya at FinAlytiQ in 2017 cast light on the challenges presented by sequencing risk.

> *'Sequence risk is the risk that the order of investment returns is going to be unfavourable. This risk exists at accumulation stage but it is amplified by withdrawals from a portfolio during the retirement stage. If you get good returns in the early part of retirement, you are unlikely to run out of money with a sensible withdrawal rate of, say, 4% or even 5%. If you get poor or even mediocre returns in the early part of retirement, it is a different story.*
>
> *The crucial lesson is that your income over a 30-year retirement period is driven largely by the investment return you receive in the first decade of retirement. Accordingly, the early period of retirement is far more important than average return over the entire period. This means that the way you draw income from your retirement portfolio needs to be carefully managed, particularly in the early part of retirement.*
>
> *Take for example, a 30-year period starting in 1921. The average real return in the first decade was nearly 14.4%, compared to 3.9% pa in the second decade and 3.6% in the third decade of retirement. Someone starting their retirement in 1921 could have enjoyed an annual income of £12,000, adjusted for inflation over the subsequent 30 years. (A whopping withdrawal rate of 12%!) Why? Because they had such a great first decade. The return in the second and third decades did not matter as much.'*

3.4.8 Uncrystallised Funds Pension Lump Sum (UFPLS)

The introduction of flexi-access drawdown also saw the introduction of the uncrystallised funds pension lump sum (UFPLS). The rationale behind its introduction was that the government did not want individuals to be forced into taking pension income products and to be able to easily access lump sums.

The UFPLS is covered further in the section below.

4. Pension Rules

As mentioned earlier, major changes to UK pension legislation became effective on 6 April 2006, known as A-Day, and again in 2015 as a result of pensions freedom. The rules are very detailed and complex, and the following provides a summary of some of the main ones that are now in place.

4.1 Annual Allowance

Before pensions simplification, there was a mass of different rules defining the maximum contributions that could be made into a pension scheme, dependent on the type of scheme. In occupational schemes, different limits applied to the member and employer. All such confusing rules were supplanted by a single set of rules under simplification.

4.1.1 Contributions

In the UK, a relevant UK individual may contribute to any number of registered pension schemes or an overseas pension scheme (as long as either they or their employer qualifies for UK tax relief on those pension savings), and the amount is technically unlimited. It is important to note that although the contributions are uncapped so that any amount can be paid in, the tax relief available on the contributions is restricted and there are limits on contributions that are eligible for tax relief.

Employers can also contribute to a member's pension. Employer contributions can be claimed as a business expense and are eligible for tax relief. Contributions are normally treated as an allowable business expense but must meet the 'wholly and exclusively' test.

4.1.2 Annual Allowance for Pension Savings

Although there is no limit on the amount of annual contributions that can be made, there is a tax charge for any contributions above the annual allowance which effectively negates the value of the tax relief on the excess contribution.

The tax relief for the amount saved is subject to an annual allowance which, for 2025–26, is £60,000. However, since 2011–12 if the client did not use their full allowance over the previous three tax years, they can carry forward their unused pension allowance.

If the client's pension savings are still more than the total of the annual allowance and unused allowance, then they will pay a tax charge on the excess.

There are two scenarios under which the annual allowance can be less than £60,000:

1. **Money Purchase Annual Allowance (MPAA)** – this applies where someone has used pension flexibility to access their pension pot. The MPAA limit is £10,000 pa, for 2025–26.
2. **Tapered Annual Allowance (TAA**) – if an individual's threshold income is more than £200,000, and adjusted income is more than £260,000 pa, the annual allowance is reduced. For every £2 of adjusted income above £260,000, the annual allowance reduces by £1, down to a minimum of £10,000 for 2025–26.

If contributions exceed the annual allowance, an annual allowance charge applies. In simple terms, the charge is calculated by adding the excess contributions to the individual's income to identify their top rate of tax which is then used to calculate the charge.

In some circumstances, the member can give notice to the scheme administrator that they want to pay the annual allowance charge from their pension benefits.

If the client exceeds their annual allowance, the pension provider will issue a statement informing the client. This will need to be reported on the Self Assessment tax return, even if the pension provider pays the tax on the client's behalf.

4.1.3 Tax Relief on Pension Contributions

An individual can get tax relief on contributions of up to 100% of relevant UK earnings each year, providing that they paid the contribution before the age of 75.

Definition of Relevant UK Individual and Earnings	
UK Individual	A relevant UK individual must generate relevant UK earnings chargeable to income tax in that year and: • be a resident in the UK for tax purposes at least some time during that year, or • have been resident in the UK at some point during the preceding five years, and in the year of joining a registered pension scheme, or • be (or their spouse be) an overseas Crown Employee with earnings subject to UK tax.
Earnings	Relevant UK earnings are defined as: • Income from employment, including salary, commissions, overtime, or bonuses. • Income from a trade or profession as sole trader or partner. • Income from intellectual property rights treated as earned income (eg, royalties from copyrights, patent rights). • Income as an overseas Crown Employee which is subject to UK tax.

Tax relief is available on the following contributions:

- Individuals with earnings chargeable to UK income tax or who are resident in the UK – the greater of £3,600 gross and 100% of UK earnings.
- Non-UK resident individuals with no relevant earnings – £3,600 gross.

There are three methods of claiming tax relief:

- **Net pay** – this is used by occupational schemes where contributions are deducted from salary before tax is calculated and a gross contribution is made into the pension scheme.
- **Relief at source** – this is used by non-occupational pension schemes such as personal pensions and group personal pensions. Contributions do not reduce the individual's earnings which are subject to deduction of tax in full. Instead, contributions are made net of basic rate tax and the scheme administrator claims basic rate tax relief from HMRC which is paid directly into the scheme.
- **Assessment** – claim must be made to HMRC for scenarios that are not covered above. Similarly, if the individual is entitled to tax relief above the basic rate, they claim this from HMRC via Self Assessment.

Where the annual allowance (or MPAA/TAA) is breached, there will be a separate charge which will claw back some of the relief gained.

4.2 Lifetime Allowance (LTA)

The lifetime allowance (LTA) was the maximum amount of pension savings from all sources that could benefit from tax relief over an individual's lifetime before tax penalties applied. Funds in excess of the LTA were felt to have benefited unduly from pension scheme tax advantages and, therefore, a tax charge was made.

The UK government made a significant change to pension regulations by abolishing the lifetime allowance on pension pots, as part of the Spring Budget 2023, with the aim of encouraging individuals to remain in the workforce for longer. The implementation process involves the removal of the lifetime allowance charge was removed in April 2023, followed by the complete abolition of the allowance from April 2024.

This measure boosts efforts to encourage inactive individuals, especially those aged 50 and above, to rejoin the workforce by removing pension tax limits that incentivise reduced hours or leaving the job market. Recent data indicates increased inactivity among the 50-64 age group, driven by self-reported retirement. It supports retirement savings, enhances work's financial appeal, and balances pensions tax relief cost.

Previously, the lifetime allowance capped the total pension savings that could benefit from tax relief without incurring a tax charge. It peaked at £1.8 million in 2012 after rising from £1.5 million in 2006, before being reduced to £1 million and then gradually increased to £1,073,100 by 2020–21. This limit remained until the allowance was abolished in April 2024 as part of government reforms aimed at encouraging longer workforce participation.

The decision to abolish the lifetime allowance was unexpected, as it was initially anticipated that the government would increase the limit. It was welcomed by organisations in the pensions industry.

4.2.1 Relevant Benefit Crystallisation Events (RBCEs)

From 6 April 2024, the UK pension system introduced relevant benefit crystallisation events (RBCEs) to replace the previous benefit crystallisation events (BCEs) that were tied to the lifetime allowance (LTA). RBCEs specifically apply to the payment of relevant lump sums and lump sum death benefits.

A relevant benefit crystallisation event occurs when an individual becomes entitled to a relevant lump sum, or when a relevant lump sum death benefit is paid. This definition emphasises the timing of these events in relation to the individual's entitlements.

Types of Relevant Lump Sums

RBCEs include the following types of relevant lump sums:

- **Pension Commencement Lump Sums (PCLSs)** – a one-time tax-free payment available when an individual first accesses their pension.
- **Serious Ill-Health Lump Sums** – payments made if an individual is diagnosed with a terminal illness.
- **Uncrystallised Funds Pension Lump Sums** – withdrawals made from uncrystallised pension pots.
- **Stand-Alone Lump Sums** – payments that do not form part of a pension benefit crystallisation.

Relevant Lump Sum Death Benefits

Relevant lump sum death benefits are defined as any lump sum death benefits paid, excluding:

- Charity lump sum death benefits
- Trivial commutation lump sum death benefits

Treatment of Multiple RBCEs

If an individual has multiple RBCEs on the same day, they will be treated in a specific order:

- Immediately before the individual's death
- Immediately after any PCLS to which the individual becomes entitled immediately before death
- In an order decided by the individual's personal representative

Allowances

The new RBCE framework introduces two key allowances:

- **Lump Sum Allowance (LSA)** – the maximum amount that can be taken tax-free from pension savings, set at £268,275. If you take a lump sum that exceeds this allowance, the excess will be taxed at the marginal income tax rate.
- **Lump Sum and Death Benefit Allowance (LSDBA)** – this encompasses all relevant lump sums, including serious ill-health lump sums taken before age 75, and lump sums received by beneficiaries within two years of the member's death. The LSDBA is capped at £1,073,100.

Transitional Rules

Individuals who have taken benefits before 6 April 2024, need to rely on transitional calculations to determine their lump sum and death benefit allowance at their first RBCE after this date. These calculations account for any benefits previously crystallised under the LTA, ensuring a smooth transition to the new system.

No Retesting for Pre-April 2024 Crystallised Funds

Importantly, lump sum death benefits paid from funds crystallised before 6 April 2024, will not be retested against the new allowances. This means they will retain their previous tax treatment under the LTA, providing clarity and stability for individuals who have already accessed their pensions.

These changes reflect a significant shift in the UK pension landscape, aiming to provide greater flexibility and reduce the complexity associated with pension withdrawals and tax implications.

4.3 Retirement Benefits

As mentioned earlier, the minimum age at which retirement benefits can be taken is at age 55. Pension scheme rules vary though and many occupational schemes will have a normal retirement age that is much later, meaning taking a pension early may involve a significant actuarial reduction.

The government has stated that the minimum pension age will increase to 57 in 2028, when the state retirement age increases to 67, thus, maintaining the ten-year differential between minimum pension age and state pension age.

A member of a pension scheme may take benefits at any age if they are medically incapable as a result of injury, sickness, disability or disease, of carrying out their current occupation, and have ceased to carry on that occupation.

- The scheme administrator must have received evidence from a registered medical practitioner that the member is unlikely to be able to return to work before their normal retirement age.
- Some scheme rules may be stricter and require that the member cannot carry out any occupation, not just their own occupation.
- In addition, an ill health pension may stop or be reduced if the member recovers and is capable of returning to work.
- The tax position on ill-health early retirement is the same as for a standard benefit crystallisation.

In the event of serious ill health, the benefits may be commuted to a lump sum if a registered medical practitioner provides written evidence that the member will live for less than 12 months. The tax treatment is different to other RBCEs:

- If this takes place before age 75, the lump sum is paid tax-free but the member must have available LSA and LSBDA.
- If it takes after age 75, the lump sum is taxed as pension income at the member's marginal rate.

Aside from ill health, the two situations allowing members under 55 to take benefits are special occupations (eg, sportspeople) and unqualified contractual early retirement rights. If an individual exercises their option to retire before age 50 under the above options, they will be subject to a reduction in their LSA of 2.5% for each complete year they take benefits before age 55.

4.3.1 Tax-Free Lump Sum

There is an upper limit on the amount of PCLS available to a member when they take benefits; in most cases, this limit is 25% of the value of the pension being put into payment.

The PCLS limit is tested at each relevant event when benefits are accessed. So, for example, if an individual has already used part of their pension pot to buy an annuity without taking any tax-free lump sum and then takes the remaining amount, the maximum PCLS is 25% of the funds being taken at that time.

The six conditions that a member must meet to receive a PCLS are:

1. The member must be entitled to receive a pension although they do not necessarily need to actually draw that income.
2. None of the member's lump sum allowance, or none of the member's lump sum and death benefit allowance is available.
3. The lump sum must be paid in the time between six months before and 12 months after the member becomes entitled to the relevant pension.

4. It cannot be paid unless the member has reached the normal minimum pension age, satisfies the ill-health criteria, or they have a protected early retirement age.
5. The lump sum is not an excluded lump sum.
6. The payment does not reduce the rate of payment of any pension to which the member has become (actually) entitled, or extinguish the member's entitlement to payment of any such pension.

For Uncrystallised Funds Pension Lump Sums (UFPLS) taken before age 75, an individual must have sufficient funds for a tax-free lump sum to be paid. For such payments, no allowance is made for any protected tax-free cash; thus, a UFPLS must be paid as 25% tax-free and 75% taxed at the individual's marginal rate.

4.3.2 Pension Recycling

Pension recycling is where the tax-free lump sum (a RBCE) or flexible pension income is recycled back into a pension scheme as a tax relievable contribution. There are rules in place to prevent or restrict pension holders from using either a RCBE or flexible pension income to make further pension contributions and so gaining further tax relief on money that has already benefited from tax relief.

The RBCE recycling rules focus on lump sums crystallising pension benefits. These rules consist of six conditions; if all conditions are met, the amount of the RBCE (such as a PCLS) is treated as an unauthorised member payment and charged accordingly. The six conditions are:

- The individual receives an RBCE payments.
- Due to the lump sum, the amount of contributions paid in respect of the individual is significantly greater than it otherwise would be.
- Additional contributions are made by the individual or by someone else, such as an employer.
- The recycling was pre-planned.
- The amount of the RBCE, added to any other similar payments received in the previous 12-month period exceeds £7,500 for events on or after 6 April 2015.
- The cumulative amount of the additional contributions exceeds 30% of the RBCE.

As long as one of the conditions can be discounted, these recycling rules do not apply, so the payment would not be regarded as an unauthorised payment.

In contrast, drawing an income from a flexi-access pension does not trigger these rules; however, it triggers the Money Purchase Annual Allowance (MPAA), which limits future money purchase contributions to £10,000 pa. By reducing the annual allowance in this way, the tax relief that can be obtained on contributions is restricted.

Note that recycling non-flexibly accessed pension income, such as unneeded income from a DB scheme, would not in itself result in the triggering of the MPAA.

4.3.3 Uncrystallised Funds Pension Lump Sum (UFPLS)

A UFPLS allows an individual to withdraw part of their pension pot or all of their uncrystallised funds as a lump sum, without first designating the funds for drawdown or purchasing an annuity. Each withdrawal is treated as a RBCE.

For each UFPLS withdrawal, 25% of the permitted maximum is paid tax-free, with the remainder taxed as pension income at the individual's marginal rate. The permitted maximum is the lower of the individual's remaining LSA (higher if protections apply) and the individual's remaining LSDBA (higher if protections apply).

Individuals can manage the timing and size of UFPLS withdrawals to stay within desired tax bands.

In general terms, to qualify as an UFPLS:

- the individual must have reached age 55 (or meet the ill-health conditions or have a protected early retirement age)
- it must be payable from uncrystallised rights under a money purchase arrangement, and
- the tax-free element cannot exceed the lower of the individual's available LSA and LSDBA at the time of withdrawal.

Unlike under the former lifetime allowance regime, there is no special age-75 test or charge. UFPLS payments can be made after age 75, but the taxable element is always assessed at the individual's marginal rate of income tax.

If the member dies before age 75, any lump sums paid within two years of notification are tax-free up to the deceased's remaining LSDBA, with any excess taxed at the beneficiary's marginal rate, and beneficiary drawdown or annuity income is normally tax-free. If death occurs at or after age 75, all death benefits, whether lump sums or income, are taxed at the recipient's marginal rate, and LSDBA limits generally do not apply.

Taking any UFPLS triggers the MPAA. If the value of the pension pot is £10,000 or more, starting to take withdrawals means that the amount of tax relief on pension savings that the individual can get is reduced to the level of the MPAA.

4.3.4 Tax Treatment of Pension Income

Pension income, whether through a scheme pension, a lifetime annuity or drawdown is treated as earned income for income tax purposes and taxed accordingly. It is paid by the scheme administrator after deduction of tax under PAYE. The scheme administrator, therefore, needs a notice of tax coding from HMRC to be able to deduct the correct amount of tax.

For the first payment, a notice of coding is often not available, so the scheme administrator has to use an Emergency Month 1 code (in simple terms this is 1/12th of the annual personal allowance for income tax) and request a tax code to be used for ongoing income. If a UFPLS payment is made, this may result in an overpayment of income tax which will need to be reclaimed from HMRC.

4.4 Death Benefits

Pension schemes typically provide death benefits as part of the package of benefits associated with a pension. A pension member's death constitutes an RBCE if death benefits are paid. Death benefits will normally be paid to a dependant.

In general terms, HMRC describe a dependant as follows:

- A person who was married to, or a civil partner of, the member at the date of the member's death.
- Additionally, if the rules of the pension scheme permit, the above test can be extended to apply not only at the date of the member's death, but to the point in time when the member first became actually entitled to a pension under the pension scheme.
- A child of the member (including a legally adopted child) is a dependant of the member:
  - Has not reached the age of 23.
  - Has reached age 23 and, in the scheme administrator's opinion, was dependent on the member because of their physical or mental impairment at the date of the member's death.
  - For continued access to a dependant's drawdown fund or flexi-access drawdown, has reached age 23.
- A person who was, at the date of the member's death, in the opinion of the scheme administrator:
  - financially dependent on the member
  - in a financial relationship of mutual dependence with the member (ie, there is some element of reliance on each other financially), or
  - dependent on the member because of their physical or mental impairment.

The rules of the pension scheme may restrict the definition of a dependant to a narrower class.

The default position is that the surviving spouse will receive the money in most circumstances. The main exception is where a spousal bypass trust has been set up with clear instructions for the scheme trustees to pay to that trust. It is likely that the scheme trustees would want to see that the bypass trust deed includes the surviving spouse/civil partner as at least a potential beneficiary, and any letter of wishes written by the member to the trustees of the bypass trust. The trustees can, at their discretion, ignore any bypass trust, particularly if the surviving spouse/civil partner asks them to do so.

4.4.1 DB Schemes

A DB scheme usually offers death benefits as part of its pension benefits. It will include a lump sum or a scheme pension payable to dependants.

Lump Sum Death Benefit

A DB scheme may pay a death benefit if a member dies before retirement. It will usually be a multiple of the individual's salary or based on some other measure and will be specified by the scheme rules. It can be provided directly from the scheme or through some form of insurance arrangement.

HMRC do not limit the amount that can be paid as a death benefit, but there are rules around what qualifies as a DB lump sum death benefit. HMRC provide the following examples of what would qualify:

- A multiple of earnings such as 3 or 4 x final salary.
- A multiple of service such as £500 for each year of service with the employer.
- A multiple of another factor, such as 3 x prospective pension or 10% of the employer's profits in the accounting period before the member's death.
- A fixed amount to provide a lump sum or pension benefit.

However, a fixed amount that is not expressed in the form of benefit or is to be decided after death is not a DB lump sum death benefit; instead, it is a cash balance benefit. Similarly, a **term assurance** policy that pays out a set monetary amount (rather than being based on the member's salary) cannot be classed as a DB lump sum death benefit. In such cases, the payment will be treated as an uncrystallised funds lump sum death benefit.

Taxation of the Lump Sum Death Benefit

The tax treatment of the lump sum death benefit will depend on whether the member dies before or after age 75.

If the pension scheme member was under age 75 when they died, and the lump sum benefit is paid within two years, then it is tax-free, unless the LTA is payable.

If the member was aged 75 or over when they died, or payment is not within the two-year period, the DB lump sum death benefit is not tested against the LTA. There will have been a benefit crystallisation event (BCE 5) when the member reached the age of 75. In this scenario, the benefit is taxable in the hands of the recipient. If the recipient is an individual, it is treated as the recipient's pension income and tax will be deducted under PAYE. If the payment is to what is described as a 'non-individual' such as a trust, then the special lump sum death benefit charge of 45% applies.

Dependant's Pension

A dependant's scheme pension may be provided under a DB arrangement.

Where death takes place before crystallisation, any dependant's pension will usually be based on a percentage of the member's pension entitlement. If death takes place after crystallisation, the scheme rules will determine what benefits are payable, which may be a dependant's pension or a continuation of the member's pension for a guaranteed period.

If the capital value of the dependant's benefits is under £30,000, under trivial commutation lump sum death benefits rules, the benefits can be paid as a lump sum. The whole amount of any trivial commutation lump sum death benefit is taxable in the hands of the recipient. Where a dependant's pension is paid through a scheme pension, the dependant will be liable to income tax on the continuing pension payment, at their own rate of tax.

4.4.2 DC Schemes

DC schemes may offer lump sum and income death benefits. Each scheme may be different and the benefits from an occupational scheme may not offer the full range of flexible options.

If allowed in the pension scheme's rules, it is possible to have a mixture of death benefits and for the death benefits to be provided to more than one beneficiary. The recipient(s) of death benefits are usually chosen at the discretion of the pension scheme trustees or administrator. However, a member can nominate whom they wish to receive the benefits by completing a nomination of beneficiaries form (sometimes called an 'expression of wish') and the trustees will usually take this into account.

Lump Sum Death Benefits

The pension freedoms transformed the death benefits available.

Occupational schemes will often continue to provide the same lump sum death benefits as before. The lump sum may be paid as a cash amount or used to provide a dependant's pension. Others may offer a greater range of options, so if the member wishes to access options not offered by their particular scheme, they would have to transfer to an alternative scheme.

Following pension freedom, lump sums and income can be paid tax-free if the deceased was aged below 75, as long as the benefits are assigned to the beneficiaries within two years. Otherwise, the benefits are subject to income tax. Most significantly of all, any beneficiary can now potentially use their share of the death benefits to buy an annuity or put into drawdown.

- With a lump sum payment, the funds are simply withdrawn from the pension scheme and transferred to the beneficiary. Lump sums are the only form of death benefits available to beneficiaries such as trusts and charities.
- A beneficiary may use their share of the death benefits to purchase an annuity in a similar way to someone purchasing an annuity with their own pension benefits.
- With drawdown, the beneficiary keeps the money within a pension environment where they can continue to benefit from tax-free investment growth. The undrawn funds remain outside their estates. Income can be withdrawn in the same way as from a normal drawdown account, except that there is no minimum age and the withdrawals do not affect the beneficiary's own lifetime or annual allowances. If a beneficiary dies still holding some of the funds in drawdown, their own beneficiaries can also inherit those funds under the same rules.

Drawdown is often considered the most flexible and tax-efficient death benefits option under the current rules.

4.5 Overseas Considerations

The rules allow an individual to be a member of a UK-registered pension scheme regardless of where they live or where their employer is based.

If someone moves abroad, they have several options including the following:

- Leaving their pension within their UK pension plan. The pension will continue to be held by the pension provider within a tax-free environment. When they reach the minimum retirement age (currently 55), they can access the fund, as discussed above.
- Transferring their pension to an approved arrangement in their new country of residence as a qualifying recognised overseas pension scheme (QROPS) (see below).
- Continue paying into their UK pension scheme from abroad. Living or working abroad no longer limits the amount that can be paid into a UK pension scheme, but tax relief may be limited or not available.

4.5.1 Qualifying Recognised Overseas Pension Scheme (QROPS)

Qualified Recognised Overseas Pension Schemes (QROPS) are pensions that HMRC recognises as eligible to receive transfers from UK-registered pension schemes. Recent regulatory changes, however, have imposed stricter conditions. Notably, from 30 October 2024, the 25% Overseas Transfer Charge (OTC) exclusion for QROPS in the EEA or Gibraltar will no longer, unless the member resides in the same country as the QROPS (residency requirement).

The Overseas Transfer Allowance (OTA), introduced on 6 April 2024 caps tax-free transfers at £1,073,100, with a 25% charge on amounts over this limit. Additionally, as of 6 April 2025, QROPS in the EEA must be regulated by a local authorised pension regulator to qualify as recognised by HMRC.

HMRC continues to publish a QROPS list and transfers to non-listed schemes may lead to unauthorised payment charges and penalties.

4.6 Divorce/Dissolution and Pensions

From time to time, a wealth manager may become involved in advising a client on how divorce or dissolution of a civil partnership will affect their financial affairs or may need to take account of the effect of divorce/dissolution on the assets of a client.

In general terms, there are three ways in which pension arrangements may be involved in a divorce settlement.

1. **Offsetting** – this is where the CETV of the pension benefits is included in the total value of the matrimonial estate to be divided on divorce/dissolution. As the courts are unable to compel the pension holder to set aside any of their pension benefits, they take account of the pension's value by offsetting it against other assets.
2. **Attachment order** – this is effectively deferred maintenance. The court issues an order that is served on the pension scheme administrator which directs them as to what payments to make.
3. **Pension sharing** – the aim of this approach is to create a clean break. The court issues an order splitting the pension rights between the member and the spouse or civil partner. The existing pension scheme can choose to allow the ex-spouse or civil partner to join the scheme in their own right or, as is more likely, to take the transfer value to another registered pension scheme.

The impact on the LSA and LSDBA is as follows:

- **Offsetting** – no impact as the financial arrangements operate outside the pension scheme.
- **Attachment order** – the total benefits to be paid through the order are assessable against the member's LSA and LSDBA. The pension remains the income of the member who is chargeable to income tax on the whole amount without any deduction for the amount paid under the attachment order. The pension received by the ex-spouse or civil partner is tax-free in their hands.
- **Pensions sharing** – the value of the pension rights allocated do not count against the member's LSA and LSDBA, although it may have an effect if they have primary or individual protection. The amount allocated to the ex-spouse or civil partner count against their own LSA and LSDBA, even if the pension is already in payment and any pension income is taxed as the their own.

5. Regulatory Background

The regulatory environment surrounding advising on pensions is not straightforward, so in this section, we will look at some of the key considerations wealth managers should bear in mind when considering retirement planning for clients.

5.1 Pension Regulators

The sector is regulated by The Pensions Regulator (TPR) and the FCA although pension rules are set by HMRC.

TPR regulates work-based pensions, ensuring employers enroll staff in pension schemes and contribute. It's responsible for protecting members' benefits in occupational schemes and workplace personal pensions with direct payment arrangements. The FCA regulates providers of personal pensions, advice in the pensions market, and investment firms in the sector.

TPR and FCA collaborate to address risks in retirement income adequacy. Key focus areas include:

- Ensuring pensions and retirement products support adequate savings for later life.
- Promoting well-funded and appropriately invested pension schemes.
- Driving value for money while ensuring good governance.
- Improving people's ability to make informed pension decisions through access to information, guidance and advice.

5.1.1 The Pensions Regulator (TPR)

TPR was established to oversee the governance and administration of workplace pensions in the UK. Its statutory objectives are:

- Safeguard benefits for members of occupational and personal pension schemes.
- Enhance effective management practices in work-based pension schemes.
- Reduce situations that could lead to claims on the Pension Protection Fund.
- Ensure employers meet their pension responsibilities and comply with relevant laws.
- Balance DB scheme funding with the sustainable growth of employers.

The Pension Schemes Act 2021 gave TPR additional powers, including issuing contribution notices for employer insolvency or resource failures and prosecuting avoidance of employer debt.

5.1.2 Pension Protection Fund

The Pensions Act 2004 established the PPF. It provides compensation for members of eligible DB schemes which are unable to meet their liabilities where the sponsoring employer has become insolvent. The PPF can also pay compensation to schemes which have lost out financially due to dishonesty.

The PPF is a public corporation funded by a levy, payable by all UK DB schemes which would rely on the PPF in the event of insolvency. They also accept the assets of schemes that transfer to them and recover what they can from insolvent employers. The levy is calculated in two parts: a scheme-based levy, based on the scheme's liabilities (to which the PPF applies a scheme-based multiplier), and a risk-based levy (based on the risk of the employer becoming insolvent and the potential size of the claim that might be passed to the PPF).

The PPF will pay compensation in specific circumstances:

- When a sponsoring employer becomes insolvent and they have an eligible defined benefit pension scheme.
- The pension scheme is underfunded and unable to pay benefits at PPF levels.
- There is no realistic chance of the scheme being rescued.

The PPF levels of compensation:

- 100% for members at or over the scheme's normal retirement age when the employer became insolvent, those retired due to ill-health, and those receiving a survivor's pension.
- 90% for members below the scheme's normal retirement age when the employer became insolvent.

Statutory increases in pension, but only for pensions earned since April 1997. PPF payments are subject to a limited price indexation (LPI), which is inflation capped at 2.5%.

PPF compensation increases annually in line with inflation (CPI), capped at 2.5%, but only for benefits accrued on or after 6 April 1997. Benefits accrued before this date do not receive increases.

For PPF intervention, schemes must meet specific eligibility criteria:

- Be a DB or hybrid scheme with DB elements.
- Be a tax-approved or tax-registered scheme.
- Have more than one member.
- Not be a public service pension scheme or have a full Crown guarantee.

The PPF also provides compensation for eligible spouses, civil partners, and dependent children, subject to the rules of the original pension scheme.

PPF 7800 Index

Since July 2007, the PPF has published the latest estimated funding position, on a **Section179** basis, for the DB schemes in its eligible universe. The PPF 7800 index is published on the second Tuesday of every month.

The key metric reported in the PPF 7800 Index is the funding ratio, calculated by dividing a scheme's total assets by its **Section 179 liabilities**. These liabilities represent, broadly, the estimated cost of securing PPF-level compensation through an insurance provider. As of June 2025, total scheme assets stood at £1,110.3 billion, while total Section 179 liabilities were £879.8 billion, resulting in a funding ratio of 126.2%.

Here are key figures for the PPF 7800 Index at the end of June 2025:

Item	June 2024	June 2025
Total scheme assets – estimated total value of all assets held by eligible DB schemes (Section 179 basis)	£1,138.9 billion	£1,110.3 billion
Total scheme liabilities – estimated value of what eligible schemes owe to members (Section 179 basis)	£919.9 billion	£879.8 billion
Funding ratio – the ratio of assets to liabilities (Assets ÷ Liabilities × 100%). A ratio above 100% indicates an overall surplus	123.8%	126.2%
Schemes in surplus – schemes with more assets than liabilities	3,660	3,635
Schemes in deficit – schemes with liabilities exceeding assets	1,309	1,334
Total schemes in universe – schemes in deficit + schemes in surplus	4,969	4,969
Aggregate funding position (total scheme assets – total scheme liabilities)	£219.0 billion	£230.5 billion
Deficit of schemes in deficit – the combined shortfalls of all schemes where liabilities exceed assets	£23.5 billion	£28.7 billion

When interpreting the PPF 7800 Index, it is important to note that while the overall DB universe may show a surplus, many schemes are in deficit and their combined shortfalls are reported separately by the PPF.

Another key point to note from this is the variable nature of scheme liabilities in response to market volatility. Equity markets and gilt yields are the main drivers of funding levels. Section 179 liabilities are sensitive to the yields available on a range of conventional and index-linked gilts. Liabilities are also time sensitive in that, even if gilt yields were unchanged, scheme liabilities would increase as the point of payment approaches.

Understanding the funding of both DC and DB pensions is a very useful tool in understanding the long-term funding risks for a particular pension scheme. The funding ratio of the PPF 7800 is therefore a useful barometer of the state of UK pension scheme funding. For wealth managers, these considerations

are relevant as the index offers a macro-level insight into the security and health of the DB pension landscape, informing discussions with clients about their pension security, de-risking strategies and the broader economic factors that impact their retirement planning.

Further information can be found at: https://www.ppf.co.uk/PPF-7800-index

5.1.3 FCA Regulatory Developments in Pensions

The FCA has undertaken numerous thematic reviews of the pensions and retirement sector particularly since the introduction of the pension freedoms. The scandal surrounding the British Steel pensions was just the latest in a line of issues that clouds the public's perception of financial advice and the probity of advisers. Since 2015, they have carried out three reviews across the sector looking at higher risk firms that were giving DB to DC transfer advice and have worryingly found unacceptably high standards of unsuitable advice. This area remains a high priority for the FCA.

As well as thematic reviews, the regulator has been active in issuing consultation papers and changing the rules around retirement and pension advice. The range of such documents and rules is extensive and candidates would be well advised to read the consultation papers and policy statements issued by the FCA to gain an insight into the market, their thinking and the rationale for the current rules.

The following list shows just a selection of some of their publications that warrant reading:

Retirement Outcomes Review
Policy Statement 19/1
https://www.fca.org.uk/publications/policy-statements/ps19-1-retirement-outcomes-review
Policy Statement 19/21
https://www.fca.org.uk/publications/policy-statements/ps19-21-retirement-outcomes-review-feedback-cp19-5

Pension Transfer Advice: Contingent Charging and other Proposed Changes
Consultation Paper CP 19/25
https://www.fca.org.uk/publications/consultation-papers/cp19-25-pension-transfer-advice

Improving the Quality of Pension Transfer Advice
Policy Statement PS 18/20
https://www.fca.org.uk/publications/policy-statements/ps18-20-improving-quality-pension-transfer-advice

Consultation Paper CP 18/7
https://www.fca.org.uk/publication/consultation/cp18-07.pdf

Advising on Pension Transfers
Policy Statement PS 18/6
https://www.fca.org.uk/publications/policy-statements/ps18-6-advising-pension-transfers

Consultation Paper CP 17/06
https://www.fca.org.uk/publication/consultation/cp17-16.pdf

Insistent Clients
Good and Poor Practice
https://www.fca.org.uk/firms/pension-reforms-insistent-clients/good-poor-practice

Pension Transfers
Consumer Guidance
https://www.fca.org.uk/consumers/pension-transfer

The FCA also published three further documents in June 2020 that address its continued concerns about transfers from defined benefit to defined contribution schemes:

- Its most recent assessment of advice suitability found that too many firms failed to collect the information necessary to provide suitable advice. The most common gaps identified were missing details of expected income and expenditure in retirement and how these amounts could fluctuate the role their pensions would play in meeting those objectives.
- PS20/6 follows on from CP19/25 above and imposed a ban on contingent charging effective from 1 October 2002 and also introduced a process for 'abridged advice' where a recommendation not to transfer can be provided or explain that the situation is unclear.
- Guidance Consultation GC20/1 on a scheme data template to help advisers understand what information they need from a DB scheme for the advice process and an updated version of the joint FCA and The Pension regulator factsheet that provides guidance to employers and trustees.

5.2 Advising on Pensions

Advising on pensions is a regulated activity and falls within the regulated activity of advising on investments. Wealth managers may work with clients to plan their retirement needs and therefore be involved in the provision of a regulated activity that requires authorisation.

Importantly, where a pension scheme provides 'safeguarded benefits', advising on conversion or transfer of pension benefits is a separate regulated activity and requires specific regulatory authorisation. It should be noted that rights or interests under a pension scheme which provides safeguarded benefits is a specified investment exclusively in respect of the regulated activity of 'advising on conversion or transfer of pension benefits' and not any other regulated activity.

5.2.1 Rights under a Personal Pension Scheme

A personal pension scheme refers to pensions designed for individuals who do not belong to an occupational pension scheme.

This will be a scheme where the sole or principal purpose of which is to provide benefits to members of the scheme upon their reaching a pensionable age. This will typically include pension schemes that are intended to be registered with TPR and to be eligible for tax relief relating to pension schemes. This will include SIPPs as well as personal pensions. It will also include other types of pension schemes such as QROPSs that are not occupational pension schemes.

'Rights under a personal pension scheme' is a specified investment and includes the following:

- Making payments into a scheme or placing certain types of property into the scheme.
- Instructing the operator of the scheme to buy, sell or switch assets.
- Appointing someone to manage the assets.
- Receiving benefits from the scheme, transferring the value to another pension scheme and in certain circumstances withdrawing sums from the scheme.

This specified investment is classed as a security, so the following regulated activities apply in relation to such rights – advising on investments, arranging, dealing, managing investments, and safeguarding and administering investments.

The regulated activities involved may, therefore, include the following:

- Advice given to join a particular scheme or to establish a personal pension and when regular or occasional additional payments are made into the scheme.
- Advice given on acquiring particular assets to be held in the personal pension, managing the pension portfolio or giving instructions to buy, sell or switch the assets.
- Advice given when an annuity is purchased, income withdrawals are made or benefits are transferred to another scheme.

5.2.2 Retirement Risk Warnings

Where a firm communicates with a client on options to access their pension savings, they are required under COBS 19 to provide risk warnings about using decumulation products.

These rules apply where the client intends to take one of the following actions:

- buy a pension decumulation product
- vary their personal pension scheme, stakeholder pension scheme, FSAVC, retirement annuity contract or pension buy-out contract to enable the client to:
  - access pension savings using a drawdown pension
  - elect to make one-off, regular or ad-hoc UFPLS payments
- receive a one-off, regular or ad-hoc UFPLS payment
- access their pension savings using a drawdown pension, or
- withdraw the funds in full from their pension savings, reducing the value of their rights to zero.

The firm is required to follow the below three-step process in COBS 19 when this arises.

Retirement Risk Warnings	
Step 1	• Determine whether the client has received guidance or regulated advice. • If the client says that they are unsure, the firm must explain that the decision to access pension savings is an important one and encourage the retail client to use pensions guidance or to take regulated advice to understand their options at retirement.

Retirement Risk Warnings	
Step 2	• Based on how the retail client wants to access their pension savings, the firm must identify the risks associated with the pension decumulation products it offers and question the client to determine whether any risk factors are present (unless the value of the pension savings is less than £10,000). • Examples of the risk factors include the following: ◦ The client's state of health. ◦ Loss of any guarantees. ◦ Whether the client has a partner or dependants. ◦ Inflation. ◦ Whether the client has shopped around. ◦ Sustainability of income in retirement. ◦ Tax implications. ◦ Charges (if a client intends to invest their pension savings). ◦ Impact on means-tested benefits. ◦ Debt. ◦ Investment scams.
Step 3	• Provide the client with risk warnings: ◦ If the client's pension savings are less than £10,000, then warnings about the range of decumulation products offered. ◦ If the pension savings are above that figure, then the risk warnings identified in response to the client's answers to the firm's questions.

Whatever the means of communication, the firm must ensure that the client cannot progress to the next stage of the sale unless the relevant signpost in step 1 or retirement risk warning has been communicated to the client.

5.2.3 Advising on Conversion or Transfer of Pension Benefits

Advising on conversion or transfer of pension benefits is a separate regulated activity. It applies to any pension scheme that has 'safeguarded benefits' which means it includes advising on transfers between occupational pension schemes where the transfer payment is in respect of safeguarded benefits with a view to acquiring a right or entitlement to flexible benefits.

The concept of safeguarded benefits was introduced by the Pensions Act 2015 which defines them as '*benefits other than money purchase benefits and cash balance benefits*'. In practice, this means any benefits which include some form of guarantee or promise during the accumulation phase about the rate of secure pension income payable.

These include the following:

- **defined benefit** – a promised level of income based on length of service and salary at retirement
- **guaranteed minimum pension** – a guaranteed minimum level of income based on pension rights built up through an employer's pension scheme, and
- **guaranteed annuity rate** – a guaranteed annuity using a minimum rate at retirement.

The pension freedom rules, however, made a transfer out of a DB scheme attractive for some and the Act, therefore, introduced a requirement on individuals to take appropriate independent financial advice before a transfer can be accepted.

An individual with safeguarded benefits worth more than £30,000 under the scheme must take financial advice before they can do any of the following:

- Convert these benefits into a different form of flexible benefits under the scheme.
- Transfer these benefits to another scheme to take flexible benefits.
- Take a cash lump sum in respect of these benefits.

An adviser firm now needs to have the extended 'advising on pension transfers and pension opt-outs' permission to advise on transfers and conversions of safeguarded benefits to flexible benefits. This includes payment of UFPLSs in respect of safeguarded benefits.

Advice on the transfer or conversion of safeguarded benefits must be provided by, or checked by, a pension transfer specialist. This includes where the purpose of the transfer or conversions is to obtain immediate access to the pension savings.

5.2.4 Advising on Pension Switches, Conversions and Transfers

Wealth managers must understand what safeguarded benefits are to fulfil regulatory requirements, undertake the advice process properly, and ensure the appropriate process is followed for pension transfers and conversions. It is also vital that they understand the differences between switches, conversions and pension transfers as it drives the whole advice process thereafter.

The focus of the FCA's requirements is to ensure that individuals switching, converting or transferring their pension arrangements receive the appropriate level of advice, provided by advisers who have sufficient knowledge to ensure that the client understands the implications of the proposed action.

This is especially important where there is potential for significant consumer harm if unsuitable advice is given to consumers who are considering giving up safeguarded benefits.

5.3 Pension Switches

A key point to note is that a pension switch differs from a pension transfer or pension conversion.

A pension switch is one that falls outside of the definition of a transfer or conversion (see section 5.4 of this chapter). A pension switch involves moving pension benefits from one scheme to another scheme of the same type, such as where a retail client transfers pension benefits from one personal pension where there are no safeguarded benefits to another personal pension scheme.

The reason why a pension switch may be appropriate includes gaining greater investment flexibility, providing flexible options, servicing and cost benefits, and access to other investments that meet their needs. It could also include consolidating multiple pensions that a client has built up from various jobs into one or more schemes.

The FCA confirm that a transfer value comparator (TVC) is not required for switches between personal pensions without safeguarded benefits, the adviser is not required to be a pension transfer specialist nor does the firm require specific transfer permissions.

The FCA clearly requires the advice to switch to be suitable and to be based on a full examination of the client's circumstances and needs. In 2008, the regulator undertook a thematic review into the quality of advice on pension switching and found that unsuitability fell into four main areas:

1. Unjustified additional costs.
2. Unsuitable investments that did not take account of the client's attitude to risk and individual circumstances.
3. Unjustified loss of benefits from the transferring scheme.
4. Inadequate ongoing reviews or the importance of regular reviews not properly explained.

The FSA (the former UK regulator) issued a template to assess the suitability of advice on pension switching, and the key questions involved in the assessment are still relevant and are summarised in the following table.

Pension Switching	
Customer needs analysis	• What drivers for the pension switch were stated in the suitability report or in other documents on file?
Costs	• Is the receiving scheme more expensive than the ceding scheme or a stakeholder pension? • For each pension switch, did the advice consider any market value adjustments or penalties that applied on switching out? • Does the receiving scheme have the features/options that meet the customer's needs? • Could the features/options/funds have been achieved more cost effectively by a different product? • Is the recommendation to switch to a more expensive scheme than the ceding scheme or a stakeholder pension without good reason?
Benefits	• Were guarantees in the ceding scheme considered and was there good reason for their loss on switching out?
Attitude to risk	• Is the investment recommendation suitable given the customer's attitude to risk and personal circumstances?
Ongoing reviews	• Did the suitability report explain the importance of regular ongoing reviews? • Have these have been offered, carried out or arranged for a future date?

Other key points from the review included the following:

- Advice was considered unsuitable where the reason for the switch was investment flexibility but this was not likely to be used; the reason was fund performance but there was no evidence that the new scheme is likely to be better; or the reason was flexibility of a drawdown option but there was no evidence this was needed.

- Costs are important, but this does not mean that advising a client to switch to a more expensive contract is unsuitable advice, but it does mean that the extra costs must bring extra benefits which are explained and justified to the client.
- Advisers must take into account not only attitude to risk, but also other factors such as length of time to retirement. Strategies, such as lifestyling or inclusion of guarantees to coincide with retirement dates, helps tailor a plan to the client's specific circumstances.

5.4 Pension Transfers, Conversions and Opt-Outs

The FCA rules on pension transfers, conversions and opt-outs are contained in COBS 19. Although advisers need to know specifically what constitutes each of these, we will start with a simple explanation of what each involves:

- A pension transfer involves giving up safeguarded pension benefits in return for a cash value which is invested in another pension scheme.
- A pension conversion involves giving up safeguarded pension benefits in return for access to flexible benefits, or payment of a UFPLS.
- A pension opt-out involves opting out of or declining to become a member of an occupational scheme to which their employer contributes in favour of a personal pension scheme or stakeholder pension scheme.

5.4.1 Definitions

Understanding what falls within and outside the regulatory definition is important, and so the definition of each from the FCA Handbook is shown in the table that follows.

Pension Transfer	A transaction resulting from the decision of a retail client who is an individual: a. to transfer deferred benefits (regardless of when the retail client intends to crystallise such benefits) from: • I. an occupational pension scheme • II. an individual pension contract providing fixed or guaranteed benefits that replaced similar benefits under a DB pension scheme, or • III. (in the cancellation rules (COBS 15)) a stakeholder pension scheme or personal pension scheme to • IV. a stakeholder pension scheme, • V. a personal pension scheme, or • VI. a deferred annuity policy, where the eventual benefits depend on investment performance in the period up to the date when those benefits will come into payment, or • VII. a DC occupational pension scheme, or b. to require the trustees or manager of a pension scheme to make a transfer payment in respect of any safeguarded benefits with a view to obtaining a right or entitlement to flexible benefits under another pension scheme.

Pension Conversion	A transaction resulting from a decision of a retail client to require the trustees or managers of a pension scheme to: • convert safeguarded benefits into different benefits that are flexible benefits under that pension scheme, or • pay a UFPLS in respect of any of the safeguarded benefits.
Pension Opt-Out	A transaction, resulting from the decision of a retail client who is an individual, to: a. opt out of an occupational pension scheme, group personal pension scheme or group stakeholder pension scheme to which their employer contributes and of which they are a member, or b. decline to become a member of an occupational pension scheme, group personal pension scheme or group stakeholder pension scheme to which their employer contributes and of which they are eligible to join, or will be eligible to join at the end of a waiting period in favour of a stakeholder pension scheme or personal pension scheme.

5.4.2 Regulatory Permissions

As part of the introduction of pension freedoms and the requirement in certain circumstances to receive independent financial advice, a new regulated activity of 'advising on conversion or transfer of pension benefits' was introduced.

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2015 inserted a new article in the Regulated Activities Order making giving advice in relation to the transfer or conversion of a class of pension benefits, a regulated activity. In terms of the Order, any person providing advice on transferring from a DB scheme to a DC scheme will need to be FCA authorised and have the appropriate permission.

The change means that firms require pension transfer permissions to be able to transact any pension transfers or pension conversions, even where a firm is not dealing with safeguarded benefits or providing the services of a pension transfer specialist.

Advice and recommendations on pensions need to meet the suitability requirements in COBS 9 and pensions transfers, conversions and opt-outs must additionally meet the obligations set out in COBS 19 which set out the pensions supplementary provisions. These are covered below.

In Policy Statement PS20/6, the FCA issued further rules designed to address weaknesses across the DB transfer market where its research had shown that too many cases of pension transfers were not in the customer's best interest. Its targeted supervisory work led to it providing detailed feedback to over 1,600 firms on the advice given which has led to over 700 firms giving up their permission to provide pension transfer advice and enforcement investigations against a number of firms. Its research also showed that inadequate professional indemnity insurance was common, leading many advisers to leave the market and the latest changes are likely to shrink the advice market further.

5.4.3 Pension Transfer Specialist (PTS)

FCA rules require that a PTS must give or check advice on certain pension transfers, conversions and opt-outs. Areas requiring a PTS include transfers of:

- DB to a DC scheme
- DB to a flexible benefits scheme, or
- an occupational DC scheme with safeguarded benefits to a flexible benefits scheme.

They are not required for transfers of a DC scheme without safeguarded benefits to a flexible scheme or transfers or conversions involving guaranteed annuity rates (GARs).

The steps required of the pension transfer specialist when checking advice are as follows:

- Check the entirety of the advice process, not just the numerical analysis, and consider whether the advice is sufficiently complete.
- Confirm that any personal recommendation is suitable, taking into account the obligations in COBS and those matters contained in COBS 19 (see below).
- Confirm in writing that they agree with the proposed advice before it is provided to the client.

The FCA's rules do not prevent two separate advisers advising respectively on the pension transfer and the destination investments. For a firm with the permission, an individual who is not a PTS is permitted to advise on pension transfers but the firm must ensure that the advice is checked by a PTS. The firm advising on the transfer remains responsible for the advice, including the advice checked by the PTS, even where that specialist is not employed by the firm. The FCA made it clear that where a firm is operating a two-adviser model, it needs to make the role of the advisers and the fees involved clear to its client.

5.4.4 Giving Advice and Assessing Suitability

All advice on the transfer and conversion of safeguarded benefits should include a personal recommendation to either transfer or remain in the current scheme.

The starting assumption when giving advice on a DB transfer is that firms should begin by assuming that the transfer is not suitable. The FCA had consulted on changing this to a neutral position with a statement in the Handbook that advisers should have regard to the likelihood that, for most people, retaining safeguarded benefits is likely be in their best interests. However, it decided not to proceed given concerns about the significant proportion of unsuitable advice found during supervisory work.

To demonstrate that the transfer, conversion or opt-out is in the retail client's best interests, COBS 19 provides guidance on the factors a firm should take into account, as shown below.

- Their intentions for accessing pension benefits.
- Their attitude to and understanding of the risk of giving up safeguarded benefits for flexible benefits, taking into account:
  - the risks and benefits of staying in the ceding scheme
  - the risks and benefits of transferring to a flexible benefit arrangement
  - their attitude to certainty of income in retirement

  - whether the client would access funds in an unplanned way and the likely impact on the sustainability of the funds over time
  - their attitude and experience of managing investments or paying for advice whilst the funds last
  - their attitude to any restrictions on accessing funds in their present scheme.
- Their attitude to and understanding of investment risk.
- The client's realistic retirement income needs including:
  - how they can be achieved
  - the role of safeguarded benefits in meeting those needs
  - the consequent impact on those needs of a transfer, conversion or opt-out including any trade-offs.
- Alternative ways to achieve the client's objectives instead of the transfer, conversion or opt-out.

The FCA expects advisers to collect sufficient information for both the pensions transfer advice and the investment advice. An adviser will need to determine the client's objectives, income needs and wants and ensure that where necessary these are challenged. A critical element is to determine the client's income needs in retirement and be able to show that if there is a transfer, then the income levels or cash flows will be sustainable for a reasonable period beyond average life expectancy.

They need to determine the features of both the DB scheme and the flexible benefit scheme. For the DB scheme, this includes identifying the benefit structures, and where there is a risk of the scheme entering the PPF, what the protected amount would be compared to the transfer value. For the flexible benefit scheme, it should be noted that this includes the assets in which the client's funds will be invested in the flexible benefits scheme.

A robust assessment of the client's attitude to the risks involved in the transfer is essential. The client should be told about risks such as longevity risk, investment risks and the risk of insolvency for the sponsor of the existing scheme in a balanced way so that any bias or misconception of the client is managed. The investment advice should take into account the impact of the loss of any safeguarded benefits on the client's ability to take on investment risk. A transfer from a DB scheme to a DC scheme almost always involves higher risk for the client and both the transfer risk and the investment risk must be assessed.

The tax position of the client should also be taken into account as tax issues can arise on transfer and FCA guidance requires advisers to consider the impact on tax and access to state benefits particularly where there would be a financial impact from crossing a tax threshold or band.

As part of this process, a firm needs to document an appropriate pension transfer analysis (APTA) that is personalised to each client's needs and objectives and which should demonstrate the suitability of the personal recommendation in the context of the client's objective. A mandatory TVC has to be included that shows:

- a projection of the ceding scheme benefits to normal retirement date
- the estimated cost of purchasing those benefits using an annuity, and
- for those more than 12 months from their scheme retirement date, a determination of the present value needed today to fund the annuity.

Most importantly, as laid out in COBS 19.1.6, a firm should only consider a transfer, conversion or opt-out to be suitable if it can clearly demonstrate, based on contemporary evidence, that it is in the client's best interests. A suitability report is required regardless of the outcome of the pension transfer advice.

6. The Mansion House Accord: Transforming UK Pension Investment

The UK's defined contribution (DC) pension system has long faced challenges: low participation rates, disengagement among savers, and overly cautious investment allocations. In response, the UK government has sought to unlock pension capital to drive both better long-term outcomes for savers and greater investment in the domestic economy. The cornerstone of this reform agenda is the Mansion House Accord, announced in May 2025, and significantly advanced through a series of milestones in 2025.

From Compact to Accord

The Accord builds on the Mansion House Compact of 2023, in which nine leading DC providers voluntarily committed to investing fund assets into unlisted equities. By May 2023, this initiative had evolved into the Mansion House Accord, now backed by 17 of the UK's largest DC pension providers, covering over £252 billion in assets – more than 90% of the market. These assets are expected to rise to £740 billion by 2030, significantly increasing the capacity to invest in long-term productive opportunities.

2025 Milestones: Policy Becomes Practice

Two key milestones were reached in 2025:

- In May 2025, the UK government published the final report of its Pensions Investment Review, estimating that the Accord could unlock £50 billion in private market investment by 2030, including £25 billion specifically in UK opportunities. It also confirmed the ambition to create 'DC megafunds', which should drive significant efficiencies and reductions in costs.
- In July 2025, as part of her Mansion House Speech, Chancellor Rachel Reeves reaffirmed the government's support for the Accord through the launch of the Leeds Reforms and a new Financial Services Growth & Competitiveness Strategy. The focus remains on voluntary industry action, but with legislative 'backstops' in place to encourage compliance.

Meanwhile, the Lord Mayor of London, Alastair King, issued a call for pension schemes and employers to shift their focus from minimising fees to maximising long-term value for savers. Major employers, including Tesco and Octopus, signed a new Employer Pledge committing to prioritise net returns and transparency over cost alone.

Objectives and commitments

The Mansion House Accord's core objectives are:

- To improve member outcomes by increasing allocation to private markets, such as infrastructure, private equity and growth capital, thus enhancing diversification and return potential.
- To stimulate UK economic growth by ensuring that at least half of these private market investments are directed toward UK-based opportunities, including innovation, clean energy and infrastructure.

By 2030, the signatories have committed to:

- Investing at least 10% of default DC assets in private markets.
- Allocating a minimum of 5% of total DC assets to UK-based private markets.
- Upholding fiduciary duties and adhering to FCA Consumer Duty principles, ensuring all decisions remain aligned with members' best interests .

A significant challenge lies in connecting a highly fragmented DC sector – often described as a 'cottage industry' – with institutional-grade private market managers. New fund structures such as Long-Term Asset Funds (LTAFs) and **Reserved Investor Funds (RIFs)** are intended to bridge this gap. Furthermore, it is worth noting that the Accord is explicitly UK-focused. For private equity and venture capital firms, the message is clear: capital raised through the Accord is intended for domestic use – not for international investments, such as Silicon Valley or China.

Strategic investment scope

Investments are likely to include:

- **Clean energy and infrastructure** – helping to meet the UK's net zero goals.
- **Life sciences and fintech** – areas of high innovation and job creation.
- **Defence and dual-use technologies** – including modern military tech that can drive economic as well as national security benefits, given its civil-military application potential.

These sectors align with government industrial strategy and present significant opportunity for long-term capital deployment.

Implications for wealth managers

While the Accord is aimed at institutional pensions, the ripple effects will shape the broader investment landscape:

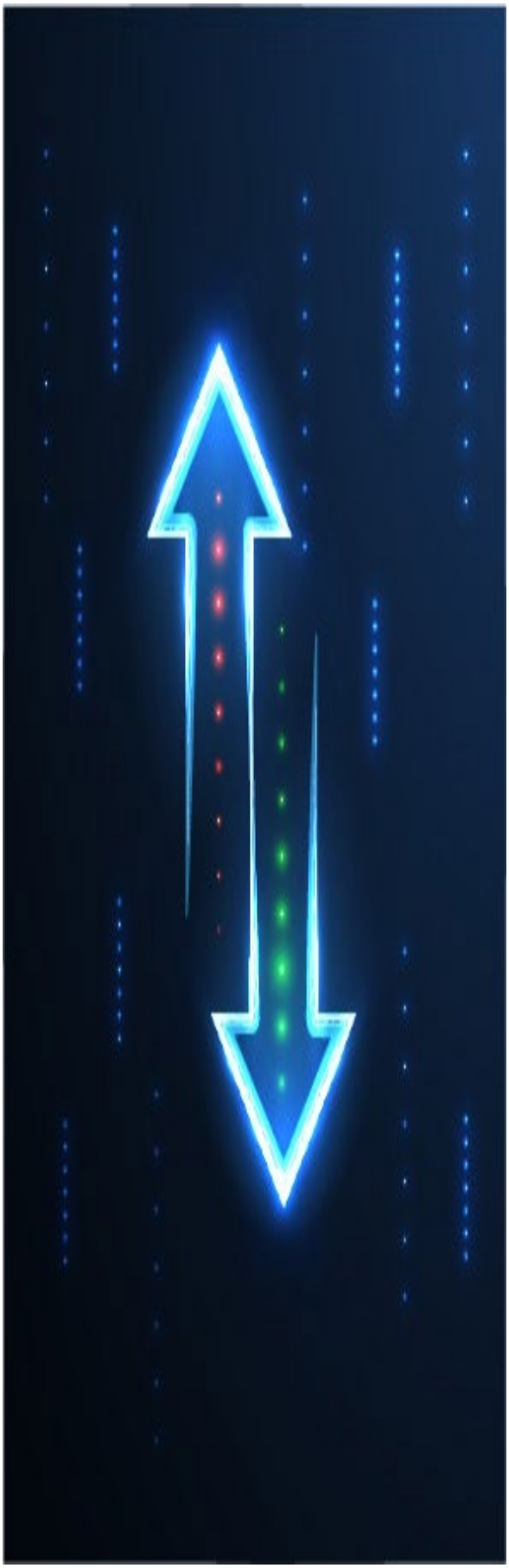
- **Product innovation** – increased institutional demand will likely accelerate development of private market funds accessible to high-net-worth clients (eg, via LTAFs or semi-liquid alternatives).
- **Enhanced transparency and governance** – standards for performance reporting, sustainability and risk disclosure may rise across all channels.
- **Increased UK investment appeal** – a successful implementation could improve long-term domestic growth, benefiting UK-centric portfolios.
- **Alignment with values-based investing** – clients interested in clean energy, innovation and national resilience can now more easily align their wealth strategies with these priorities.
- **Adviser awareness** – wealth managers should stay abreast of evolving policy and product developments to ensure client portfolios reflect the new opportunities and regulatory landscape.

The CISI has played a proactive role in supporting the Accord's development and awareness and will continue to do so in the future.

Chapter Five

Life and Protection Planning

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Insurance products are essential to wealth management because they address the very real flip side to wealth accumulation: loss – the loss of life, the loss of health, of assets, income or earnings. This chapter examines the range of life assurance policies, from protection to investment types, and their structure and taxation. Annuities, which have recently been impacted by a period of huge regulatory change, upheaval and evolution, are considered separately. Finally, general insurance and other protection insurances are examined, and how they can be used in both personal and business financial planning.

Insurance products have been in existence for more than 600 years. The principal role of insurance is to protect against the financial consequences arising from the occurrence of the insured event, eg, theft, fire or accidental damage. In the case of life assurance, this means ensuring financial security for dependants on the death of the insured person(s) by providing a lump sum, a regular income, or both. It is designed to meet several aims:

- Paying final expenses (for example, funeral, legal).
- Paying off outstanding debts (for example, mortgage, loans).
- Providing income to maintain the dependant(s) lifestyle.

It is also sometimes used in estate planning to ensure that children have the necessary funds to pay an inheritance tax (IHT) liability when one or both parents have died. It is often used to ensure that a business can survive the death of someone who may be key to its success, or that the business share owned by the deceased can remain in the correct hands.

1. Life Assurance Policies

In this section, we will look at the main types of life assurance policies. Before we look at these, however, we will consider some of the terminology used and the main characteristics of life assurance.

1.1 Characteristics of Life Assurance Policies

It is important to be aware of the different terminology used for life assurance policies and some of the main points are covered below.

Life Assurance Terminology	
Life office (or insurer)	• The institution that undertakes the risk of insurance. This is usually a life assurance firm (either corporate or mutual) but may be a Friendly Society (an early type of mutual organisation) or other entity.
Proposer	• The person who applies to the insurer for a policy – this may be an individual, company or other legal entity.
Sum assured	• The amount that is guaranteed to be paid out on a valid claim. The sum assured is frequently level, ie, it does not vary during the life of the policy but increasing and decreasing sums assured are available on certain types of policies.
Life assured and assured	• The life assured is the person whose life is being insured, and on whose death the policy pays out. • The assured is the entity (either a person or other legal entity) who is the legal counterparty who contracts with the life office to establish the policy, and is, therefore, the original owner of the policy. • The life assured and assured are commonly the same person, as people frequently insure their own lives, in which case the policy is referred to as an own life policy. However, this is not always the situation, and the life assured and the assured can be different. These policies are then known as 'life of another policies'.
Insurable interest	• The economic stake in an event for which the assured purchases the insurance policy, to mitigate the risk of loss. • In theory, under English law, anyone can insure anyone's life provided they have a valid reason for doing so (see below).
Single or joint life	• Most life assurance policies are 'single life', so the death of the life assured will result in the policy pay out and the end of the agreement. • Policies can also be written for two lives assured (which is the most common type of multiple life policy, although it is possible to write policies for more). This is common in the case of spouses/civil partners and is called a joint life policy. • Joint life policies come in two forms, joint life first death, which pays out on the first death – typically used for family protection – and joint life second death which, as neither of the insured is alive at maturity, is typically used for estate and ITH.
Loading	• Loading is applied by the insurer in some cases. This means a higher premium than normal is required, due usually to age, occupation or health issues.

1.1.1 Insurable Interest

The notion of insurable interest has its origins in a legal aberration which was not corrected until the Life Assurance Act 1774. Before that, it was legally possible to take out life assurance on any person irrespective of whether the proposer (assured) had a legitimate interest in the life assured. This possibility was used as a form of gambling, with effectively bets being taken on how long a named person might live; criminals were popular choices, given the range of capital offences on the statute book in the 18th century.

Although the Act introduced the concept of insurable interest, it did not define the expression; instead it has been case law that has effectively determined what counts. In essence, it must be an interest which would otherwise result in identifiable financial loss to that person as a consequence of the death of the other. Examples of insurable interest established by case law include:

- A creditor may insure the life of a debtor, but only to the value of the debt.
- The recipient (donee) of a lifetime gift has an interest in the life of the donor for up to seven years to the extent that the gift might fall back into reckoning for IHT to be payable.
- Commonly, employers may insure the lives of key employees for the value of their services or loss to the business (key person insurance) or partners may insure each other. The latter is particularly relevant where there is a cross-option arrangement in place to buy out deceased partners' shares.
- A person has an unlimited interest in their own life and no evidence is required (ie, there is no legal limit to the amount they may insure themselves for if there is an insurer willing to accept the risk) and, by extension, this includes spouses/civil partners. However, the case of cohabiting couples is unclear, not yet having been tested in court.

Similarly, instances where there is no insurable interest include the following:

- A parent is deemed to have no financial interest in their children (except under Scottish law where parents and children are assumed to have a right to be supported by each other). In general, under English law it is not permitted to benefit financially from the death of a child, although this might appear to raise issues around life-insurance-based savings and investment vehicles for children. In such products, the life assurance element is negligible and the death value is normally the value of the investment fund. In the event of the death of a child, the parents might benefit through inheritance (or intestacy rules) but cannot benefit directly from the fact of the death.
- A child has no insurable interest in their parents (although this is not the case in Scottish law; see above).
- Similarly, a beneficiary under a will has no financial interest in the testator simply because the testator may change the will at any time, and so the beneficiary retains only the expectation or hope of benefit but no absolute entitlement.

Other points to note:

- To be valid, insurable interest need only exist at the date the policy commences. If the conditions giving rise to the interest later change, the policy nevertheless remains valid and in force.
- If a policy goes into effect without insurable interest it is null and void. It is not a crime on the part of either the proposer or insurer. It appears possible that an insurer can choose not to avoid the contract, even though defective; however, case law is ambiguous on the point.

- Where a policy goes into effect without insurable interest, there is no automatic right to recovery of premiums paid by the policyholder unless the insurer demonstrably carries the main burden of fault by misrepresentation, for example.
- In any event, the insured cannot recover more than the value of the insurable interest (ie, over-insurance is unenforceable).

1.1.2 The Legal Basis of Insurance Contracts

Insurance contracts are, in general, governed by the English Law of Contract. However, like contracts of insurance of every kind, life assurance/insurance contracts are subject to the common law principle of utmost good faith (*uberrimae fidei*).

The Consumer Insurance (Disclosure and Representations) Act 2012 and the Insurance Act 2015 modernised the common law principle of utmost good faith and significantly altered the landscape for insurance contracts, addressing several aspects of insurance law that previously were identified as potentially unfair:

- **Duty of Disclosure** – for consumer insurance, the duty to volunteer material facts has been replaced with a duty to take reasonable care not to make a misrepresentation. For non-consumer insurance, a 'duty of fair presentation' has been introduced.
- **Test of Materiality** – the 'prudent insurer' test has been modified. For consumer insurance, the focus is now on whether a reasonable consumer would know that information is relevant to the insurer.
- **Remedies for Breach** – the Acts introduced proportionate remedies for non-disclosure or misrepresentation, replacing the previous 'all or nothing' approach.
- **Warranties and Conditions** – 'basis of contract' clauses have been abolished, and warranties are now treated as suspensive conditions rather than conditions precedent to the insurer's liability.
- **Fraudulent Claims** – the law on fraudulent claims has been clarified, giving insurers clear statutory remedies.

However, some aspects of insurance law remain potentially unfair:

- **Intermediaries' Status** – the Acts have not significantly changed the legal position regarding intermediaries, including brokers, who are generally still treated as agents of the insured. The insured remains responsible for any failings on their part, even where the intermediary is closely connected with the insurer.
- **Insured's Knowledge** – while the Acts have improved the situation, there may still be cases where an insured could be in breach if their error was unreasonable in the circumstances – for example, if a question was unclear or required specific technical knowledge they did not have.

It is worth noting that the FCA has rules in place regarding the use of intermediaries, as outlined in the FCA Handbook. These rules require firms to ensure that the intermediaries they use have the appropriate permissions and authorisations, which provides some level of protection for consumers.

In addition, the new Consumer Duty significantly impacts insurance intermediaries and aims to set higher and clearer standards of consumer protection across financial services and promote good outcomes for customers.

For insurance intermediaries, this means:

- ensuring products and services are fit for purpose and designed to meet the needs of consumers
- providing fair value, where the benefits of the product or service are reasonable relative to its price
- communicating in a way that is clear, fair, and not misleading, helping consumers make informed decisions, and
- providing a level of support that meets consumers' needs throughout their relationship with the firm.

These changes above have aimed to strike a fairer balance between the interests of insurers, intermediaries, and policyholders, while also clarifying and simplifying certain aspects of insurance law. However, it remains essential that a full and frank disclosure is made to insurers to ensure the validity of the policy and avoid potential disputes at a later stage.

1.2 Types of Life Assurance Policy

Life policies cover a spectrum, from those with no inherent (investment) value which provide life insurance, to those which are effectively investment vehicles held within a life policy structure for tax mitigation reasons.

Life assurance contracts are split into two broad types – those that have a protection element only and those that have both a protection and investment element. There are three main types of life assurance policies:

1. Term assurance.
2. Whole of life assurance.
3. Endowment assurance.

Technically, the expression life assurance should be used to refer to a whole of life policy that will pay out on death, while the expression life insurance should be used in the context of term assurance policies that only pay out if death occurs within a specified period.

1.3 Term Assurance

At the pure protection end of the spectrum sits term assurance, which pays out only if the life assured dies within the specified term of the policy. There is no inherent value, and no pay out if the life assured survives to the end of the stated term. There is, therefore, also no surrender value at any time. This is pure life insurance and comes in various forms.

Types of Term Assurance	
Level term assurance	This is the simplest type of term assurance. The sum assured on a level term assurance policy does not vary during the policy term and, once the term expires, the policy expires with no value.
Renewable term assurance	The renewable option provides the opportunity for the life assured to take out a further term assurance without requiring further evidence of health.

Types of Term Assurance	
Increasing term assurance	Similar to level term, except that the sum assured increases.
Decreasing term assurance	These policies have a sum assured which reduces each year by a given amount, decreasing to zero at the end of the term.
Convertible term assurance	This is a term assurance which allows the policyholder to convert it to a whole of life or endowment assurance contract.
Family income benefit	This form of protection gives the beneficiaries a tax-free regular income, as opposed to a lump sum.

There is also unit-linked term assurance but this is a relatively costly way of buying both term cover and insurance-linked investments, and it is rare that this would ever be recommended.

Term assurance is normally sold with monthly premiums payable, but other premium frequencies are possible, as is a single lump sum premium.

1.3.1 Level Term Assurance

Level term assurance is the simplest type of term assurance. The life office pays the sum assured only if the life assured dies during the term (ie, before the expiry date) of the policy. The sum assured is level, ie, it does not change during the life of the policy. These policies are usually own life and can be written for long-term periods.

Uses of Level Term Assurance

- **Family protection**
  - Typically, these are used to protect a family during a calculated period where the death of the main breadwinner(s) would expose the family or other dependants to hardship. They produce a tax-free lump sum which can be used to meet capital debts (eg, a mortgage) and/or be used to generate the income lost through the death.
  - This may not be ideal, as most people expect their income to increase and on a level term policy the sum assured remains static.
- **Interest-only mortgages**
  - Level term policies have also been used to provide cover alongside an interest-only mortgage. As no capital is being paid out, the liability remains the same. This is ideally covered by a level term policy.
- **IHT planning**
  - Level term assurance can also be used for IHT planning when a lifetime gift may mean all or part of an estate falls above the nil-rate band if death occurs within seven years.
  - An alternative is a decreasing term policy.

This type of policy is almost the cheapest available (however, see family income benefit in section 1.3.5) and commonly represents the most basic form of protection. Premiums depend on term, gender, age and health and are fixed at the outset and do not change during the period of the policy. Policies will lapse if premiums are not paid although there is usually a short period of grace.

Note that insurance contracts made before 21 December 2012 can discriminate against you because of your sex or because you are pregnant by applying different premiums and benefits under the insurance policy.

1.3.2 Renewable Term Assurance

This is similar to level term in its basic structure, however, the renewable option provides the opportunity for the life assured to take out a further term assurance at ordinary rates, without requiring further evidence of health – known as 'guaranteed insurability'. The length of the renewed term is normally restricted by the original term, and also possibly by a maximum age. Each subsequent policy will have the same renewability option, incorporating the restrictions noted.

Uses of Renewable Term Assurance

- This type of policy is used when there is a definite need for cover, but it is not known how long that need will last.
- These renewable options can be exercised up to a limit for the final expiry date. For example, a 35-year-old could take out 30-year term cover or, alternatively, opt for ten-year renewable cover, deciding at each expiry date whether to renew and pay the new premium.
- These policies are conventionally recommended where the need for initial cover is clear, but the eventual required length of cover is uncertain. In such cases, however, it will often be cheaper to buy the longest term practicable and simply lapse the policy if the cover is later found unnecessary.
- Often this may be the case with business insurance scenarios, such as key person protection, where an employee may be deemed a key person now, but may not remain so indefinitely.

The initial premium will be higher than for a level term policy. When the policy comes up for renewal, the premium will increase further as it will be based on the increased age of the life assured.

1.3.3 Increasing Term Assurance

Increasing term assurance is intended to offset the consequences of future inflation and ensure that the sum assured is maintained in real terms.

Uses of Increasing Term Assurance

- This type of policy is also used for family protection with the added bonus of being able to offset the effects of inflation.
- The rate of increase differs from one life office to another. The escalation may be based on inflation indices, such as the CPI; other variations include a cap or a periodic uplift over, say, five-year periods. Some life offices offer a series of short-term renewable policies giving the policyholder the right, for example, to renew every five years, say, at a higher sum assured.
- The policyholder has the right to freeze the sum assured at any point.

Some policies offer 'guaranteed insurability options', which allow the sum assured to be increased by much more substantial amounts (for example, 50% of the original sum assured). These increases are offered alongside key events in an assured's life, such as marriage, the birth of a child or a remortgage for a higher sum.

The initial premium for this type of policy is slightly higher than that for level term policies, and the premium increases each time the sum assured increases throughout the term, although usually without additional evidence of health. These refinements make this type of policy somewhat more expensive than a level term for the same sum assured.

1.3.4 Decreasing Term Assurance

These policies have a sum assured which reduces each year by a given amount, decreasing to zero at the end of the term.

Uses of Decreasing Term Assurance

- These policies are typically used to insure the policyholder during a period of debt repayment, commonly a repayment mortgage.
- A special form of seven-year decreasing term assurance (a gift *inter vivos* policy) can be used by recipients of gifts that exceed the IHT nil-rate band but have a decreasing liability due to taper relief.

Although the cover is decreasing, the premium remains level throughout the term. The initial premium will be lower than for level term assurance, as the overall liability to the insurer is less. Occasionally, the premiums are actually payable for less than the full term, to try to remove the temptation for individuals to lapse the policies in the last few years when the cover is relatively low.

1.3.5 Convertible Term Assurance

This is a term assurance which allows the policyholder to convert it to a whole of life or endowment assurance contract. This conversion can take place at any time during the policy term, and there will be no need to provide any further evidence of health.

Uses of Convertible Term Assurance

- This type of policy is used when there is a current need for term assurance but also the likelihood of a more substantial policy requirement in the future.
- Ideally, the whole of life or endowment policy option would be chosen immediately, but there may be an impediment – usually cost – that is stopping an assured from being able to pursue that route at the outset.

If an option is exercised, the new premium would normally be at ordinary rates (for the age then applicable) for whole of life or endowment policies. Sometimes, partial conversion is possible in which case the original sum assured is reduced by the sum assured on the new policy.

The initial premium will be higher than that for a level term assurance, as it carries this greater flexibility. Significantly, on conversion, the premium will be based on the nature of the new type of life policy, both of which are much more expensive than term assurance. Such policies are marketed on the basis that simple term cover may be needed initially, but later the policyholder may prefer to utilise an investment orientated vehicle.

1.3.6 Family Income Benefit

This form of protection gives the beneficiaries a tax-free regular income, as opposed to a lump sum.

The structure of the plan means that the total amount that can be paid out normally decreases each year, as the payments are only made until the end of the policy term. For example, a family income benefit plan is set up for 20 years to pay £20,000 a year. If a claim is made after five years, £20,000 x 15 years, or £300,000 is paid. However, if a claim is made after 18 years, £20,000 x 2 years, or £40,000 is paid. These policies are also available on an increasing basis.

Uses of Family Income Benefit (FIB) Protection

- FIBs or family income policies are often overlooked, but can provide the cheapest cover and are suitable for protection needs where clients are in the early stage of their lives and perhaps starting a family meaning there may often be just one income available.
- FIBs are particularly useful as joint life policies: the consequence of the death of the main earner is, in financial terms, the loss of net income. However, if the home-partner dies, it is likely that childcare and home help will be required as the main breadwinner would normally continue working.
- Instead of a lump sum benefit, FIBs pay out a regular tax-free capital sum (monthly, quarterly or annually) from the point of death till the end of the term selected at the outset.
- The income is paid tax-free and does not affect any entitlement to Bereavement Support Payment, although it may affect entitlement to any means-tested state benefits.

It is said that family income benefit is one of the most useful and best value protection products that can be purchased. It is particularly attractive to anyone who likes to know that their beneficiaries will receive a regular monthly income and will not have to worry about complex investment decisions as they might with a lump sum payout.

1.3.7 Factors to Consider

Term assurance is the most basic type of life insurance but there are a number of variations on the basic theme and it is important to be aware of the factors that should be kept in mind when selecting a suitable solution.

- There is usually no upper limit on the amount of cover that can be taken out, but a life company will want further information on the life assured before they will agree to cover larger amounts.
- As well as selecting the type of cover, consideration also needs to be given as to whether to take out single or joint life cover, where the benefit is payable only once, and whether to include Waiver of Premium, which involves the term assurance premiums being waived if the person covered is incapacitated for a specified period, such as for longer than 26 weeks. This benefit will only be available if the reason the person is incapacitated meets the conditions included in the policy.
- The other variable that is selected when the policy is taken out is the period for which the cover will last. An individual is normally able to select a period up to 40 years with a limit that the cover must end before their 70th birthday.

It is very important to note, however, that policies are normally issued with cover that lasts for five years. At each five-year anniversary, the client has the option to renew without any further underwriting. Equally, the insurance company can recalculate the premiums based on the individual's age and market conditions at the time. The client, therefore, needs to be aware that the premiums payable can change.

Term assurance can also be purchased on either a reviewable or guaranteed basis. If selecting a guaranteed basis, the premiums are fixed at outset and guaranteed not to increase during the length of the contract. Reviewable cover means the cover will be reviewed after the initial ten-year period, and premiums will increase to maintain the level of cover selected, or remain the sum in exchange for the client accepting a lower level of cover. Thereafter, premiums will then be reviewed every five years. They will be recalculated based on the life assured's age at renewal, but underwriting will not be required.

Term assurance has a variety of uses, such as ensuring there are funds available to repay a mortgage in case someone dies, providing a lump sum that can be used to generate income for a surviving partner, or providing funds to pay IHT when a person dies.

Note that this type of policy is not guaranteeing to repay a mortgage or loan but instead pays a known sum. Where term assurance is used to provide protection for payment of an outstanding mortgage in the event of death, it will only do so if:

- the initial amount of cover was not less than the outstanding loan
- mortgage payments are kept up to date
- the term of the mortgage has not been extended
- the period when the cover is in place is at least the same as the mortgage
- any further mortgages are separately covered, and
- the mortgage interest rate does not exceed the one that the insurance company originally quoted for.

The latter point is particularly relevant and requires regular checks to be made to ensure that the mortgage interest rate does not remain above the quoted rate; otherwise, the client may have insufficient cover.

It should also be noted that life cover, where appropriate, should be written into trust and can be a valuable way for a client to ensure that their beneficiaries will receive a lump sum to pay, say, the IHT that arises on their death. The policy is written in trust and, if it becomes payable, then the lump sum is paid to the trustees of the policy and so does not form part of the deceased's estate for inheritance tax purposes. Payment of benefits into trust avoids the need for production of the grant of **probate** and means benefits are paid much more quickly. In certain cases, especially where there may be significant wealth or an interest-in-possession under a trust, low-cost whole of life or maximum cover might be appropriate as, when written under trust, this can provide important IHT protection.

If the life assured dies during the period when the cover is in place, then a lump sum will be paid out that equals the amount of life cover selected. With some policies, if a life assured is diagnosed as suffering from a terminal illness which is expected to cause death within 12 months of the diagnosis, then the lump sum is payable at that point.

Payment will be made to the person covered or their legal representatives, provided the conditions under the policy have been met. These include the requirement that the illness meets the definition of a terminal illness, all required evidence has been provided and accurate, complete and true information was provided, when the policy was taken out.

If payment is made following death, it will be paid to the personal representatives of the deceased or, if the policy was written in trust, to the trustees.

1.4 Whole of Life Assurance

Whole of life assurance policies will result in the pay out of the sum assured on the death of a life assured, whenever that occurs.

All whole of life policies are just that: for life. It is a permanent contract and not limited by a contractual expiry date. This means such policies can be assigned as security for a loan. To maintain cover, premiums normally must be paid for life, and the policy pays out only on death (whenever it occurs). Unlike term policies, where the life office's liability is contingent on the life assured dying within the term of the policy, whole of life policies represent effective certainty that the life office will have to pay out the sum assured at some point. The expectation of when that will be is based on actuarial principles, often backed up by medical underwriting for larger sums assured, and the premiums calculated accordingly. As the assured can never benefit personally, whole of life policies are normally used for estate planning and IHT mitigation.

Due to the permanent nature of the cover and the certainty of a claim as long as premiums are maintained, the premiums are more expensive than for term assurance policies. Whole of life policies can in some instances also build up cash-in values, although these can be very low, particularly in the early years.

Certain whole of life policies have been established more as investment than protection vehicles, and we will look at them later in this section. In some respects, this is a sort of halfway house in the life assurance world. Policies can be structured as almost wholly life cover, or almost wholly investment, and at almost any point in between. The first type is usually called something like maximum cover or low-cost (terminology varies between providers), and it is normally possible to vary the investment and life insurance elements over time according to personal circumstances and need.

There are four types of whole of life assurance policies that we will cover in this section; we will look at how they are structured and their uses and merits.

1.4.1 Non-Profit Whole of Life Policies

Non-profit whole of life policies have level premiums, payable throughout life. They pay out a fixed sum assured, whenever death occurs.

It is possible to obtain products of this nature that cease collecting premiums at a specified age, such as 80 or 85, although the cover continues. The initial premiums will be slightly higher as a result.

Uses of Non-Profit Whole of Life Policies

- Non-profit whole of life policies, with relatively small sums assured, are sometimes sold by direct sales techniques to older clients and regularly appear in television adverts.
- These types of contracts have become more popular in the IHT market recently.

As a claim is certain, the premiums will be higher than for term cover. The proposal forms for these tend to be very short, with few medical questions. However, it is common for the sum assured to be paid out only if death occurs after a predefined period, typically after two years, and there is no surrender value.

1.4.2 With-Profits Whole of Life Policies

These operate in much the same way as non-profit policies, with the death benefit being the sum assured, plus bonuses declared before death.

With-profits policies offer the opportunity for the sum assured to be increased by the addition of bonus payments. These bonuses are not guaranteed but, once allocated, cannot be removed. The level of the bonus depends on the performance of the life office and its funds, assets and liabilities.

- Bonuses that are added regularly are known as 'annual' and/or 'reversionary'. They are usually expressed as a percentage of the sum assured and may be based purely on the original sum assured or compound (based on the original sum assured plus previous allocated bonuses).
- It is possible that another bonus may be added when a policy comes to the claim stage (rather than surrender). This is known as the 'terminal bonus' and is usually expressed as a percentage of the total reversionary bonuses.

Uses of With-Profits Whole of Life Policies

- As a standard form of **whole of life cover**, for family protection and IHT planning.
- The with-profits format should, in theory, be less risky than a unit-linked approach, as allocation of bonuses should provide a smoother increase in benefits. However, see section 1.5.2 of this chapter covering the with-profits debacle.

As mentioned, once a bonus has been allocated it cannot be removed. However, most life offices reserve the right to apply a market value reduction (MVR) factor if a policyholder surrenders the policy, or wants to switch out of the with-profits fund. This is most likely to be applied during periods of adverse stock market conditions and poor economic climate. The MVR enables the life office to reduce the surrender or switch value, in an attempt to apply fairness across all with-profits members (including those who are remaining in the fund).

Bonuses are allocated from surpluses, but during times of market downturns these surpluses are reduced. If an assured person is allowed to keep their full allocated bonus, it could impact negatively on those who are remaining in the fund. Therefore, MVRs are generally only applied in periods of poor market performance, and only on surrender or switching – not on death.

Some companies have MVR limits and MVR-free periods when the MVR does not apply – known as an MVR window. The Financial Conduct Authority (FCA) has conduct of business rules that companies must follow when considering MVRs to ensure that with-profit policyholders are treated fairly.

Most legacy with-profits funds are now fully in claims out-go (paying out to members) and gradual run-off to final wind-up.

1.4.3 Low-Cost Whole of Life Policies

These are a type of with-profits policy that are sold as one policy but are a combination of a with-profits policy and a decreasing term assurance policy.

The policy will pay out a full sum assured on death, based on the combined value of these two elements. In the longer term, the bonuses added to the with-profits element will increase the payout from that element, while the decreasing term sum assured is reducing progressively. The structure means that the underlying with-profits investment will grow over time, allowing the underlying term assurance to decrease.

Uses of Low-Cost Whole of Life Policies

- This type of policy is used for family protection and IHT mitigation. As usual, they can be single life or joint life first or second death.
- They are used for much the same purposes as full with-profits contracts but at a much-reduced cost.

Premiums and death benefits are both lower than those for a traditional full with-profits whole of life policy. As low-cost policies have a lower sum assured, bonus additions are lower than for a full policy with a higher sum assured. The surrender values of these policies, as they are based only on the with-profits element, are even less than those available on a full with-profits policy.

1.4.4 Unit-Linked Whole of Life Policies

Unit-linked whole of life policies have become the most commonly used type owing to their flexible structure, which allows the policyholder to vary the weighting to investment or life cover. Due to this benefit, they are often referred to as 'flexible whole of life' policies.

A notional growth rate is usually assumed at the outset, and premium levels are reviewed typically every ten years. At each review point a check is made on the investment performance to see how it compares with the original assumption. If the actual growth has been high relative to the assumption, the sum assured can be increased; if it is lower than the assumed rate, the policyholder can decide between reducing the sum assured or increasing the premium. Usually policyholders can vary the sum assured (within limits), and this flexibility can allow higher life cover in the earlier years, and then a higher investment content later.

Uses of Unit-Linked Whole of Life Policies

- The attraction is the flexible level of cover, enabling a high degree of protection in the early years (for example, when children are still dependent) and less protection with more investment in later life (when the children should have left home and are independent).
- These policies are also used for estate planning to provide a lump sum to pay an IHT liability.
- In essence, the maximum cover option is fairly similar to a ten-year convertible term assurance, with only a small amount of units being actively invested. It is unlikely that anyone would opt for the minimum cover option at the outset, as there are probably better ways to invest money if that is the intention.

These policies tend to attract high charges and the frequency of premium reviews increases over time, from ten to five years or more frequently in later life, and premium increases can be significantly higher than expected in later life if investment performance has been insufficient. Clients need to plan for such increases, which tend to happen when financial circumstances can become strained in later life.

As mentioned above, most legacy with-profits funds are now fully in claims out-go (paying out to members) and gradual run-off to final wind-up.

Universal Life Policies

These policies represent an attempt to provide a more flexible unit-linked contract. The policyholder can choose from a menu of benefits and change the selection from time to time, and the premiums are adjusted accordingly. Because of the range of options (rather than being limited to death or disability) these policies are non-qualifying for UK tax purposes.

The chosen benefits will vary from one insurance company to another. They can be set at the beginning, or added over time, and would typically include options such as:

- death benefit
- critical illness cover
- accidental death
- income protection
- hospital income cover
- waiver of contribution, and
- indexation of benefits.

1.5 Endowment Assurance

Endowment assurance combines life cover over a specific term (like term assurance), with the guarantee that there will be some kind of pay out (like whole of life assurance). They were designed to provide a steady mix of protection and investment.

Endowments acquired a bad reputation in the marketplace owing to many policies being sold, particularly in the 1980s and early 1990s, to repay interest-only mortgage debts. Despite the fact that ultimate cash-in values are very rarely guaranteed on any form of endowment, there were many policyholders who were not informed of this fact. Many were then surprised to receive a letter from their life office informing them there was likely to be a shortfall in their endowment funding, and therefore they would not be able to fully repay their mortgage if they kept premiums at the existing level. The 'endowment misselling scandal' then followed.

Endowments are still sold, albeit rarely, as they do have some advantages. However, the word 'endowment' is so tarnished that it is rarely used in the product name, with alternatives, such as 'regular savings plans', proving more acceptable.

1.5.1 Types of Endowment Policies

The common life policy structures and investment options are available for endowments.

Types of Endowment Policies	
Non-profit	• These are the most basic form, with level premiums and a pay out of a fixed sum on the earlier of maturity at the end of the term or death. • These types of endowments are expensive, as the premium paid has to be sufficient to provide the required sum at maturity without the benefit of any investment related bonuses, and would generally be inefficient in today's market. Older policies may still be found when reviewing a client's existing provision.
With-profits	• These guarantee that the sum assured will be paid out on maturity at the end of the term or death, whichever is earlier. • In addition, there may have been reversionary bonuses added during the term, and the possibility of a terminal bonus added at maturity. • Equally, **market value adjustments (MVAs)** or market value reducers (MVRs) can be applied in times of poor performance, if wanting to surrender, transfer or mature.
Low cost	• These operate in much the same way as low-cost whole of life policies. • They guarantee to pay out the full sum assured on death. However, there is no such guarantee on the maturity of the plan, as that will depend on the bonuses added to the with-profits endowment element throughout the term. Often, they rely substantially on the terminal bonus pay out, to determine whether the amount required will be met. • They were heavily sold in the 1980s and 1990s to repay interest-only mortgages at a (seemingly) reasonable monthly cost. They were often surrendered early, for example when people moved houses and changed their mortgage deal and term. This provided extremely poor value for money, with very low surrender values in the early years, often a lot less than the premiums paid.
Low start	• Low-start endowments are a development of low-cost endowments, but have a lower initial premium. • These policies were originally aimed at professional people who could realistically expect their income to increase at a reasonable rate across a short period of time, for example, solicitors, doctors and accountants. • Unfortunately, due to a lower initial premium, they were often sold to individuals whose income was not likely to rise, or certainly not by as much as was required to keep up with the payments. These would typically be individuals taking on a large mortgage and having to keep their costs as low as possible. • Again, a lot of these policies were therefore surrendered early, providing a minimal return to the assured.
Unit-linked	• These operate in a similar way to other unit-linked policies. The fund choice selection is often wider than for whole of life policies, as it is more of a pure investment product. • Along with other forms of endowment, the surrender values in the early years are very low, owing to the high level of initial charges. Despite this, many unit-linked endowments have been surrendered early.

1.5.2 The With-Profits Debacle: Lessons from History

The concept of a with-profits fund dates almost from the beginning of mutual life companies. The basic principle was that premiums were pooled in the company's life fund, and a policy would participate in the profits, with at least a part of annual surpluses being distributed to policyholders as bonus payments. Over time this evolved from an ad hoc process to a structured form of investing.

A key feature of with-profits is the concept of smoothing, in which a proportion of profits generated in good years is retained by the company with the intention of subsidising poor investment years. This enables a relatively stable overall rate of return to be predicted and was the basis of the low-risk view of with-profits investing.

In general, the structure of a with-profits contract requires the payment of premiums in return for the guarantee by the life office of a minimum cash payment, or annuity in some cases, at maturity or death if earlier. This basic sum assured is gradually increased by adding annual bonuses called variously annual, regular or reversionary and, once applied, are guaranteed and contractually cannot be withdrawn. In addition, at maturity a terminal or final bonus was usually added, which could be large relative to the sum assured and accumulated annual bonuses.

For many years, the with-profits model appeared very resilient and robust. It was considered extremely low–risk and, in the last quarter of the century, large terminal bonuses (although not technically guaranteed) were expected and usually delivered. However, this coincided with an era of intense competition and consolidation among life companies which saw the weighting to more risky assets increase, reserves reduced and increasing terminal bonus rates offered to gain more market share.

The dotcom crash in 2001–02 found life offices in a position where they could not meet the expected returns, and they turned to small print in their contracts that permitted a market value reduction (MVR) to be applied for early surrenders or transfers. As markets fell further and panic led to more selling, higher MVRs were imposed, and stayed for some years, until the underlying funds began to recover.

The with-profits debacle is best exemplified with the collapse of Equitable Life which was widely used for both investment and pension investments. When equity markets collapsed in the 2000–03 crash, it was in terminal trouble. The firm had missed the gilts market, where yields had fallen steadily in the 1990s, and the collapse in value of its equity holdings meant its with-profits fund was incapable of meeting its guaranteed liabilities. Consequently, Equitable went bust.

Most with-profits providers were in trouble to a greater or lesser extent. Most sought refuge in switching assets from equities to bonds in an effort to meet regulatory solvency margins and to stem further losses as markets continued to deteriorate, limiting their future growth.

Many simply stopped declaring bonuses; if they were contractually bound to pay out a set return in the future, they could at least ensure this would be paid on a smaller final contract value than the policyholder might otherwise have expected. The main focus of most funds was to fund cash outflows (claims out-go) as maturing members claimed their terminal bonus.

Apart from the Equitable Life story, the biggest scandal in all of this was the way that interest-only mortgages had been sold (or mis-sold) on the back of promises of excess returns from with-profits endowments.

1.5.3 Second-Hand Endowment Market

A market has developed in the purchase of second hand with-profit endowment policies. This started in the late 1980s when a few market makers were established to specifically deal in this market; since then the market has increased considerably.

The seller may decide to sell a with-profits endowment policy prior to maturity for a number of reasons, eg, a change in circumstances, such as divorce or change in mortgage requirements. Individuals have found that selling such a policy is more beneficial in terms of the sum received rather than surrendering it back to the insurance company.

Traded endowment policies (TEPs) have become attractive to both UK and international investors, pension funds and offshore investment funds as well as specialist investment trusts. TEPs are attractive because, in buying a mid-term policy, the investor purchases a product with a guaranteed value which includes the basic sum assured, plus any bonuses already attached. At the same time, the policy is exposed to a fund which invests in equities and property, so it also has some element of inflation-proofing. A TEP also has the benefit that all initial charges have already been paid by the original policyholder.

1.6 Investment Bonds

Investment bonds, also known as insurance bonds, are designed primarily as a wrapper to hold investments and usually offer very little in the way of life assurance cover. Most bonds are written as whole life policies, so that the investment period is effectively open. Bonds may be written on a single life or joint life basis, the latter having the advantage that, for example, the bond can continue throughout the lifetimes of spouses/civil partners.

Bonds can be written on a single, joint life, life assured or capital redemption basis.

- An advantage of writing a bond on a joint life basis is that the bond can continue throughout the lifetime of a spouse/civil partner.
- The advantage of writing a bond on a life assured basis means, for example, that partners, children, and grandchildren can be added as life assureds to the plan (normally a maximum of six) to ensure longevity of the plan and to avoid automatic encashment on death of the holder in times of poor fiscal or market conditions. Equally, for tax planning reasons, bonds are usually issued in 'segments'; these segments can be assigned to a lower paying tax individual and encashed in their hands which can be a useful form of passing wealth on without it suffering from being held by a higher tax paying individual.
- A bond issued on a capital redemption basis means that the bond can remain open on the death of the bondholder, and will only come to an automatic end at the end of the capital redemption basis, normally set at 99 years (although this may differ by provider). As with the life assured option, this method allows the executors of the estate the option to retain the investment to avoid encashing in times of unfavourable conditions.

Investment bonds can be best thought of as a tax wrapper in which a series of collective investment funds can be held. Investment choice is now wide-ranging, with life offices offering selection from their own funds as well as from various external fund managers. Most allow at least ten underlying funds and permit a number of free switches each year.

Investment bonds permit up to 5% withdrawals of the original investment per annum (part surrenders) which are tax-deferred, not tax-free. Many higher-rate taxpayers take an automatic withdrawal of 5% and avoid any immediate payment of tax, and this can be continued for 20 years until all these allowances have been used up. If 5% is not drawn in one year, the income will roll up on a cumulative basis; hence if no income was taken for three years, then 15% of the original investment could be withdrawn in year three.

The 5% includes any adviser charging; hence if an adviser is taking 0.5% ongoing from the bond wrapper, the client can only receive 4.5% as a tax deferred income.

1.6.1 Types of Investment Bonds

The characteristics of a number of different single premium bonds are set out in the table that follows.

Types of Bond	
Unit-linked bonds	• A non-qualifying single-premium life assurance policy used for lump sum investments. • They are usually written as whole of life policies with no fixed maturity date and no obligation to pay any more contributions during the duration of the plan. • They can be written on a single or joint life basis and the policy may be written in trust or assigned in a similar way to other life policies. • They are structured primarily for investment so there is only a small amount of life cover built into the policy, which is typically just in excess of the value of the fund on death, usually a payment of 101% of the bid value. • On investment, the single premium is used to purchase units in one or more internally managed or externally managed funds. • Where possible, advisers should aim to use a segmented policy, with up to 20 or more sub-policies. This allows more efficient withdrawal of income, as there will be a choice between universal 5% annual withdrawals, partial surrenders, or surrender of individual segments. • Unit-linked bonds do not separate income and capital; rather, any withdrawals taken as a form of income are achieved by encashing units.
Distribution bonds	• Unlike unit-linked bonds, distribution bonds effectively distinguish between income and capital so that the actual income paid reflects the income generated by the fund and so leaves the capital intact. • To qualify for inclusion in the Association of British Insurers (ABI) Distribution Fund sector[1], the fund must have an equity content not exceeding 60% before deduction of management charges. All income must be capable of being paid to the investor.

1 Association of British Insurers, September 2017. ABI Sector Definitions. Retrieved from https://www.abi.org.uk/globalassets/files/subject/public/regulation/abisectordefinitions.pdf (Accessed: March 2023)

Types of Bond	
Guaranteed income bonds (GIBs)	• A single premium bond that provides a guaranteed income, usually for terms of one to five years. Income can be paid annually or monthly and, on maturity, the investor's capital is returned. • The guaranteed income is an attraction of these bonds, but the rates on offer at any time depend upon market conditions. • The payments are actually based on part surrenders and a return of capital on maturity of the bond, which impacts their tax treatment. • The minimum investment is usually £5,000 and the maximum £1 million. • Charges are built into the product and there can be heavy penalties for early encashment, if it is available. • Life offices offer GIBs from time to time depending upon their own internal tax position, and at any one time there are usually only a few life offices in the market offering limited tranches. GIBs have become increasingly scrutinised by the regulator and their use has diminished.
Guaranteed growth bonds	• Similar to GIBs, but pay no income. In return for payment of a single premium, the investor receives a guaranteed capital sum at the maturity of the bond and there is usually a range of maturity dates available in the market, ranging from one to five years. • To achieve the return, the life company invests in cash and short-dated government bonds, and so returns are again dependent upon market conditions.
Guaranteed and protected equity bonds	• A number of unit-linked bonds are now available with some form of guarantee or protection. They are fixed-term single premium policies that use a combination of call options and fixed-term deposits to provide growth and guarantee. • Arguably this puts them into the structured products category rather than being an insurance bond. When evaluating the merits of an insurance company's guaranteed bond, it should be compared against the similar structured products available from asset management houses and the investment notes that are listed on the LSE.

1.6.2 Offshore Bonds

Offshore bonds are generally issued by subsidiaries of well-known UK insurance companies in domiciles such as the Channel Islands, Dublin, the Isle of Man and Luxembourg.

Offshore bonds are structured in similar ways to onshore bonds and, although charges tended to be slightly higher, competition is driving down costs and improving flexibility; open architecture structures are now available at near institutional rates. The policies are classified as non-qualifying investment bonds because the insurance companies are domiciled outside the UK's jurisdiction.

The main difference between onshore and offshore bonds is in the tax treatment of the underlying life fund and the investor. Insurance companies have set up subsidiaries in offshore centres to take advantage of a more beneficial tax regime in those countries. Offshore life companies are generally

subject to little or no tax in their host country. The underlying investment fund will be free of capital gains tax (CGT). However, overseas dividend income will be subject to irrecoverable withholding tax. This permits the underlying fund to roll-up gross, without any taxation on the underlying fund during its growth.

For UK-resident individuals, there are both advantages and disadvantages regarding the taxation of offshore bonds. The key point is that all gains, whether from rolled-up income and dividends, or pure capital growth, are taxed under UK income tax rules and not under the CGT regime.

There is no credit for basic rate tax, so there is a full income tax charge at the taxpayer's marginal rate. Therefore, basic-rate taxpayers face a 20% basic rate tax charge and higher and additional rate taxpayers will pay the full 40% or 45% rate, as would be the case for an onshore bond. Top-slicing relief is always calculated by reference to the start date of the bond rather than the last chargeable event. Note that income tax is only payable of gains over the 5% permitted withdrawals are taken or the bond is encashed and the proceeds remitted back to the UK.

The other main difference is that, if the policyholder was a non-UK resident during the life of the policy, then the gain is reduced by a fraction equal to the period of non-residency.

One advantage of an offshore bond is that income can roll up gross and so generate an eventual greater return. Against this must be set the full income tax charge on offshore policies, which represents a higher **effective rate** of tax than applies to UK policies.

An offshore bond could, however, be advantageous if the investor expects to be non-resident for part of the term of the investment. They are also usually issued in segments that can be hived off from the plan and assigned to other parties such as a non-tax paying spouse or adult child in order to pass on wealth.

Many of the offshore bonds available today have transparent, low-cost structures and are often provided by large mainstream UK insurance companies. The fact that the income generated by offshore bonds rolls up without being taxed is attractive. However charges and withholding tax (which is irrecoverable) needs to be taken into consideration. Offshore jurisdictions are in competition with each other – Dublin, for example, has no VAT on charges, making it cheaper than, say, the Isle of Man. Since offshore bonds can be domiciled in various different tax jurisdictions, carefully choosing the provider and location of the bond is important as this will dictate many of the rules surrounding taxation and access.

1.6.3 Personal Portfolio Bonds Legislation

The UK government considers a personal portfolio bond (PPB) a life insurance policy that lets the policyholder choose certain assets for their premium investments.

In legal terms, the ownership of property determining the benefits in a life policy lies with the insurer, not the policyholder. However, when the policyholder has the ability to select the property determining the policy benefits, they retain most benefits of direct personal ownership of that property. This setup allows them to avoid income tax on dividend and interest income from the investments and capital gains tax on disposals when altering the underlying investments within the policy. The tax on gains is deferred until the policy ends.

To counter potential avoidance, the PPB legislation imposes a yearly tax charge on certain life insurance policies, capital redemption policies, and life annuity contracts. This applies when the policyholder can choose the property influencing the benefits paid by those policies/contracts.

The Finance Act 1998 introduced an annual tax charge on personal portfolio bonds (PPBs) issued by both UK and non-UK resident life companies. This tax charge is calculated on a deemed chargeable event gain, which is 15% of the premiums paid and all previous amounts that were subject to tax under the PPB provisions.

For UK tax resident, there is a list of 'permitted assets' – if these are selected, the policy will not be regarded as a PPB:

- Unit trusts (category 2)
- Open-ended investment companies (OEICs) (category 4)
- Other collective investment schemes (category 7)
- Shares in a UK Real Estate Investment Trust (REIT) or an overseas equivalent (category 8)
- Interest in an authorised contractual scheme (ACS) (category 9)
- Exchange-traded funds
- Options, warrants and other rights to acquire interests in schemes

Advisers should also be aware that issuing insurance companies in most of the popular offshore jurisdictions have accepted a reporting regime, in which all cumulative transfers (partial or full surrenders) above a threshold to UK tax-residents will be reported to HMRC. This apparently gives HMRC some comfort that withdrawals will be declared under self-assessment more reliably than in the past.

1.7 Factors Influencing Insurance Choices

For the purposes of this qualification, it is assumed that candidates will have comprehensive prior knowledge of the following:

- The salient features of non-profit, with-profits and unit-linked investments; in particular the dual and single pricing structures of unit-linked investments, and the composition and characteristics of the ABI's fund sectors.
- To the extent that the issues have not been covered elsewhere in this workbook or the qualification, the expected shape of returns from each investment solution and how they can be measured and benchmarked.
- Consideration of how investment related insurance solutions can be related to a client's true attitude to risk and their suitability demonstrated, as required by the regulator.

However, insurance-linked investments may still have some advantages over perhaps more obvious direct investments into OEICs, unit trusts and other collective investment schemes, whether held in a general portfolio or tax-advantaged wrappers, such as individual savings accounts (ISAs). Such factors include the following:

- Some tax benefits of holding investments within a life assurance wrapper, particularly for basic-rate taxpayers.
- The possibility of long-term tax-deferral for all taxpayers.
- Guaranteed income bonds and growth bonds.

- Access to direct holdings of bricks and mortar property, rather than property shares more commonly found in real estate investment trusts (REITs) and other direct collectives.
- In some insurance-based structures, switching between funds and assets classes can usually be done at little or no cost, and without any direct personal tax liability.

1.7.1 Underwriting

When an individual applies for life, critical illness or income protection cover the insurer will make an assessment of the risks through a process known as underwriting. Through this they determine whether the individual is eligible for insurance cover, and how much the premium will cost.

Insurers carefully assess each application, taking into account the level of risk associated with the following assessment factors:

- **Age** – the cost of buying cover rises as the person gets older because the risk factors increase.
- **Health** – certain medical conditions carry a greater risk of death or disability. Typical conditions include raised blood pressure, high cholesterol, heart disease, diabetes, stroke or cancer. Some conditions like back/joint problems, or anxiety and depression are especially significant when applying for disability cover.
- **Build** – overweight people are more likely to suffer major diseases, such as diabetes and heart disease. The medical profession sets out recommended guidelines for an individual's ideal body mass index (BMI). If a person has a high BMI ratio insurers may have to increase their premium or in certain circumstances insurers may not be able to offer cover.
- **Family history** – certain conditions, such as coronary heart disease and some types of cancer, tend to run in families. While these conditions are not always hereditary, their presence in the family may increase – statistically – the chance of someone developing the same condition.
- **Hazardous activities and occupations** – some jobs or hazardous activities carry an increased risk of accidental death or disease. Examples include underwater diving, mountaineering, private aviation, working at heights and certain duties in the armed forces.
- **Smoking, alcohol and drugs** – using tobacco products, non-prescription drugs and alcohol consumption over the recommended limits are well-recognised risks. Applicants who have not used any tobacco products in the last 12 months will pay lower premiums, as they are less likely to suffer the health problems associated with smoking.
- **Residency and travel** – living or travelling abroad, including past or potential future travel or residency, may influence an underwriting decision.

1.7.2 Tax Treatment of Insurance Policies

For tax purposes, the most important distinction is between 'qualifying' and 'non-qualifying' life insurance policies. Qualifying policies usually do not give rise to a chargeable event gain unlike non-qualifying policies which often give rise to gains.

Qualifying Policies

- These policies typically require a minimum term of ten years and involve consistent premium payments at regular intervals, eg, weekly, monthly, or annually. For policies taken out on or after 21 March 2012, or policies taken out before that date but subsequently modified, the total premiums paid by any beneficiary for all such policies within a 12-month period must not exceed £3,600 per year.

- Qualifying policies generally do not give rise to chargeable event gains unless the policy has been surrendered or premiums have ceased within the first ten years of the policy, the £3,600 premium limit has been breached or the policy has been purchased from a third party.
- The detailed rules governing whether a policy is qualifying are complex, but insurers will take steps in determining whether the policies they are offering are qualifying, or not, and inform potential customers accordingly in their product literature.

Non-qualifying will often be single premium life insurance policies.

The most common occasions on which a gain arises are if:

- cash or other benefits were received on a full or part surrender of a policy
- a policy matured or was brought to an end by the death of the life insured
- the sale or assignment of a UK policy (or part of a policy) for value, and
- the policy was a personal portfolio bond even if the insurer had not paid cash or other benefits.

If the calculations which are required following these events show that a gain has arisen, the insurer should send a chargeable event certificate to the policyholder – this certificate will show the gain that has arisen, whether tax is to be treated as paid on that gain, and the number of complete years that the policy has run from commencement or from the previous gain. UK insurers are required by law to issue a certificate if they know that a gain has been made on a life insurance policy. In most cases, policyholders who have made a gain will receive a certificate reporting the gain, either directly from the insurer or indirectly via trustees or a lender.

Withdrawals

Investment bonds are non-qualifying policies. Policyholders can withdraw 5% per annum (cumulatively) of their original investment for 20 years with no immediate tax liability (note that this is 5% of the original investment less any adviser charging set up on the plan). However, any withdrawals are eventually taken into account when the bond is surrendered or on death. Many higher rate taxpayers take an automatic withdrawal of 5% and avoid any immediate payment of tax. This can be continued for up to 20 years until all these allowances have been used up. For higher rate taxpayers, this can provide the equivalent of a gross return of 8.33%. Provided that the underlying funds grow at more than 5% a year, the capital sum payable on encashment will also be growing.

Tax Treatment

For the policyholder, the tax treatment is as follows:

- Any gain made from an investment bond, eg, following a withdrawal or surrender, is taxed as savings income. Basic rate tax is deemed to have been paid on both income and gains within unit-linked bonds.
- If the policyholder is a basic-rate taxpayer, and part of the gain from a withdrawal or surrender takes their income above the higher rate tax threshold in that tax year, they may be liable to pay tax on that part of the gain. If the gain pushes a basic-rate taxpayer into higher rates, top-slicing relief is available (see section below).
- If the investor is a higher rate taxpayer, any gain on encashment of the policy will incur an additional tax liability – the difference between the higher rate and the additional rate.

- Higher rate taxpayers are subject to an additional 20% or possibly 25% tax (at the additional rate of 45%).
- From April 2016, basic-rate taxpayers have a personal savings allowance of £1,000 and higher rate taxpayers have an allowance of £500. Gains from investment bonds are treated as savings income and so the personal savings allowance can be used to reduce the amount of the gain liable to tax.
- If the investor is currently a higher rate taxpayer and will be a basic-rate taxpayer when the bond matures, they can defer the chargeable event until they become a basic-rate taxpayer.

Top-Slicing Relief

The life office pays tax on income and capital gains within its funds, but the tax paid is not reclaimable by the investor. UK investment bondholders are, however, deemed to have paid tax at a rate of 20%, so a basic rate investor has no further liability on any gain or chargeable event, but a liability may arise if withdrawals exceed the limits or the gain takes the investor into higher rates of tax.

Chargeable event gains are generally treated as forming the highest slice of total income. A basic-rate taxpayer can, therefore, be pushed into higher rate or a higher rate taxpayer can be pushed into additional rate. When the chargeable event gain does not move a taxpayer into a higher tax rate, there may still be some top-slicing relief available due to the effect of the personal savings allowance nil rate and the starting rate for savings. Top-slicing relief may assist in reducing the rate of tax charged by applying a spreading mechanism.

Since the chargeable gain on a bond may have built up over a number of years, it would be unfair to treat it all as having been earned in the year of receipt. Therefore, a method of relief known as 'top-slicing' is allowed, which divides the excess or gain by the number of years over which it built up to give an average yearly gain.

Where there is an 'excess event', such as a part surrender gain, the rules are more complex. For partial withdrawals, the gain or excess takes account of the number of years since the start of the bond (in the case of the first chargeable event) or since the last chargeable event (for subsequent excesses). As the calculations can only be carried out at the end of the policy year (by which time all withdrawals for the year will be known), the top-slicing calculation for part withdrawals includes the current year. The chargeable gain on final encashment will be assessed in the year in which it occurs and will take into account all previous chargeable events.

Note that the calculation of top slicing relief is covered in chapter 6, section 2.2.5.

1.7.3 Insurance Bonds and Trusts

Life policies are frequently placed under trust as part of inheritance tax (IHT) planning or bought by trustees of existing trusts.

Writing Policies in Trust

A normal life assurance policy will pay the sum assured on death to the estate of the policyholder. This means it will be aggregated with their other assets and increase the overall value of the estate at death for inheritance tax purposes. However, if they can keep the assured sum out of their taxable estate then they will be able to save the 40% IHT charge.

Most people settle life assurance policies in trust at the same time as taking the policy out. This allows them to use the insurance company's standard form to create the trust and assign the death benefit to their named beneficiaries, although legal advice is more appropriate for complex situations. It is important to remember, however, that in most cases, once a policy is written in trust, the trust is generally irrevocable and, in most cases, it is not possible to simply cancel the trust.

It also avoids the need to wait for probate to be granted, as the life insurance company will usually pay the claim to the trustees once they have produced the original trust deed.

Investment Powers of Trustees

The Trustee Act 2000 introduced wide changes to the law surrounding trusts, including authorising trustees to invest in investment bonds and life assurance policies. Prior to that act, the trust deed itself had to contain the necessary investment powers to permit trustees to consider investment in such products.

Bonds offer an alternative investment route for trustees who for many years had been restricted to direct portfolios and collective investment schemes.

Apart from offering a wide variety of funds to meet differing risk requirements, life policies are non-income producing assets (an issue well settled in law and accepted by HMRC as being non-contentious), so if a trust only holds life policies it does not become involved in accounting for income or the tax due on it. For trusts that accumulate income, life policies are administratively advantageous.

Investment Bonds and Interest in Possession Trusts

Interest in possession (IIP) trusts is one example of a trust where the income has to be distributed. With these trusts, one or more beneficiaries (the life tenants) have the right to receive the income generated by the trust, or the right to enjoy the trust assets, for a fixed period of time or until their death. Upon death, the trust property is distributed to the capital beneficiaries (the remaindermen).

Life policies would be inappropriate for an IIP trust since trustees have a duty to balance the needs of the life tenant and the remaindermen. By employing an investment strategy which technically generates no income for tax purposes, they could be seen to be depriving the life tenant and failing to treat them fairly.

With an interest in possession trust, any income arising is normally paid to the life tenant who will then be liable to tax based on their personal tax position. Whilst withdrawals of no more than 5% of the amount invested each year would not give rise to a tax liability, trust law and practice make this less straightforward. The withdrawal from the bond is a return of capital as opposed to income and an income beneficiary can only indirectly receive investment bond withdrawals if the trustees have the power to advance form capital. That, however, raises the real risk that HMRC will assess the income beneficiary to tax on the capital advance as if it were income.

Tax Treatment of Investment Bonds Held in Trust

Investment bonds are 'non-income producing assets' and as such, there is only an income tax charge when there is a chargeable event under s484 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA) and those are:

- the full surrender of the policy or of individual segments of the policy
- the assignment for money, or money's worth of all rights under the policy
- where periodic calculations show gains, ie, when the cumulative 5% annual allowance is exceeded
- death of a life assured which gives rise to a death benefit being payable, and
- the maturity of a policy.

In brief, the tax treatment of chargeable events is as follows:

- If the chargeable event gives rise to a chargeable gain, and the policy is written in a bare trust, the gain is assessed on the beneficiary.
- If it is an IIP or discretionary trust, the gain is firstly assessed on the **settlor** of the trust as long as they are still alive and UK resident in the tax year of the chargeable event. Normal top-slicing rules apply.
- If the settlor died in a previous tax year, or is not UK resident, then the assessment will fall on the trustees as long as at least one trustee is UK resident at the rate applicable to trusts, currently 45%.
- If there are no UK trustees, the gain will be assessed on any UK resident beneficiary who benefits from the trust.

In all cases, if the gain arises under a UK bond, the individual or trustees liable for tax are treated as having paid income tax at 20% on the gain.

2. Protection Policies

Having looked at life assurance products, we will now consider the insurance solutions that provide benefits in the event of the ill health or incapacity of the life assured and other events.

2.1 Income Protection (IP)

Income protection (IP) insurance, also known as permanent health insurance, is designed to pay out an income benefit when a person is unable to work for a prolonged period due to sickness or incapacity.

Some of the key features of such policies include the following:

- They run for a set term.
- The circumstances under which a benefit will be payable are clearly defined.
- They provide a regular income after a certain waiting period.
- Payments will cease on the policyholder's return to work or when they retire.

Uses of IP Polices

- An IP policy can benefit almost anyone who is working. Their use and value can be readily appreciated by considering how a family would continue to pay its bills if the main income-earner were to fall ill.

- For an employed person, the benefit can be tied in with any sick pay they receive from their employer.
- For a self-employed individual, the deferred period might have to be shorter, but the need might be greater, as it is possible that an illness could lead to all income ceasing.
- Some insurance companies also offer IP cover for 'homemakers', conscious that an illness can lead to greatly increased costs if the partner who normally looks after children and the home becomes too ill to do so.

Since the benefit under these policies may be paid for a significant period of time the premiums are relatively expensive. There are three types of premiums available:

1. **Reviewable premiums** – this is where the premium may start off relatively low but will be reviewed in the future and may increase every few years or so. In some cases, the premium may be reviewable every year, or every five years, to take into account changing circumstances.
2. **Renewable premiums** – these are a variant of reviewable premiums, and are reviewable whenever the policy is due for renewal.
3. **Guaranteed premiums** – these tend to be more expensive but are fixed for the life of the policy, which may be as long as 25 years or the maximum term offered by the insurer.

They come, however, with a series of conditions that it is important that the adviser understands, so that they can explain any restrictions to the client.

Conditions for IP Policies

- An individual must be aged between 18 and 59 when the cover starts and it will stop when they reach 65.
- The illness or injury that an individual may suffer is referred to as incapacity, and the insurance policy will define what constitutes this in relation to their occupation. Pre-existing medical conditions will often be excluded so that they cannot claim if they are unable to work because of these conditions.
- The benefit starts once the deferred period finishes, and will cease once the individual no longer meets the incapacity definition.
- The longer the deferred period chosen, the lower the premiums will be and the options available will be periods such as 4, 8, 13, 26, 52 and 104 weeks.
- Once a claim is made, the insurance company may extend the deferred period or even decline the current or future claims.
- The claim will not be met if incapacity arises as a result of specific situations, including unreasonable failure to follow medical advice, alcohol or solvent abuse, intentional self-inflicted injury and so on.

Apart from the considerations above, it should also be noted that the benefits are also directly related to the individual's earnings and that state benefits may reduce the benefit paid. The amount of cover should be based on the individual's earnings after tax, as the benefits can usually be paid tax-free and so should be kept under regular review. If excessive cover is selected, the insurance company may not pay the full amount.

There are also group or employment-based versions of income protection plans. The tax treatment differs because the benefits are totally free of income tax where the premium has been paid by the policyholder, but the benefits are taxable in the hands of the policyholder where the premium is paid by the employer.

2.2 Critical Illness Insurance

Critical illness cover is designed to pay a lump sum in the event that a person suffers from any one of a wide range of critical illnesses.

Some of the key features of such policies include the following:

- The critical illnesses that will be covered will be closely defined – there is a set of standard definitions which most insurers have adopted.
- Some significant illnesses may be excluded and the list of illnesses covered by a life office differs.
- Illness resulting from certain activities, such as war or civil unrest, will not be covered.

Looking at how many people suffer from a major illness before they reach 65, the use and value of this insurance can be readily seen; someone under 65 is five times more likely to suffer a critical illness than to die. Critical illness may force an individual to give up work and so could cause financial hardship, to say nothing of how they will pay for specialist medical treatment or afford the additional costs that permanent disability may bring about.

Features of Critical Illness Insurance

- Critical illness cover will pay out a lump sum if an individual is diagnosed with a critical illness and will normally be tax-free. The cover will then cease, and it is important to note that this can be the case even where more than one person is covered under the policy.
- There will be conditions attached to the cover that determine whether any payment will be made. A standard condition applying to all illnesses covered is that the insured person must survive for say 14 days after the diagnosis of a critical illness to claim the benefit.
- There will be other conditions that have to be satisfied and as a result, it is important to understand what illnesses are covered and the circumstances in which a claim can be made. This requires a detailed examination of the terms of a policy, especially as the amount of cover needed will be significant and the premiums can be expensive. There are still wide variations among providers.

Critical illness cover can usually be taken out on a level, decreasing or increasing cover basis, and can often be combined with other cover, such as life cover, so that the individual is then covered whatever happens first, the diagnosis of a critical illness or their death.

This type of cover can also be extended to provide for total and permanent disability, to give a greater level of protection, as this will then cover conditions and circumstances that are not included as part of the standard critical illness cover. In fact, there is surprisingly little standardisation in critical illness policies, and the detail varies widely among providers. Dealing with this sort of cover requires extreme attention to detail, particularly to the definitions and types of condition covered and excluded.

2.3 Long-Term Care Protection

Today, it is common for people to live well into their 80s or 90s. This increasing longevity is not always matched by good health, leading to an increasing demand for long- term care due to illness, frailty and conditions such as strokes, falls, and dementia.

The average weekly cost for residing in a residential care home in the UK amounts to £1,291, while for a nursing home is £1,545. Both types of facilities offer around-the-clock care and support, but the primary

distinction lies in the level of care provided. Nursing homes can cater to higher care needs, such as dementia care, therefore tend to be more expensive, varying based on the specific care requirements.

The average cost of care homes in the UK, encompassing both residential and nursing care, also fluctuates depending on the geographical location. For instance, care homes in London are more expensive than those in the North West or South West of England.

State Assistance

- An individual may be able to get care and support from their local authority to support them and this involves an assessment of the needs of that person and their carer and a financial assessment of how much the individual should pay towards the care home fees and how much the local authority will cover.
- The financial assessment is a means test which has a set of rules for testing which results in the decision as to whether or not a person qualifies for assistance from the local authority.
- There are no fixed rules for working out how much a person should contribute because all local authorities operate different means test systems.
- In England, a person will generally have to pay the full cost of care if their capital is worth more than £23,250; below this threshold, the council covers some of the cost – there are different limits in Wales and Scotland.

Certain capital is partly or fully disregarded in the financial assessment; for example, investment bonds with life assurance elements are disregarded. A client's financial assets that have either been put into trust and given away, under, say, the potentially exempt transfer (PET) rules before care was needed would also be excluded. It is important to note, however, that deliberate deprivation of assets will result in the possible inclusion in the calculation.

The purpose of long-term care is to provide the funds that will be needed in later life to meet the cost of care. There are two main types of long-term care insurance – immediate care and pre-funded although currently there are no pre-paid plans available in the market.

Immediate care plans can be very useful. The immediate care plan is purchased with a lump sum, and pays a regular income until death: the income pays for the care provision, and is tax-free, if it is paid directly to the care home. Subject to approval and medical evidence, if a client becomes infirm and requires residential (or domiciliary) care, this can be worth considering.

It acts effectively as a tax-exempt immediate annuity, and is paid directly to the care home provider in a very cost-effective way. It is most advisable to obtain at least two independent assessments of life expectancy before buying any product like this, and to do a cost-benefit analysis with the immediate family.

Such lump sum expenditure can obviously impact on possible inheritances, so the adviser must be fully aware of possible conflicts of interest among the family when discussing the appropriate course of action. There are very few providers in the market, but a degree of negotiation is usually possible.

2.4 Business Protection

Businesses face a wide array of risks in the normal course of their business. Small and medium sized enterprises (SMEs) can be particularly exposed to unexpected events and can quickly fall into administration or even insolvency as a result.

Uses of Business Insurance

- Indemnity cover for claims against the business for faulty work or goods.
- Cover for loans that have been taken out and secured against an individual's assets.
- An income if the owner is unable to work and the business ceases.
- Payments in the event of a key member of a business dying to cover any impact on its profits.
- Money in the event of the death of a major shareholder or partner so that the remaining shareholders can buy out their share and the estate can distribute the funds to their family.
- Directors' insurance – insurance taken out to protect directors from being sued due to undertaking an action as part of their actual job.

Business insurance protection can take many forms. Business protection uses essentially the same life, critical illness and, to a lesser extent, individual protection products as are used for individual protection. Premiums depend on the amount of cover required and the ages, genders, occupations and medical histories of the individuals being covered.

Business protection products tend to be highly flexible. Insurers will, for example, normally allow life assurance pay outs to be made in instalments to aid cash flow and avoid corporation tax liabilities. Most will also allow risks to be placed on cover immediately, before the completion of the underwriting process. This can be especially useful in a management buyout situation if negotiations are kept secret until the very last minute, but cover is then required instantly.

Most businesses have insurance cover for their buildings and compulsory insurance for any vehicles they might own. In addition, they have probably taken great care to insure the contents of their buildings, but what many businesses have not done is taken account of their most important assets – the people that contribute most to the success of the business and how that business would be affected by their death or inability to continue working because of a serious illness.

In the following sections, we consider the key features of three of the main types of business protection policies encountered.

2.4.1 Key Person Protection

Key person protection involves a company insuring itself against the financial loss that it may suffer from the death or serious illness of an employee who is essential to their fortunes. They are the individuals whose skill, knowledge, experience or leadership contribute to the company's continued financial success and whose death or serious illness could lead to a financial loss for the company. They may be the founder of a company, a salesman, or a specialist who is essential to the success of a company.

The problems associated with the loss of such an individual may be either loss of profits or a loss of loan facilities.

If a company were to lose a key individual due to death or serious illness, it could suffer financially for any one of a number of reasons, including:

- financial penalties due to a delay in completion or cancellation of existing contracts and projects
- costs of urgent replacement of key person
- debts being called in or restricted credit lines by banks due to a decline in confidence
- lost sales and loss of competitive edge afforded by innovation or design expertise, or
- people issues, including increased pressure on the remaining workforce to meet deadlines, impact on staff morale and recruitment costs.

Some of the above will affect the company's profitability in the short term, while others may last into the medium and longer term.

Types of Policy

Key person cover is simply life insurance written on the life of the person who is crucial to the business. Critical illness cover can also be included; most policies would normally include terminal illness benefit as well (critical illness cover typically pays out a lump-sum benefit on diagnosis of a list of illnesses. Terminal illness cover pays out if the individual is diagnosed as having a life expectancy of less than 12 months).

The policy is usually taken out on a short-term, renewable basis. The term at the outset is often no more than five years, which can be renewed for another five years without having to provide any evidence of health or medical records.

How to Set up the Policy

The policy is written on a 'life of another' basis. This is where the life insured is the key person, but the ownership of the policy remains with the company. Because of this, in the event of the life insured's death, the sum insured is paid directly to the company as the policy owner. If the policy is set up in this way, then a trust is not needed.

For a policy to be taken out on this basis, insurable interest must exist at the outset and at the right level to warrant the amount being requested. The underwriters should be satisfied that the company has sufficient insurable interest in the life insured to support the policy and ensure that there is no element of 'over-insurance'.

The term of the policy also needs consideration. It could be that the key person is only going to stay with the company for a short time, in which case the policy term should match this. If the company thinks that the person will be a valuable asset to them for the longer term, then the time frame should match this. As a person ages, premiums increase, so it is best to match the term as accurately as possible at outset. If it turns out that the key person leaves before the end of the term, then protection policies can easily be cancelled without penalty.

The amount of cover needed can be determined in a number of ways and can be based on a loss-of-profit calculation, a salary multiple of the key individual, the length of time it may take the company to recover, or the business loans secured on those individuals.

Finally, the business will need to consider whether it would want all the insured sum paid in one go in the event of a claim. It is possible with some insurance companies to arrange for the payments to be staggered over a number of months or years (generally up to five years) and this may have important tax or other implications for the business.

The tax position needs to be clarified with the firm's tax office, or at a higher level. It is commonly believed that if tax relief is claimed by the firm on the cost of premiums then the (death) benefits will be taxed. Alternatively, if the premiums are paid gross, then the (death or other) benefits will be tax-free. This issue appears to be not yet settled, therefore the matter should be discussed and agreed with HMRC at the appropriate level before the insurance contract is completed. Care should also be taken that there is no conflict or complication in respect of any cross-option agreement in place. Specialist advice is usually needed.

2.4.2 Shareholder Protection

With a private company, the death or serious illness of a major shareholder can have a major impact both on the future of a business itself and on their family.

Shareholder protection cover can protect both the company and the family by making sure that the capital is available to buy out their shares without leaving the company crippled financially.

If a major shareholder dies, then their beneficiaries acquire the shares, and this could lead to tensions in the running of the company, as they may not have the necessary skills and experience to take on such a role or may not share the objectives that the surviving shareholders have for the business. Alternatively, they may want to receive the value of the shares in cash. The **articles of association** will usually require that these be offered firstly to the surviving main shareholders, but they may not have sufficient capital to purchase the shares. Without the necessary capital, the shares may have to be sold to an outside third party, potential hostile bidder, or even a direct competitor.

Shareholder protection can provide cover to ensure sufficient funds are available to enable the purchase to take place. This is achieved by establishing a policy on each of the shareholding directors' lives for an amount that reflects the value of their individual holdings. The policy is written under a special form of business trust so that any proceeds payable will be payable to the surviving shareholders.

This approach requires the shareholders to agree a policy at the outset that the shares may be purchased at a price that will be calculated in accordance with an agreed formula. This is then included in a double option agreement which gives each party an option to buy or to sell their holdings on death. If either party chooses to exercise their option, the other must comply.

In this planning, it is critical that there is no element of contractual obligation on either side. If the arrangement can be construed as a formal agreement amounting in law to a contract, it will probably fail. It is essential that all documentation be completed by a specialist to ensure that all that has been created is a cross option among the parties, without any element of contractual right or obligation.

If the owner was also a director of the business, there may be a **director's loan account**. This will probably represent capital that the director has lent to the firm at some stage, over and above any subscription for shares. However, if the loan account has arisen, it will become repayable on the death of

the director. The director may also demand repayment of the loan in the event that they can no longer work in the business through long-term or serious illness.

2.4.3 Partnership Protection

As with a private company, the death or serious illness of a partner can have a serious impact on the future of the business itself, and on the partner's family. To enable the continuity of the partnership, a partnership protection plan can be put in place that enables the surviving partners to purchase the deceased partner's share of the business and to provide the deceased partner's dependants with a willing buyer and cash instead of an interest in the business.

Other alternatives include:

- taking out a life of another arrangement, although this can present issues when partners join or leave
- establishing an absolute trust which can be inflexible as partners change, or
- joint life first death policies.

As with shareholder protection above, a cross-option arrangement can work, provided there is no binding agreement amounting to a contract.

Additional Considerations

The Partnership Act 1890 defines a partnership as the '*relation which subsists between persons carrying on a business in common with a view to a profit*' and while many partnerships will be formally established with a partnership agreement, some are not. In the absence of any agreement to the contrary, the Act provides for a general dissolution of the partnership on the death of a partner. A formal partnership agreement should state what happens in the event of the death of a partner or their inability to carry on working due to serious or long-term illness. If there is no formal partnership agreement in place, it is probably in the partners' best interests to have one drawn up.

The main difference between a partnership and a limited company is that there are no physical shares to be transferred or sold – instead there will be the value of the partner's capital account which will need to be returned to the family, but this is unlikely to bear any relation to the value of the deceased's partners share of the business as a going concern. This may well be considerably more than the value standing to the partner's capital account.

2.4.4 Other Business Protection Products

There are a number of other products which provide for the needs of small businesses and property owners. These policies provide for:

- property damage
- loss of rent
- equipment breakdown
- terrorism
- employer's liability, and
- property owner's liability.

Additional protection can be insured to cover areas such as cover for the effect of temporary or permanent works at the business premises, legal expenses relating to employment or contract disputes, and cyber attacks.

2.5 Other Protection Solutions

There are a wide range of other protection products sold by insurance companies and the following sections highlight the key features of some of these.

2.5.1 Private Medical Insurance (PMI)

Private medical insurance (PMI) is obviously intended to cover the cost of medical and hospital expenses. It may be taken out by individuals, or provided as part of an individual's employment.

Some of the key features of such policies include the following:

- The costs that will be covered are usually closely defined.
- There will be limits on what will be paid out per claim, or even over a period, such as a year.
- Standard care that can be dealt with by a person's local doctor may not be included.

Again, there will be exclusions such as for pre-existing conditions.

In the UK, there is a school of thought which says that PMI is rarely a high priority. Its main advantage is in queue-jumping if the client requires surgery for varicose veins and hip replacements, for example. However, in the event of an acute and critical condition, such as a heart attack or stroke, the patient will automatically be dealt with by the NHS, whose ambulance, surgeons/physicians and intensive care facilities will be used. Almost no private hospitals have critical care facilities.

For some, PMI can be relatively expensive and advisers should check the cost of premiums against the client's ability to afford private medical care. Factors such as age, health history, the cost of PMI and the ability to afford medical care are helpful if giving a client a balanced view of the cost-benefit analysis. Some may consider all insurance to be expensive, that is, until it is needed; and the older one gets, the more likely it is going to be needed.

2.5.2 Mortgage Payment Protection Insurance (MPPI)

Mortgage payment protection insurance (MPPI) is designed to ensure that the payments that are due for a mortgage continue to be paid if the borrower is unable to work because of accident, sickness or unemployment.

They tend to be available from the lending institution, as well as insurance companies, although costs need to be carefully compared. They are designed to cover short-term problems, such as covering the costs if an individual loses their job and until they find alternative work, rather than long-term benefits.

The same basic principles as reviewed above under income protection cover will apply, along with the following further considerations:

- The protection provided will be on a level basis, so regular reviews are needed so that the cover reflects the payments due as mortgage interest rates change.
- The amount of benefit payable can be reduced to take account of income from other sources, and there may be limits on the maximum amounts that will be paid.

As a result, the amount of benefit paid may not cover the mortgage payments.

Advisers should be aware that this area has been the subject of a major inquiry by the regulator, which believes there has been wholesale misselling of these contracts.

2.5.3 Accident, Sickness and Unemployment (ASU) Insurance

Personal accident policies are generally taken out for annual periods and can provide for income or lump sum payments in the event of an accident. More general Accident, Sickness and Unemployment (ASU) policies may also cover unemployment as an alternate to short-term income protection policies. However, ASU policies tend to also be time limited.

Although relatively inexpensive, care needs to be taken to look in detail at the exclusions and limits that apply. These may include:

- the amount of cover may be the lower of a set amount or a maximum percentage of the individual's gross monthly salary.
- the waiting period between when an individual becomes unable to work and when benefits start may be 30 or 60 days.
- the insurance company will assess eligibility at the time of the claim, and may refuse a claim as a result of pre-existing medical conditions even if they have been disclosed.

2.5.4 Household Cover

House and contents insurance are well-established products and are well understood by consumers, so these will only be covered briefly. Wealth managers are unlikely to deal with this area but, if offering holistic financial advice, the adviser must make sure that this has at least been reviewed. This will include checking if the client has cover, whether it is up to date, whether it has been reviewed recently and if it provides a sufficient level of cover.

The results should be documented as part of the fact-find. Key considerations include the following:

- Has the client taken standard or additional cover and what exclusions apply?
- Is the cover enough to pay for the complete rebuild of a home?
- To what extent are external features of a house covered, such as walls, gates, drives and pathways?
- What cover is there in case a neighbour sues you for your tree falling on their property or a similar accident?
- What is the extent of cover for personal possessions?
- Is legal cover included?

While an adviser would not necessarily advise on individual home insurance policies, or making a will for that matter, advisers should make sure the client has at least considered making arrangements.

3. Life and Protection Planning

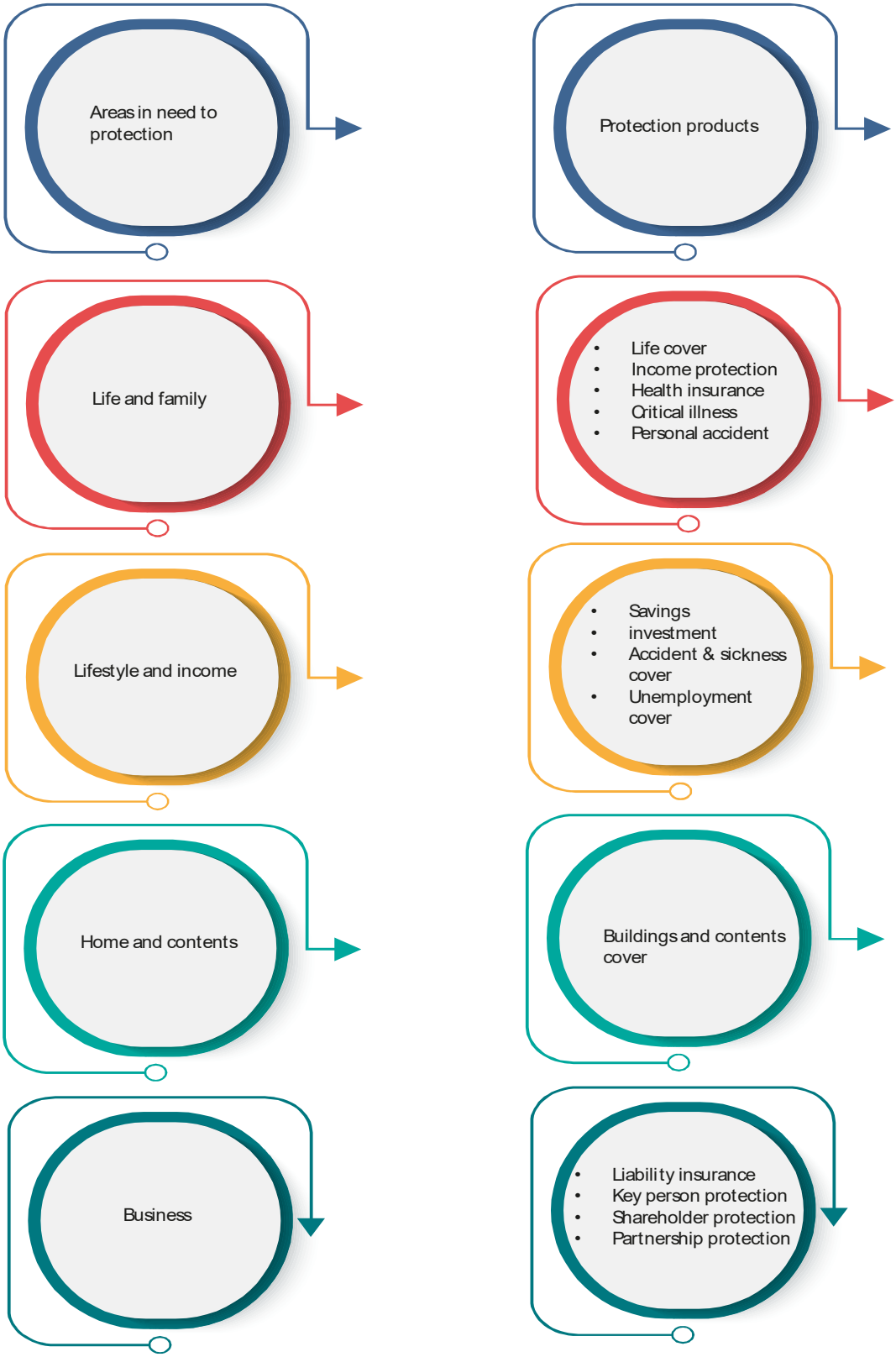
We will now consider some of the key features of how this wide range of life and protection products can be used to make sure that a client has made appropriate steps to protect themselves, their family or business from anticipated problems.

Protection products are designed to provide financial protection in case certain risks occur, but it needs to be remembered that risk is part of life, and a judgement needs to be made as to which areas are in need of protection. Just as it is not possible to eliminate risk entirely, it is not financially feasible for clients to insure against all events.

3.1 Main Areas in Need of Protection

It is important, therefore, to appreciate what the main areas in need of protection are and why that is the case. With an understanding of that, the adviser can then consider the client's personal circumstances and make an assessment of whether taking out protection should be considered.

The following gives some indication of the range of needs and protection products that are available.


Areas in need to protection
Protection products
Life and family
• Life cover
• Income protection
• Health insurance
• Critical illness
• Personal accident
Lifestyle and income
• Savings
• investment
• Accident & sickness cover
• Unemployment cover
Home and contents
Buildings and contents cover
Business
• Liability insurance
• Key person protection
• Shareholder protection
• Partnership protection

The age of the client may give some indication as to what needs to be considered:

- If the client is in their 20s or 30s and is married with children, life cover will be important, as premature death would have very serious financial consequences. Life, sickness and redundancy cover should be considered a high priority.
- When a client is in their 30s, they may be starting to think about a mortgage and pension. The focus may be income protection and, by age 40, mortgage payments might reduce, leaving more money left over for pension and investment savings. However, for in recent years, people have been joining the property ladder much later in life, and this will have a knock-on effect on other financial decisions.
- If the client is in their late 40s, then their life and financial position will have started to change. Life and mortgage cover may become less important, depending upon whether they have paid off the mortgage and the children have left home. Sickness cover remains important, however, as increasing age brings more risk of illness.
- In their 50s, their priorities may well change. Life and redundancy cover may not be as important as the children might have left home and the mortgage possibly paid off. Sickness cover remains important and consideration of long-term care starts to appear on the planning horizon.
- When the client is in their 60s or older, the need for redundancy cover may no longer required. Pure life cover is even less relevant and, instead, clients will be thinking about preserving their wealth and how to reduce any inheritance tax liabilities; IHT mitigation might involve whole of life insurance. Health and sickness cover should be a particular concern as well as long-term care. If children are no longer dependent, more money is left over for savings just before retirement, and clients would normally start to seek financial advice to plan the next phase of their lives – retirement planning. However, increasingly, both the dependency of children and retirement decisions are being extended later into life.

3.2 Information Needed from Clients

As part of the first meeting with their client, the adviser will collect all of the factual information needed about the client as covered in chapter 4, Retirement Planning (eg, personal information, dependants, health, assets. and liabilities, and income).

Assessing clients' understanding of investments is crucial if there is an investment element to the policy. If clients have no experience of investments, the adviser needs to take this into account when making the recommendation and confirm why in the client suitability report/letter.

The next stage is to identify which needs should be addressed as part of the financial planning process, and any goals to be planned for.

3.3 Assessing Protection Priorities

To assess what type of protection is required involves the adviser exploring with the client what might happen in their life, and what the consequences might be. Although none of us can predict the future, it does not prevent us considering what might happen and then assessing whether we are prepared for it.

This can be achieved by looking at each of the main areas in need of protection and asking what could happen and what would be the effect if it did. Generally, both the main breadwinner and partner will

have employment, and consideration needs to be given to the effect of incidents affecting either one or both of them. This is particularly the case where there are younger children who require care at home, which may require skills to be bought in.

The exploration of these points will reveal the extent of the areas in which a client should consider taking action.

Having determined that protection needs to be considered, however, the adviser needs to move on to finding out whether doing so is sufficiently important that the client needs to prioritise it. The FCA has upheld complaints where clients have been over-insured, eg, PPI misselling, and advisers must make sure, therefore, that they understand their clients' needs and do not over-insure them, in other words, whether protection products being sold are appropriate.

Some examples of the situations that could occur and the potential impact on the client and their family is considered in the table below, although this is not an exhaustive list.

Area of Need	What Could Happen	Potential Impact
Life and Family	• You or spouse suffer a fatal heart attack • You or spouse are diagnosed with a critical illness • You, spouse or someone in your family needs surgery • You or spouse are unable to look after yourself and need full time care	• Your family lose your income and have insufficient funds to live on • You face major medical bills and care costs • You may want immediate access to a private hospital • The cost of care exhausts all of your savings
Lifestyle and Income	• You or spouse lose your main source of income • You or spouse suffer an accident or sickness that prevents either or both of you working • You or spouse lose your job	• Your savings are insufficient to maintain your lifestyle • Benefits from the state or your employer are insufficient • It takes a long time to find a new job and you exhaust your savings
Home and Contents	• Your home is flooded • You lose your job • You or spouse die before your mortgage is repaid	• Major expenditure to repair the damage and buy new contents • You are unable to meet your mortgage repayments • Your family is saddled with ongoing mortgage repayments
Business	• A key person/partner is no longer able to work or dies • A shareholder dies	• The business can no longer generate its products or sales • Their shareholding needs to be bought out • Their share of the partnership needs to be bought out

3.4 The Prioritisation Process

Simply because a need has been established does not mean that it can be addressed. Affordability will be a major constraint on a client's ability to protect against all of the risks that might arise.

The adviser will, therefore, need to guide the client through a planning and prioritisation process. This will involve:

- listing the areas that need to be dealt with
- quantifying the impact and likelihood of each
- ranking them in order of importance
- reviewing existing arrangements
- assessing the cost of providing protection
- identifying the extent and scope of protection that the client can afford, and
- establishing a plan which will allow some of the needs to be addressed.

Prioritising such decisions is not an easy process, especially as the client, having recognised the need, may want to deal with all of them. The adviser, therefore, has a key role in explaining the process to the client. The adviser needs to manage the natural concerns that this will generate and explain that, although a risk has been identified and need to be addressed, the client also needs to take into account the likelihood of it occurring. The adviser also needs to explain the long-term nature of this process, namely that the prioritisation exercise can only identify the immediate priorities that should and can be addressed. The remainder still needs to be addressed at some stage when the client's circumstances allow, ie, they have been deferred and not abandoned.

The process of prioritisation will enable a plan to be established of what needs doing and what will be considered later. This leads naturally to the realisation that financial planning is a long-term exercise and that the client and adviser will need to regularly review progress and reassess the plan in the light of changes to needs, circumstances and priorities.

In the following sections, we will explore the remaining steps in the process, namely quantification of needs, review of existing protection arrangements and the identification of suitable protection solutions.

3.5 Quantifying Needs

The next stage is for the adviser to quantify the type and level of protection needed for each of those areas. Quantification is simply about comparing the future position of the client with their current position and then assessing the shortfall.

The starting point here is to produce an income and expenditure plan that documents the client's current position, as shown in the following table:

Outgoings	Income
Rent or mortgage payments	Salary after tax
Other loan repayments	Other income – net

Outgoings	Income
Credit card repayments	
Local taxes	
Food	
Clothing	
Gas, electricity and water	
Schooling costs	
Telephone and internet connections	
Car costs including petrol, servicing and insurance	
Socialising	
Holidays and breaks	
Other	
Total	Total

Note that clients often understate their true expenditure, and care needs to be taken. If a comparison of income and expenditure indicates that the client is living within their net income, the adviser should calculate the annual surplus. If there is no obvious explanation, it is important to go back through their expenditure to find out what has been missed. This needs to be handled sensitively with some clients, but is essential. All clients turn out to be either net savers or net spenders. It is key to find this out, as it governs large areas of advice and planning.

The client can then be asked how that might change in the event that they were no longer able to work, and the revised result will show what is at stake.

This process can then be continued by considering what would happen if something happened to the client or their partner and gaining an understanding of what the impact would be on the family of the following:

- If the client or partner were to die.
- If the client or partner become unable to work.
- Who would look after the home or the children if the client or partner were unable to?

This may then indicate that it is necessary to replace not just lost income but to generate additional income or a capital sum. Therefore, not only does the risk tolerance of the client need to be established and agreed, but also their capacity for loss, along with making sure there is a suitable cash reserve fund put aside.

As a result, there are a number of other factors that should be considered, including:

- Determining whether the client will need capital or income and whether it is best met by a lump sum payment or the generation of income, or a combination of both. Generally, a lump sum will be the best option, as it gives the client the flexibility to use the capital and either invest it for income or draw on it as necessary.

- The amount of income that can be generated from a capital sum will depend on the interest rates at the time the funds are invested and will vary. This will introduce a level of uncertainty if the client will need a given level of income. As a result, any assumptions made need to be conservative.
- The effect that inflation will have on the income flow should be established. The importance of this will depend on the length of time the income might be needed for.

These factors will direct the adviser towards consideration of a type of policy that is appropriate to the need. This will also involve choosing between different types of policy that are both capable of addressing the needs of the client. Where a regular income is required, for example, this need could be met by an income protection policy but also by a term assurance policy that would pay a lump sum that could be invested, or by Family Income Benefit, which is usually significantly cheaper.

This process can then be repeated in a similar fashion for all the other areas that may be in need of protection.

3.6 Review of Existing Protection Arrangements

The next stage in the process is to review in detail the existing protection products that the client holds.

The amount of information needed from a client is extensive, and obtaining it is essential, otherwise the planning process will be flawed. This also applies to the detail of the existing arrangements the client has made and the adviser will need to ensure they have sufficient information to assess their suitability.

Any life assurance products the client holds may be intended to provide protection or to be used for investment purposes. The adviser needs to obtain details of the type of policy, its purpose, the premium, the term and the potential benefits that may arise on death or maturity. They should also find out from the client why it was purchased, as this will provide further useful information. It may indicate their future requirements or show that it is now superfluous, for example, where a life assurance policy was taken out to protect a mortgage which has since been repaid.

Once the adviser has all the information they need, they will then need to assess the suitability of these policies against the client's current circumstances. There are many factors to consider, which will be driven by the type of product or arrangement. Items to consider include:

- Its relevance to the prioritised needs of the client.
- The extent of the cover provided and whether this is adequate given the client's current needs.
- Whether there is an option for the cover to be extended.
- Whether it is an affordable option or whether the client's circumstances have changed so that they can afford to increase what is paid.
- Whether the original timescale is still valid.
- The degree of risk associated with the product considered against the client's risk tolerance.
- The extent of any diversification, or lack of it.
- The level of charges compared to comparable products.
- Any encashment penalties.
- Whether the beneficiaries of the plan are still relevant.
- Whether the trustees of any life cover benefits are still current.

This analysis will then provide the basis for continuing the planning process. The results will show:

- Which protection products should be retained.
- Where the amount of cover should be increased or decreased.
- Products that should be disposed of as they no longer meet the client's objectives.
- Protection gaps that need to be filled.

3.7 Identification of Suitable Protection Solutions

The next step is to identify suitable protection products that can meet the client's requirements and evaluate their features. This part of the process essentially involves matching their protection objectives with the characteristics of the various protection products. For life assurance and protection products, the process essentially involves identifying the range of potentially suitable products, assessing the key product features compared to the client's needs, and selecting the most suitable options.

3.7.1 Factors to be Considered When Selecting Products

The following factors should be considered when selecting a product:

- Price.
- Product features.
- Charges.
- Tax treatment.
- Suitability to the client and client's objective.
- All summed up as value for money, especially compared to other products in the market place.

Price, or the premium that the client will pay, is clearly an important consideration, as are the charges. These can range from annual management charges, to a charge for buying units in a unit-linked policy, to initial charges for set-up costs of the policy and a policy fee. Where they are built into the premium they will be of less importance, as the product chosen can be the one with the lowest premium.

The product features will clearly need to be examined to ensure that they meet the client's objectives but they should also be checked for any additional features that may be included which may address one of the client's other needs. They should also be checked to see if there is an option to add additional cover at preferential rates.

Any charges payable on the product should be clearly detailed in the key features document, product illustration or product brochures. These should be carefully examined and compared against comparable product offerings.

The tax treatment of the product and any payments made under it should be established, as this could have a material impact on the financial position of the client should they need to claim under the policy. The features of each product should be examined to see if the benefits payable under some policies can be made tax-free and whether there is any advantage or drawback to its treatment.

Other Issues

- Whenever any sort of life assurance contract is recommended, it is almost always advisable to ensure that the policy is written in trust. In the event of a death claim, this should ensure the lump sum or other benefits do not enter the deceased client's estate, but appointments can be made by the trustees according to their judgement. Where there is a surviving spouse/civil partner and/or adult children, they can be trustees as well as beneficiaries, and thus control the money, without it entering the survivor's own estate.
- Much planning can be done by ensuring that clients have written appropriate wills. This is especially critical where couples are not married or in a civil partnership. Even where there is adequate protection insurance in place, unless there has been a proper letter of wishes or nomination form completed, death benefits will simply enter the deceased's estate. If there is no will, the intestacy rules will almost certainly ensure that the family receives nothing. Therefore, although insurance is important, much useful planning can be done through the simple and cheap expedient of ensuring good wills have been written.

3.7.2 Factors to be Considered When Selecting Product Providers

When the adviser has decided on the right product type to recommend, the next task is to decide on an appropriate product provider.

The features of a product may vary from provider to provider and may therefore be a determining factor, but where there are a number of providers the following should be considered:

- Financial strength.
- Quality of service.
- Investment choice and performance.
- Availability of tax wrappers.

Financial Strength

Protection is an area of insurance where the capital strength of the provider is important, so it is a vital factor to take into consideration when setting up protection cover.

Although the cost of the premiums may seem to be an immediate indication of the suitability of a policy for a client, it is important for advisers to also factor in the financial strength of the provider they are recommending. Protection policies can run for many years, so an adviser needs to be sure that the company will still be around when the customer needs to make a claim in 10 or 20 years' time. A lower premium is no help if the provider is not around when a claim is made.

Protection is a very capital-intensive business to write. As the economic, investment and regulatory environment becomes ever more challenging, it is also an area that insurance companies will pull out of if they are struggling financially.

Quality of Service

Assessing the quality of service of a product provider is also important, and the adviser needs to look at both the servicing and claims record of the provider and their long-term commitment to the market.

A reputable service provider should produce documentation that is clear and understandable, should provide a hassle-free service, should have prices and rates that are clear and transparent, and should progress medical examinations in a timely manner. These and other indicators, such as experience of dealing with the firm, policy terminations (lapses), compensation claims, complaints, mistakes and rectifications, product innovation, fines, complexity of products, staff turnover and remuneration, all provide useful signposts to the servicing quality of the firm. These indicators are monitored continuously by the FCA, advisers and consumer websites.

The other essential feature of the service level delivered by a provider is how they deal with claims. The adviser will want to examine the firm's claims experience and determine whether they pay claims fairly and efficiently or put hurdles in the way of the client claiming under the policy. In other words, does the provider have good product governance? Protection insurance is a long-term product and an adviser needs to be sure that the provider has a sound track record of handling claims fairly.

An adviser needs to be aware of what might happen if a provider were to leave the market. If the provider were to go bust or stop writing business, then it is possible that the policies would be transferred to a closed book specialist. This change of ownership could come with an adverse change in the company's approach to managing claims, as its motivation for being in the protection market could be very different from those providers writing new business. It can also be less straightforward and more expensive for the client to add to or amend cover once their policy has been transferred in such a way.

Worse still could be the situation that the provider moves out of the market altogether and the client is left with no cover and needs to start a new policy with another provider. The client's position by then could be such that they will have to pay higher premiums and have some cover excluded. The level of regulation on insurance companies has grown exponentially on recent years, but there is no regulation or mechanism that would compel other insurance companies to fill the market following a provider exit. Insurance companies are generally run based on solvency requirements and underwriting risk, and that does not lend itself to normal competitive practices.

Investment Choice and Performance

If a life product is being selected and the performance of the product will depend on the investment performance of the company's investment funds, then the adviser needs to assess the range of funds available and the long-term performance that they have achieved relative to their peer group. This assessment process is essentially the same as considered earlier when looking at how to assess and select a mutual fund.

3.7.3 Criteria for Matching Solutions to Client Needs

We are now close to the end stages of the protection planning process.

So far, the adviser has collected client information and evaluated protection needs and priorities. They have then quantified the required cover, considered what risk the client can and wants to underwrite personally, while considering the **opportunity cost**, and assessed existing products. Finally, the adviser has identified gaps in protection and addressed them by selecting suitable products and providers.

The next stage is for the adviser to bring the component parts together into a financial plan that can be presented to the client. In preparing the plan, there are various criteria that the solutions identified will have to meet, including:

- The solution chosen must clearly be adequate to meet the client's needs. Sometimes, however, it may not be possible to fully meet the requirements and it will have to be accepted that there is a gap, or it may be that a combination of products may be needed.
- The solutions put forward should be consistent with the client's attitude to risk.
- Whatever is recommended should be as tax efficient as possible.
- The solutions must be affordable to the client and realistic, given their level of disposable income.
- The client should be given time to read through the report. Often it is advisable to actually arrange a meeting so as to make sure the regulatory documents are read and understood by the client.

3.7.4 Presenting Recommendations – Suitability Report

In this final section, we can now look at how these recommendations should be presented to the client. As part of this, we will also consider the role of key features documents, the client's cancellation rights, and how to explain the consequences of inadequate protection if the client does not accept the adviser's advice.

Financial Report

Presenting the information in a clear and understandable manner is essential if the client is to understand the advice being given, and is an important part of the process of giving financial advice.

This is normally achieved by preparation of a formal written report which can put the products recommended into the context of the client's circumstances and objectives.

There is no single correct way to construct a report but its contents are likely to include:

- Date of report.
- An introduction that explains the content of the report.
- The current position of the client, limited to the most important aspects, and a summary of their current protection arrangements.
- The objectives and priorities that have been agreed with the client.
- The recommendations that are being made, how they relate to priorities and objectives and an explanation of the choice of provider.
- Considerations that have been deferred until later.
- Any tax implications of the recommendations on the client's position.
- The action needed to implement the requirements.

It will also be accompanied by appropriate product quotations, illustrations and brochures.

The report may, be part of a holistic review of the client's position and may, therefore, include investment, retirement as well as protection recommendations.

Providing a written report is an important way of recording what has been recommended and the key information on which it has been based, and should thus avoid the potential for misunderstandings and act as a safeguard for the adviser.

One factor which the FCA repeatedly emphasises is that any and all recommendations must be suitable to the client's needs, resources, and attitude to risk. It is advisable to ensure that every recommendation for a product or strategy refers back to these key elements, matching them specifically to each product or strategy. This is also known as a suitability letter.

Product Key Features Documents (KFDs)

A key feature of regulatory rules is that the advice given to clients is suitable and that clients should have the information made available to them to enable them to make an informed decision.

One way in which this can be achieved is by the provision of KFDs which describe the product in a way that a client can understand.

A KFD will be provided to the client as part of the product illustrations and should contain the following information:

- A clear description of the aims of the product.
- The commitment the client will be making.
- The risks involved in the product, with a description of the factors that may have an adverse effect on performance or are otherwise material to the client's decision.
- A question-and-answer section on the main terms of the product. This should give the principal terms of the product and any other information necessary to enable a customer to make an informed decision. It will include the charges to be made and will be set out in a question-and-answer format.

A well-drafted KFD will aid the client in understanding the recommendations that have been made and the commitments they are entering into will generally help in the overall planning process. The adviser needs to recognise, however, that not all KFDs are written in a style that is succinct, clear and understandable and, where that is the case, the adviser should assist the client in their understanding so that they can make an informed decision.

Cancellation Rights

An important feature of many financial services products is the right of the client to change their mind and cancel, or withdraw from, the arrangement without meeting charges. It is important that the adviser fully explains these rights and any associated documentation to the client.

Consequences of Inadequate Protection

In going through the stages of protection planning we have followed a very logical process. Whether the client will accept the recommendations will also be influenced by their attitudes, particularly their attitude to risk.

Some people want peace of mind and will want to have protection for what may go wrong and will therefore be fully prepared to pay the costs of doing so. Others will choose only to insure for the more major risks.

If clients are to make the right choices for themselves, they need to understand the risks they face, what a product can offer and what it will cost. Once they have that information, they will be better placed to make an informed choice.

It is the role of the adviser to ensure that information is presented objectively to the client and to ensure that the client understands the consequences of inadequate protection. The adviser needs to remember, though, that inadequate means different things to different people and that the final decision lies with the client.

Lastly, just as client circumstances continually change, so do the risks they face, and the level and appropriateness of a client's protection should be reviewed as carefully as other parts of the client's portfolio and be included in the agreed periodic financial review.

Cash-Flow Modelling

Many financial advisers use **cash-flow modelling** in risk management. This is a powerful tool because it provides a visual image of a client's financial situation and allows them to understand the following:

1. **Their financial situation in different 'what if' scenarios** – a financial review can undertake various 'what if' scenarios to demonstrate the impact on their financial situation of various life events (eg, what if both die or become ill, what if one dies or becomes ill).
2. **The limits of their current financial resources** – individuals may believe that their current financial resources will cover their expenses for a longer period than is the case. Cash flow modelling can show how long their current financial resources would last in each of the scenarios.
3. **How much cover they need** – calculating the level of cover to buy might be complicated. Cash flow modelling software can quickly calculate how much life insurance, income protection and critical illness to buy in different 'what if' scenarios.

In March 2024, the Financial Conduct Authority (FCA) raised concerns about the suitability of cash flow forecasting used by financial advisers, highlighting issues such as inaccurate information, unrealistic investment return assumptions, ineffective planning for uncertainties, poor communication to clients and lack of thorough review of outputs. Advisers need to address these areas and ensure their cash-flow modelling practices align with the FCA's Consumer Duty requirements[2].

4. InsurTech and ESG

FinTech is also transforming the insurance industry. Some of the leading FinTech innovators in insurance (referred to as **InsurTech**) provide users with an overview and analysis of existing insurance policies, help them detect insurance gaps using automated processes and recommend essential insurance. Others compare life and other insurance products, but are not affiliated with any particular insurance company and their algorithms work to match the user with the best policy to fit their needs (rather than generate leads for their insurance business clients, typical of many comparison sites).

Tractable, a London-based insurtech founded in 2014, utilises AI to assess vehicle and property damage swiftly. By training its AI platform on millions of data points, including images of damaged vehicles and property, Tractable enables insurance companies to expedite claims processing and make more precise decisions. Their platform also identifies salvageable parts from older cars, reducing repair costs. Leading insurance companies have employed Tractable's technology.

2 FCA, March 2024. Undertaking cashflow modelling to demonstrate suitability of retirement-related advice. Retrieved from https://www.fca.org.uk/firms/undertaking-cashflow-modelling-demonstrate-suitability-retirement-related-advice (Accessed: October 2024)

YuLife, another London-based insurtech founded in 2016, provides life insurance products through an app that encourages policyholders to take part in healthy activities and earn rewards. The app uses behavioural science and gamification principles and provides direct access to virtual GPs and mental health support. It also provides insights for businesses. YuLife has over 500,000 policyholders at businesses large (including Co-op, Jaguar Land Rover and Santander) and small.

Growing collaborations take place between traditional insurance giants and InsurTech firms.

New York-headquartered Lemonade launched in the UK in October 2022 with the help of Aviva, its strategic partner. It was originally launched as a specialist in home insurance for renters. It appealed to users with a straightforward policy that had been shortened from forty pages to four, as well as speedy processing of claims, reportedly within seconds. More recently in 2022, Lemonade has ventured into offering climate insurance to farmers on a blockchain-based architecture.

The InsurTech revolution in the UK is not only characterised by these innovative companies but also by the immense growth it is expected to experience in the coming years. Several key trends are anticipated to shape the UK's InsurTech market in the future:

- AI is enabling more and more InsurTech companies to automate tasks, enhance risk assessment, and deliver personalised customer service, driving operational efficiency and customer satisfaction.
- Big data is already playing a pivotal role in InsurTech and will do so even more in the future, allowing companies to gain deeper insights into customers. This is instrumental in developing new products, refining pricing strategies, and combating fraud effectively.
- Wearables and other IoT devices are becoming instrumental in insurance by providing real-time data on health, home security and vehicle performance. Insurers use this data to offer personalised insurance plans and dynamic pricing, prevent losses, and improve risk management.
- Blockchain technology and smart contracts are increasingly being utilised to enhance transparency, security and efficiency in insurance processes, reduce fraud, and accelerate claims settlements.
- Parametric insurance – there is a growing interest in parametric insurance products, especially for climate-related risks. These policies pay out based on predefined parameters (eg, flood depth for flood insurance) rather than assessed damages, reducing the claims process significantly.
- Embedded insurance, which is insurance coverage seamlessly integrated into the purchase of products and services, is growing, simplifying the process for consumers to obtain insurance at the point of sale.
- Cyber insurance is becoming more comprehensive and tailored as InsurTech firms develop products that include risk assessment tools and incident response services to address rising cyber threats.

The UK's InsurTech market thrives on innovation and dynamic solutions, continually evolving to meet the ever-changing demands of customers. With ongoing growth and innovation on the horizon, the future of InsurTech in the UK looks promising.

As technology continues to play a central role in reshaping the insurance industry, policyholders stand to benefit from the enhanced efficiency, personalisation, and convenience that InsurTech brings to the table.

As ESG issues have become more pressing concerns, insurers are under increasing pressure to address these within their businesses and products. The Principles for Sustainable Insurance were introduced in 2012, at the same conference that marked the introduction of the UN SDGs. These Principles contain four themes:

- Incorporating material ESG issues into decision making.
- Collaborating with clients and business partners to raise the profile of ESG factors, manage risk, and find solutions.
- Working with governments to spur societal action on ESG issues.
- Disclosing progress on the Principles in order to maintain accountability and transparency.

In terms of insurance products, ESG is of most relevance to long-term saving products with an investment component, which typically involve investing policyholders' premiums in various financial instruments, such as stocks and bonds. As investors increasingly prioritise sustainability and ethical considerations, integrating ESG principles into the investment strategy becomes crucial to meet the demands of socially conscious policyholders.

InsurTech will increasingly play a vital role in addressing ESG issues in the insurance industry through innovative approaches and digital solutions. For example, some InsurTechs use of advanced technologies like satellite imagery and weather data to enable more accurate climate risk assessments.

By leveraging cutting-edge technology and collaborative partnerships, the InsurTech revolution promises to drive the insurance industry towards a more customer-centric and sustainable future.

Chapter Six

Taxation

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Benjamin Franklin said '*nothing can be said to be certain except death and taxes*' and, where insurance products in the previous chapter covered life and death events, so tax mitigation prevents your clients from paying too much tax now and in the future. In times of flat or falling markets, the effect on a portfolio of tax mitigation can easily outweigh investment returns.

HM Revenue & Customs (HMRC) is the department responsible in the UK for the collection of tax. HMRC is undergoing one of the largest shake-ups in modern tax history as public and political sentiment drives society towards zero tolerance of tax avoidance, havens and mitigation. Whether it is the amount of corporation tax paid by global firms or the revelations of the Panama Papers (the leaking of nearly 40 years' worth of confidential client data from the wealth management firm Mossack Fonseca), the shift in direction will have long-lasting effects on how advisers provide efficient tax management to their clients.

In response to changing avoidance behaviours, the UK government introduced a number of measures to bear down on tax avoidance. In 2013, it introduced the general anti-abuse rule (GAAR) in order to counteract abusive tax avoidance and followed this up in subsequent years with further rules and sanctions. The Criminal Finances Act 2017 amends the Proceeds of Crime Act (POCA) 2002 and criminalises the failure to prevent tax evasion.

In this chapter we will look at the main taxes that wealth managers need to contend with and, more briefly, other areas, such as national insurance (NI) contributions, value added tax (VAT) and corporation tax. We conclude with an area that wealth managers need to be very aware of and up to date with – the ongoing debate as to what constitutes acceptable tax planning.

1. Residence and Domicile

Effective from 6 April 2025, the UK tax system abolished domicile status as a relevant factor for income tax, capital gains tax (CGT) and inheritance tax (IHT). This marks a fundamental shift from the prior domicile-based system to a purely residence-based taxation regime.

Under this new framework, an individual's tax residence status, determined by the Statutory Residence Test (SRT), fully governs their liability to UK tax on worldwide income, gains and IHT. The longstanding remittance basis of taxation and the concept of deemed domicile have been abolished.

1.1 Statutory Residence Test (SRT)

Introduced in 2013 (effective from 6 April of that year), the **Statutory Residence Test (SRT)** remains the principal framework for establishing UK residence status and accordingly defines an individual's tax obligations.

The aim of the SRT is to bring clarity and consistency to the assessment of whether a person is resident or non-resident for UK tax purposes. The result applies to the entire tax year unless split-year treatment is available due to specific changes in circumstances.

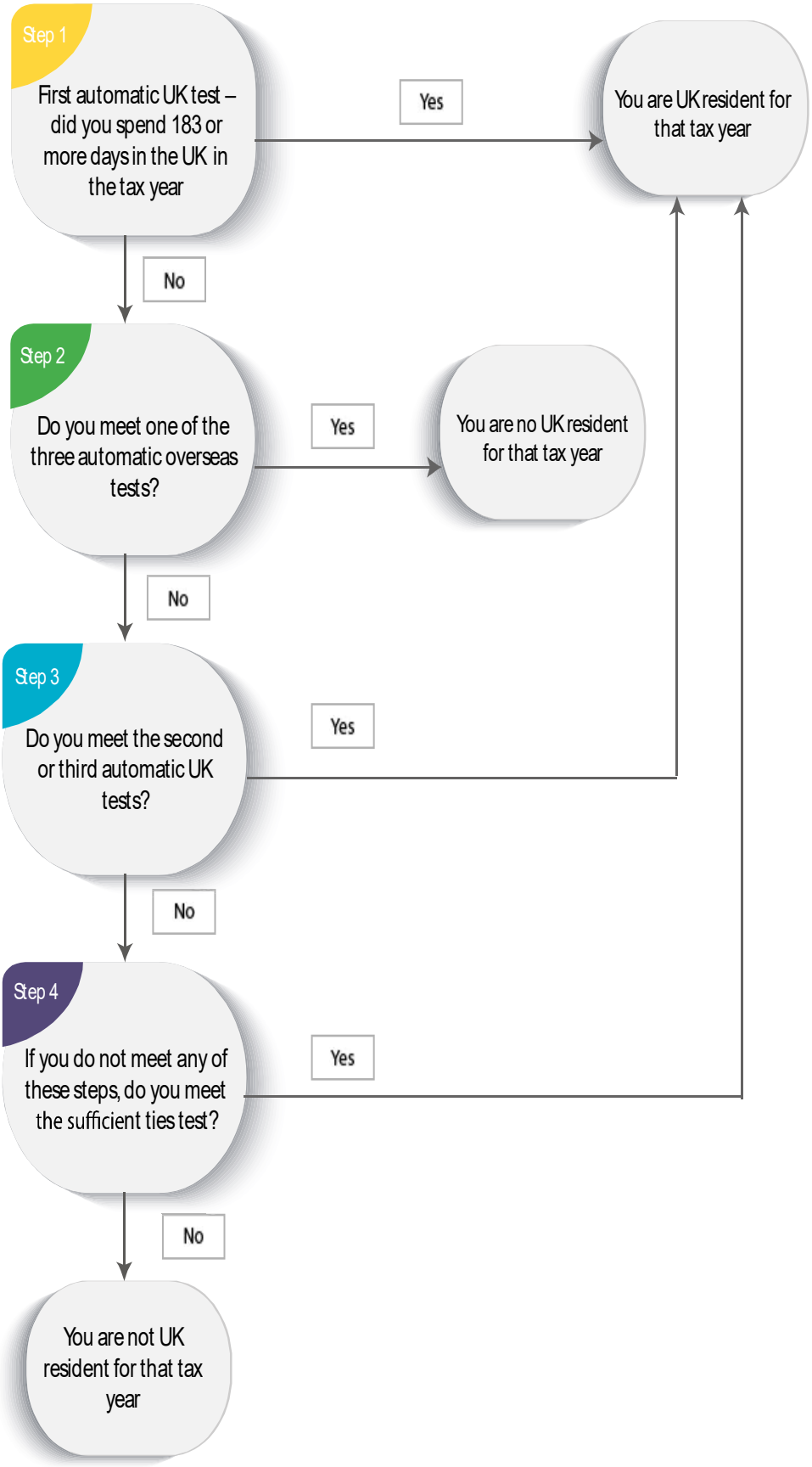
The SRT considers both the time spent in the UK and the individual's wider ties to the country. It is structured in three sequential parts:

1. Automatic overseas test.
2. Automatic residence test.
3. Sufficient ties test.

If the automatic overseas test does not confirm non-residence, the automatic residence test is considered. If this also proves inconclusive, the sufficient ties test is applied.

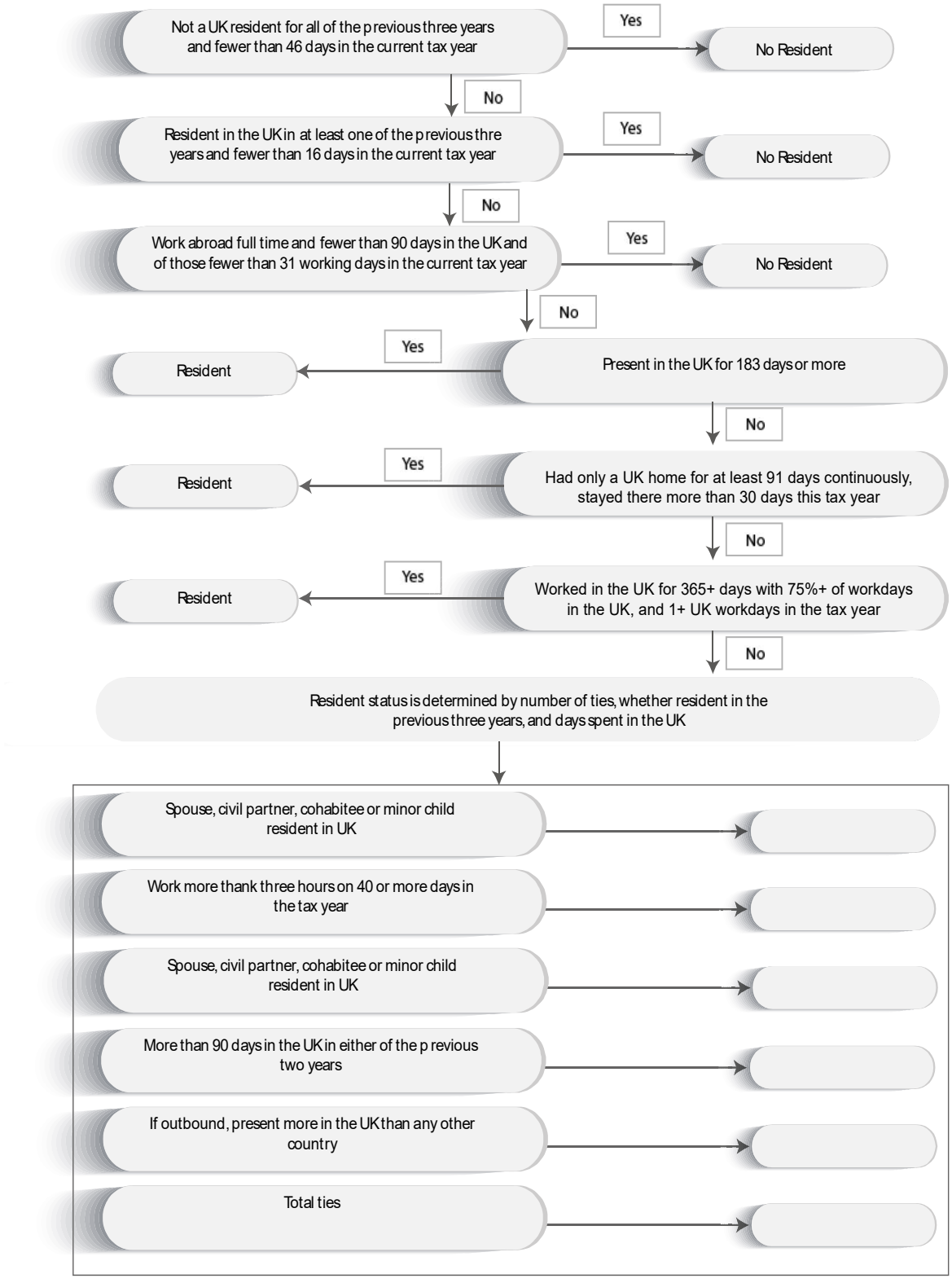
An overview of the SRT is provided by HMRC and is summarised below, with further detail in the remainder of this section.

Overview of the Statutory Residence Test



The rules are complex and the following flow chart attempts to summarise the tests where the individual is alive during the year and needs to be viewed in conjunction with the sections that follow. It is intended to illustrate how the residence test operates and should not be relied on in isolation from the detailed rules. In practice, wealth managers should seek specialist advice and refer to the HMRC Statutory Residence Test guidance notes.

Statutory Residence Test



The greater your ties to the UK, the fewer days you are allowed to stay in the UK before you attain UK residency. The following table provides a breakdown of this relationship.

Residence Status		
Arrivers	**Days in the UK in Tax Year**	**Leavers**
Not resident	0–15	Not resident
Not resident	16–45	Resident if four ties
Resident if 4 ties	46–90	Resident if three ties
Resident if 3 ties	91–120	Resident if two ties
Resident if 2 ties	121–182	Resident if one ties
Resident	183 or more	Resident

1.1.1 Automatic Overseas Tests

If you meet any of the automatic overseas tests for a tax year, you are automatically non-resident for that year. HMRC recommend you should therefore consider these tests first, as if you meet any one of them, you will not need to consider any of the other parts of the test.

A person will be conclusively non-resident if they meet any of the three overseas tests, namely:

1. A person was resident in the UK for one or more of the previous three tax years and spent fewer than 16 days in the UK in the current tax year.
2. A person was non-resident in all of the previous three tax years and present in the UK for fewer than 46 days in the current tax year.
3. A person meets the work abroad condition. The work abroad condition is met where a person works abroad for an average of at least 35 hours per week assessed over the whole tax year and does not have any significant breaks from overseas work. The person must not be present in the UK for 91 days or more in the tax year and must spend fewer than 31 days working in the UK.

The HMRC rules and guidance contain specific definitions and examples for each test.

1.1.2 Automatic UK Tests

If an individual does not meet the automatic overseas test, then they are deemed to be UK resident for tax if they meet any of the criteria for the automatic UK tests. A person will be conclusively resident if they meet any of the three automatic residence tests listed below:

1. A person is present in the UK for 183 days or more in the current tax year.
2. A person has a home in the UK.
3. A person carries out 'full-time' work in the UK for a period of at least 365 days.

A person will be regarded as having a home in the UK where they are present in that home on at least 30 separate days during the tax year and whilst they have a home in the UK, there is a period of at least 91 consecutive days when either of the following two conditions is met:

- **Condition A** – they do not have an overseas home, or
- **Condition B** – they do have an overseas home but are present in that home on fewer than 30 separate days during the tax year.

'Full-time' work means meeting the sufficient hours test to determine whether an individual has worked sufficient hours. Broadly speaking, the sufficient hours test is met provided more than 75% of the total number of days in the 365-day period are ones where you work on average more than three hours per day, although the actual calculation is complex.

The sufficient hours test has been criticised as it does not allow for an adjustment for periods of absence other than annual leave, parental leave, sick leave or embedded non-working days. An adjustment is not allowed for agreed ad hoc leave, such as compassionate leave or study days. The provisions regarding gaps between periods of work are also highly restrictive, applying only where the gap is one between two employments. It is likely the sufficient hours test will continue to evolve.

1.1.3 Sufficient Ties Test

If you do not meet any of the automatic overseas tests or any of the automatic UK tests, you should use the sufficient ties test to determine your UK residence status for a tax year.

The sufficient ties test looks at the number of ties an individual has with the UK and factors in the number of days actually spent in the UK into a sliding scale, in order to determine whether the individual is UK tax resident or not. If you were not UK resident for any of the preceding three tax years, the ties are:

- a family tie
- an accommodation tie
- a work tie, and
- a 90-day tie.

If you were resident in the UK for one or more of the three tax years before the tax year under consideration, you will also need to consider if you have a country tie. The ties are applied differently depending on whether an individual is an 'arriver' (not resident for any of the previous three tax years) or a 'leaver' (resident for one or more of the previous three tax years).

Sufficient Ties

- **Family tie** – a family tie exists if an individual's spouse, civil partner, common law partner or minor child is resident in the UK for the year. Time spent by minor children to attend school is ignored, and time spent in the UK visiting minor children is also ignored if less than 61 days per tax year.
- **Accommodation tie** – an accommodation tie exists if an individual has a place to live in the UK, and that place is available for a continuous period of at least 91 days, and they spend at least one night at that place during the year. A 'place to live' includes a holiday home or even a hotel and may include the home of a close relative.

- **Work tie** – a work tie exists if an individual works in the UK for more than three hours per day and for at least 40 days in the year, whether continuously or intermittently.
- **90-day tie** – a 90-day tie exists if an individual spends more than 90 days in the UK in one or both of the preceding two tax years.
- **Country tie** – a country tie exists if an individual spends more days in the UK than any other country during the year. This applies to leavers only.

The number of days an individual spends in the UK per tax year will determine the number of ties required to be considered UK resident for tax as shown in the tables that follow.

Number of Days and Sufficient Ties

UK ties needed if you were UK resident for one or more of the three tax years before the tax year under consideration

Days spent in the UK in the tax year under consideration	UK ties needed
16–45	At least four
46–90	At least three
91–120	At least two
Over 120	At least one

UK ties needed if you were UK resident in none of the three tax years before the tax year under consideration

Days spent in the UK in the tax year under consideration	UK ties needed
46–90	At least four
91–120	At least three
Over 120	At least two

1.1.4 Tax Impact of Residence

From 6 April 2025, the new residence-based tax regime replaced the old system based on domicile status, in the UK. This change significantly alters the tax treatment for individuals, particularly those previously classified as non-domiciled. The following table summarises the tax impact of UK residence in general terms from 6 April 2025.

Tax Impact of UK Residence						
Status of the Individual	Income		Capital Gains Tax		Inheritance Tax	
	UK source	Non-UK source	UK assets	Non-UK assets	UK assets	Non-UK assets
New Arrivals (First 4 years)	Taxable as arises	100% relief	Taxable as arises	100% relief	Taxable	Not liable
Long-term Residents (10+ years out of last 20)	Taxable as arises	Taxable as arises	Taxable as arises	Taxable as arises	Taxable	Taxable
Non-long-term Residents	Taxable as arises	Taxable as arises	Taxable as arises	Taxable as arises	Taxable	Not liable
Former Residents (3-10 years after leaving)	Taxable as arises	Not liable	Taxable on UK property	Not liable	Taxable	Taxable
Non-residents (beyond 10 years)	Taxable as arises	Not liable	Taxable on UK property	Not liable	Taxable	Not liable

However, the actual position can be difficult to determine and in most cases, advice needs to be sought from an appropriate tax specialist.

1.1.5 Split Year Treatment

Under the statutory residence test, an individual is either UK resident or non-UK resident for a full tax year and at all times for that tax year. However, if during a year they either leave the UK to live or work abroad or come from abroad to live or work in the UK, then they may be eligible to have the tax year split into two parts:

- A UK part during which they are charged to UK tax as a UK resident.
- An overseas part in which, for most purposes, they are charged to UK tax as a non-UK resident.

HMRC has further rules and guidance on the treatment of different income sources in these circumstances (see HMRC Guidance Notes).

1.1.6 Deceased Individuals

Different rules apply when someone dies in the tax year under consideration. The first automatic overseas test does not apply to someone who dies in the tax year under consideration. The other automatic overseas tests and automatic UK tests can be applied, but may need to be modified depending on the date of death.

There are some additional specific tests for deceased persons:

- The fourth automatic overseas test sets out the requirements for number of days spent in the UK, and
- the fifth automatic test modifies the sufficient hours calculation.

There is then a modified sufficient ties test where the number of days spent in the UK in the year of death is reduced proportionally depending upon the month in which death takes place.

1.2 Domicile

Domicile is a general legal concept; it refers to the country which is your permanent home. Every person must have a domicile, and it is not possible at any time to have more than one domicile.

There are different types of domicile:

- **Domicile of origin**
  - This is the domicile that every person acquires at birth.
  - A child born during the lifetime of their father has their domicile of origin in the country in which the father is domiciled at the time of the birth.
  - If a child is born after their father's death, then it has a domicile of origin in the country where their mother is domiciled at the time of the birth.
- **Domicile of choice**
  - A domicile of choice is acquired by a person residing in a country with the intention of continuing to do so permanently or indefinitely.
  - Any circumstances throwing light on the question may be considered in determining whether a domicile of choice has been acquired.
  - Where a person abandons their domicile of choice in a particular country but does not acquire a new domicile elsewhere, their domicile of origin will revive and continue to govern their legal position until they acquire a new domicile of choice or of dependency.
- **Domicile of dependency**
  - A domicile of dependency arises in respect of children, married women and individuals of any age who lack sufficient mental capacity.
  - Their domicile will generally be the same as, and will change (if at all) in accordance with, the domicile of the person on whom they are deemed to be legally dependent. So, the domicile of a child born to married parents during their minority will depend on the domicile of their father during the father's lifetime and (in general) on that of their mother after their father's death.
  - The domicile of a child born to unmarried parents during their minority will (usually) depend on their mother's domicile.
  - The domicile of a married woman is the same as, and changes with, that of her husband in some countries.

- **Deemed domicile**
  - This status applies once an individual has been resident in the UK for 15 out of 20 years, meaning it will apply in their sixteenth year of residence. If the individual leaves the UK and ceases to be resident, they will lose their deemed domicile status for IHT after three to ten years, depending on how long they were UK-resident.

The concept of domicile is of considerable importance in a number of areas of law. It is the link between a person and the legal system or rules that will apply for matrimonial, legitimacy, succession and taxation issues.

1.2.1 Non-Domiciled Status and New Tax Regime

With effect from 6 April 2025, the UK has abolished the domicile-based system, moving to a purely residence-based approach for income tax, CGT, and IHT. The former remittance basis and the relevance of domicile status for UK tax are now obsolete. UK tax residence is determined solely by the SRT.

Transition from Remittance Basis to Residence-Based Regime

Under the previous tax regime, non-domiciled individuals (non-doms) in the UK could choose to be taxed on a remittance basis, which allows them to pay tax only on their UK income and gains and on foreign income and gains when they are remitted to the UK. The remittance basis is being phased out from 6 April 2025, replaced by the new residence-based system.

The new system introduced a four-year Foreign Income and Gains (FIG) Regime, providing tax relief to individuals who become UK tax residents. Specifically:

- New UK residents who were not UK tax-resident in the previous 10 years are able to remit foreign income and gains to the UK without tax for the first four years of their UK tax residence. After this period, they will be taxed on their worldwide income and gains.
- UK-based income and gains will remain fully taxable throughout the period.

Temporary Repatriation Facility (TRF)

A Temporary Repatriation Facility will be available from 2025 to 2028, allowing individuals who have previously claimed the remittance basis to remit foreign income and gains that arose before 6 April 2025 at reduced tax rates:

- 12% for remittances in the first two years.
- 15% for remittances in the final year.

For this facility, individuals must designate the funds on their tax return for the relevant year. This designation simplifies the process, eliminating the need to identify specific sources of foreign income and gains, making it easier to manage older unremitted income.

Inheritance Tax Reforms

The government has also implemented changes to IHT rules from 6 April 2025. Under the new system, residence status is the key factor in determining exposure to IHT:

- Individuals who have been UK residents for at least 10 of the previous 20 years are considered long-term residents and are subject to IHT on their worldwide estate.
- Those who leave the UK remain within the scope of IHT for 3 to 10 years, depending on how long they were UK-resident.

Rebasing of Foreign Assets

From 6 April 2025, individuals who have claimed the remittance basis between 2017/18 and 2024/25 are allowed to rebase foreign assets to their market value as of 5 April 2017. This means that when these assets are sold, are be taxed only on the gain above their value on that date, rather than on the entire appreciation. To qualify, the individual must have held the asset on 5 April 2017, and it must have been outside the UK from 6 March 2024 to 5 April 2025.

Other Changes

Additional reforms that affect both individuals and employers:

- Income tax relief for overseas earnings have been removed for income earned on or after 6 April 2025.
- The exemption period for employer-paid travel expenses have been reduced from 5 years to 4 years, aligning with the new 4-year foreign income and gains regime.
- Overseas Workday Relief (OWR) has been extended to 4 years to match the new 4-year FIG regime. From April 2025, OWR is subject to a financial cap of £300,000 or 30% of total employment income, whichever is lower.

These reforms reflect the UK's shift toward a more streamlined, residence-based tax system, simplifying the tax treatment of non-domiciled individuals while enhancing transparency and compliance. The introduction of the 4-Year Foreign Income and Gains Regime, the Temporary Repatriation Facility, and changes to IHT aim to maintain the UK's attractiveness to international talent while aligning with global tax practices.

2. Income Tax

Income tax is the main tax levy on the UK's working population. Due to the variety of taxable earnings bands, wealth managers must invest clients into income-generating assets with care and full knowledge of their total taxable income.

2.1 Income Tax Liability

At a simple high level, income tax is calculated by adding together your sources of income and then deducting any allowances or tax reliefs to which you may be entitled.

The basic tax calculation is set out in legislation and comprises seven steps:

1. Identify and add up the amounts of income chargeable to income tax for the year to obtain 'total income'. Each of these amounts is a 'component' of total income.
2. Deduct any reliefs from each individual component to give 'net income'.
3. Deduct from the components the personal and other allowances to which the taxpayer is entitled for the tax year.
4. Calculate the tax at each applicable rate on the resulting component amounts from step 3.
5. Add together the amounts of tax calculated at step 4.
6. Deduct from the amount of tax calculated any tax reductions available.
7. Add to the amount of tax left after step 6 any other amounts of tax for the tax year (eg, pension charges such as the lifetime allowance charge).

Some of these areas will be considered in the sections which follow.

2.1.1 Taxable Income

Income tax, as the name suggests, is a tax on income. The following table shows examples of what constitute taxable income and examples of some income that is tax free.

Taxable Income and Exemptions	
Examples of taxable income include: • earnings from employment including benefits in kind such as a company car • earnings from self-employment • most pensions income including state, occupational and personal pensions • some social security benefits • interest on most savings • income from shares • rental income, and • income from a trust.	Some income is tax-free, including the following examples: • Premium Bond prizes • interest on National Savings Certificates and Children's Bonus Bonds • income from individual savings accounts (ISAs) • gambling and National Lottery wins • compensation for loss of employment of up to £30,000 and statutory redundancy payments, and • dividends on ordinary shares of a venture capital trust (VCT).

Income from pensions is taxable as are annuities derived from occupational pension schemes but there are different rules for purchased life annuities. It is possible to purchase a life annuity to give a regular income stream until death. Any receipts under an annuity are divided by HMRC into two elements – the interest element and the capital being returned. The interest element will be included in taxable income and will be taxable as with other sources of income; the capital element is not liable to tax.

In its tax calculations, HMRC distinguish between three types of income – non-savings income, savings income and dividend income. The requirement in step 1 of the basic tax calculation above identifies which of these components income falls into.

- Dividend income is all forms of dividend income, whether UK or foreign including stock dividends.
- Savings income includes bank and building society income, gilt and fixed-interest income and loan interest received, along with non-qualifying policy gains (chargeable events) and accrued income profits.
- Non-savings income might conveniently be regarded as everything chargeable as income which does not fall into the dividend income and savings categories.

2.1.2 Allowances and Deductions

As we saw above, steps 2 and 3 in a tax calculation include deductions of reliefs and allowances.

Reliefs

There are a number of deductions that an individual is allowed to make from gross income before tax is payable. Some reliefs are also available, whereby a taxpayer is allowed to deduct an amount from their tax liability prior to calculating their final liability. These are either allowances or charges on income.

Some of the main examples are as follows:

- **Personal allowance** – the personal allowance enables individuals to earn a certain amount of income each year without it falling within the income tax net. If an individual does not use up to their personal allowance in earned income, then unearned (eg, investment income) may fall within this band.
- **Contributions to a personal pension plan or a company pension scheme** – subject to certain limitations, contributions made to a self-invested pension plan (SIPP), or corporate pension scheme are permissible deductions from total income prior to arriving at taxable income.
- **Gift Aid donations** – charitable donations made by individuals on or after 6 April 2000 will be fully deductible.
- **Payroll giving** – amounts employees authorise their employer to deduct for charitable donations before calculating PAYE tax.
- **Gifts of shares, securities and other investment and land to registered charities** subject to meeting specific conditions.

Tax relief is available for interest on loans where the borrowed money is used for certain specific purposes – qualifying loan interest relief. Examples include buying shares or an interest in a **close company**, an employee-controlled company, a cooperative or a partnership. Note that interest on mortgages for owner-occupied property, overdrafts and credit cards is not allowable.

Other deductions or reliefs includes items such as professional subscriptions paid by an employee are deducted from employment income, property losses brought forward against property profits, and trade losses brought forward against adjusted trading profits. Relief would also be given in the now unusual event of gross pension contributions, for example under an old retirement annuity contract.

There is a limit on the total amount of certain tax reliefs that can be used to reduce taxable income of £50,000 or 25% of your adjusted total income if your income is over £200,000. The main limits subject to this limit are trade loss relief, property loss relief, post-cessation trade relief, share loss relief and qualifying loan interest.

Personal Allowances

Personal allowances enable individuals to earn a certain amount of income each year without being liable to income tax. Personal allowances are set against non-savings income first and if the personal allowance is not used up in full against savings income and then dividend income.

Personal Allowances						
	2020–21	2021–22	2022–23	2023–24	2024-25	2025-26
Personal allowance for those born after 5 April 1948 (1)	£12,500	£12,500	£12,570	£12,570	£12,570	£12,570
Income limit for personal allowance	£100,000	£100,000	£100,000	£100,000	£100,000	£100,000
Married couple's allowance – income limit	£30,200	£30,400	£31,400	£34,600	£37,000	£37,000
Marriage allowance (2)	£1,250	£1,260	£1,260	£1,260	£1,260	£1,260
Married couple's allowance for those born before 6 April 1935 (3) – maximum amount	£9,075	£9,125	£9,415	£10,375	£11,080	£11,270
Married couple's allowance for those born before 6 April 1935 – minimum amount	£3,510	£3,530	£3,640	£4,010	£4,280	£4,360
Blind person's allowance	£2,500	£2,520	£2,600	£2,870	£3,070	£3,130

Notes:

1. The personal allowance reduces where the income is above £100,000 – by £1 for every £2 of income above this amount. Therefore, the allowance disappears completely once someone has taxable income of £125,140, ie, 100,000 + 12,570 * 2. This reduction applies irrespective of date of birth.
2. This transferable allowance is available to married couples and civil partners who are not in receipt of the married couple's allowance. An individual transferring, who is not liable to income tax or not liable at the higher or additional rates, can transfer up to this amount of their unused personal allowance to their spouse or civil partner. The recipient must not be liable to income tax at the higher or additional rates.
3. The relief for this allowance is given at 10% (it applies to both the maximum and minimum amounts).

There are also tax-free allowances for:

- **Personal savings** – basic rate taxpayers are exempt from paying tax on the first £1,000 of their savings income, while higher rate taxpayers are exempt on the first £500 of their savings income.
- **Dividends** – no tax is paid on the first £500 of dividends.
- **Self-employment** – no tax is paid on the first £1,000 of income; this is the 'trading allowance'.
- **Rental property** – no tax is paid on the first £1,000 of income (unless the Rent a Room Scheme is being used).

2.1.3 Tax Rates and Tax Reductions

Having arrived at taxable income, the next stage is to calculate the tax liability at the rate applicable for each component.

Income Tax Rates and Taxable Bands							
	Tax Rate	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26
Starting rate for savings	0%	£0–£5,000	£0–£5,000	£0–£5,000	£0–£5,000	£0–£5,000	£0–£5,000
Basic rate	20%	£0–£37,500	£0–£37,500	£0–£37,700	£0–£37,700	£0–£37,700	£0–£37,700
Higher rate	40%	£37,501–£150,000	£37,501–£150,000	£37,701–£150,000	£37,701–£150,000	£37,701–£125,140	£37,701–£125,140
Additional rate	45%	Over £150,000	Over £150,000	Over £150,000	Over £150,000	Over £125,141	Over £125,141

The rates of tax applicable to dividends over the allowance are 8.75% basic rate, 33.75% higher rate and 39.35% additional rate.

The components are taxed in order – non-savings income first, then savings income and then dividend income. If there are any chargeable event gains they form the top tranche.

There are different rates in Scotland. The Scotland Act 2016 provides the Scottish Parliament with the power to set all income tax rates and bands except the personal allowance, which remains reserved.

The rates that apply to Scottish taxpayers' non-savings and non-dividend (NSND) income is shown in the following table.

Scottish Rates and Bands 2025–26		
Band	Taxable Income	Rate
Personal allowance	Up to £12,570	0%
Starter rate	£12,571 to £15,397	19%

Basic rate	£15,398 to £27,491	20%
Intermediate rate	£27,492 to £43,662	21%
Higher rate	Over £43,663 to £75,000	42%
Advanced rate	Over £75,001 to £125,140	45%
Top rate	Over £125,140	48%

HMRC will determine whether or not you are a Scottish taxpayer based on where your main place of residence is.

While the Scottish Parliament has the power to set the Scottish income tax rates and bands HMRC will continue to be responsible for its collection and management. As such Scottish income tax remains part of the existing UK income tax system and is not a devolved tax.

As we saw earlier, step 6 reduces the total tax by reference to the so-called tax reducer – reliefs which are defined in terms of the tax saving. Examples include the enterprise investment scheme, the seed enterprise investment scheme and venture capital trust (VCT) reliefs. These are considered below in section 2.3.

2.2 Income from Property, Savings and Dividends

Property, savings and dividend income have their own detailed provisions which are noted below.

2.2.1 Income from Property

Rental income on residential property is taxed at normal income tax rates. If an individual rents out a residential property, they will be treated as running a business, and they should report the rental income on their tax return (there is an exemption for people renting out a room in their own home, under the rent-a-room scheme, where someone can earn up to £7,500 pa tax free).

The tax payable will be based on the investor's net income profit from the activity:

Net income profit = Total rental income – Total allowable expenses

Allowable expenses include the actual cost of replacing furnishings in the rented property or room that have become unusable and have had to be replaced.

As of the 2020–21 tax year and onwards, all landlords of residential property in or outside the UK receive the same rate of tax relief on their finance costs (eg, mortgage interest) – equivalent to the basic rate of 20%. This applies regardless of whether the landlord is a higher or additional rate taxpayer.

Rental profits from commercial property are taxed in the same way as any other rental income. As with residential property, an investor is entitled to a deduction against the rental income for the general costs of running the commercial property (eg, repairs). With this type of property, the investor is entitled to various capital allowances that vary depending on the nature of the capital item involved.

2.2.2 Savings Income

Savings income includes interest from:

- bank and building society accounts
- accounts with providers like credit unions or National Savings and Investments (NS&I)
- interest distributions (but not dividend distributions) from authorised unit trusts, open-ended investment companies and investment trusts
- interest payments on government or company bonds, and
- most types of purchased life annuity payments.

The personal savings allowances for the tax year 2025–26 are:

- basic-rate (20%) taxpayers can earn up to £1,000 interest with no tax (so a maximum tax saving of £200 compared with before)
- higher-rate (40%) taxpayers can earn up to £500 interest with no tax (so a maximum tax saving of £200 compared with before)
- additional-rate (45%) taxpayers do not receive an allowance.

Interest from ISAs does not count towards the personal savings allowance as it is already tax-free. The same is the case for interest from NS&I Fixed Interest Savings Certificates and Index-linked Savings Certificates and prizes won from Premium Bonds.

Unit Trust and OEIC Distributions

Distributions from unit trusts and OEICs can be either a dividend distribution or an interest distribution which fall to be treated as either savings income or dividend income.

A fund may pay an interest distribution instead of a dividend distribution only where it satisfies the qualifying investments test at all times throughout the distribution period: that the market value of its qualifying investments exceeds 60% of all its investments. Qualifying investments are investments that yield interest or ones of a similar nature.

There are a number of other scenarios to be aware of as shown in the table below.

Other Distributions from Unit Trusts and OEICs	
Tax Elected Funds (TEF) Regime	• An investment fund may choose to pay both a dividend distribution and an interest distribution. • Under the TEF regime a fund is required to identify the different components of its income and to attribute the income between dividends and interest. • It then makes two types of distribution: a dividend distribution and a non-dividend distribution. Investors are then taxed as though they have received a dividend and a payment of interest.
Property Authorised Investment Funds Regime (PAIF)	• Where an investor holds a unit trust or OEIC that invests in property, the distributions from the fund may be treated as rental income for tax purposes. • A property fund has to elect to be treated under the PAIF regime and meet certain conditions including deriving at least 60% of its net income from property business. • Other income will arise in the fund such as interest on funds held pending investment or dividends on property investments so investors may receive three different types of distribution: ◦ a **property income distribution (PID)** ◦ an interest distribution, and ◦ a dividend distribution.
Equalisation Payments	• When a unit trust or OEIC is purchased, part of the next distribution may be classed as equalisation. • Details of the dividend payment will show the breakdown between group 1 and 2 units. Group 1 units are the units held at the beginning of the period and group 2 units are the units bought during the distribution period. • For group 2 units, the amount of equalisation applicable to those units is shown. • HMRC recognises the equalisation payment as a return of capital and so it is not liable to income tax. • It is a return of the initial price paid and it should, therefore, be deducted from the price paid when calculating the chargeable gain on eventual disposal.

Accrued Income Scheme

The accrued income scheme applies to interest payments on government and corporate bonds and determines how the **accrued interest** is taxed when purchases, sales or transfers take place.

When a bond trade is settled, accrued interest is calculated and is either added to (if selling the bond) or deducted from the consideration (if buying). Its tax treatment is as follows:

- The seller receives the accrued interest gross, so is liable to pay income tax on that amount.
- The buyer will receive the full amount of the next interest payment but has already had to pay the accrued interest to buy the holding. The buyer can, therefore, deduct the accrued interest from the next interest payment.
- If the trade takes place on an ex-interest basis, then a similar approach is adopted except this time rebate interest is paid by the seller.

Accrued Income Scheme	
Seller	• **Cum-interest sales** – if accrued interest is added to the price you receive, then tax is payable on that amount. • **Ex-interest sales** – if accrued interest is deducted from the price, you get a deduction for that amount against the next payment of interest.
Buyer	• **Cum-interest purchases** – if accrued interest is added to the price you pay, you get a deduction for that amount against the next payment of interest. • **Ex-interest purchases** – if accrued interest is deducted from the price you pay, you are taxed on that amount.

It is important to note that the interest is taxed in the year in which it is due not when the trade takes place.

The accrued income scheme does not apply where the total nominal value of securities held is less than £5,000. This exemption only applies to individuals, personal representatives and trusts for disabled people – not to other trusts.

2.2.3 Dividend Income

An investor in a company has the right to share in profits and does so by receiving dividends. Dividends are paid out of the profits of a company after any liability to corporation tax has been paid so they are treated in a different way for tax purposes to recognise that this is the case.

The allowance is available to anyone who has dividend income. Individuals pay tax on any dividends they receive over the allowance at the tax rate applicable (after deduction of personal allowance/blind person's allowance).

The rate of tax that is paid on dividends then depends upon whether the individual pays tax at the basic rate, higher rate or additional rate of tax. The dividend tax rates are covered in the Tax Rates and Tax Reductions above (section 2.1.3).

You should note that dividends payable by VCTs are not liable to income tax. VCTs are a special type of HMRC approved investment trust designed to encourage investment in small, unlisted companies – hence the tax benefits they are given.

2.2.4 Overseas Income

When a UK resident receives income from overseas, then they will be liable to UK income tax. Unless, the UK taxpayer has already paid tax to an overseas government or the gross payment will have been subject to a withholding tax, which is imposed by a foreign country on dividends or income received by individuals who are not resident in that country.

Income will often be paid via a UK paying agent. The agent is required to deduct UK tax. If overseas tax has already been paid, the paying agent will reduce the amount of UK tax deducted at source to allow for this.

Overseas income is taxed on an actual year basis, with the assessment being based on income arising in the year of the assessment. In other words, for most people, it is taxed in the year in which it arises, whether remitted to the UK or not. If the amount received is a pension from overseas, a 10% deduction may be made before arriving at the taxable amount of income.

Double taxation agreements (DTAs) exist between many jurisdictions and are designed to avoid an individual paying tax twice on the same source of income. Even where a DTA does not exist, the UK Government will usually give relief unilaterally to such an individual to avoid double taxation arising.

The fundamental premise of overseas tax relief is that any overseas tax paid is deducted from the total UK income tax liability, which is calculated including the overseas income on a gross basis, ie, before the overseas tax was deducted. The relief given is the lower of the overseas tax suffered and the UK tax on the overseas income.

2.2.5 Investment Bond Gains

Income tax on investment bond gains differ depending upon whether it is an onshore bond or offshore bond.

Onshore Bonds

Individuals liable to tax on a gain on an onshore bond are treated as having paid tax on the gain at the basic rate of tax as the underlying insurance fund is liable to corporation tax on income and gains within the fund. This tax credit satisfies the income tax liability for non- and basic-rate taxpayers so that further tax is only payable if the gain when added to all other income in the tax year falls into the higher or additional rate band. As a result, tax is only payable by those individuals with a marginal rate of 40% or 45%; top-slicing relief can reduce the tax on gains where a gain takes an individual into the higher or additional tax bracket.

Individuals do not pay tax on a bond until a chargeable event occurs; the main chargeable events are shown below.

Part surrenders	• Up to 5% of the amount invested can be withdrawn each policy year (less any adviser charging set up on the plan) without creating a chargeable event. If the tax-deferred allowance is not fully used in one policy year, any unused amount can be carried forward subject to it not exceeding 100% of the amount invested. • If more than the cumulative 5% tax deferred allowance is taken, the excess is taxable as a gain and is assessed in the tax year that the policy year ends and not when the withdrawal took place.
Full surrender	• When a bond or an individual segment is fully surrendered, any gain will be assessed in the tax year of surrender. • The chargeable gain = the proceeds + withdrawals (part surrenders) – amount invested – previous gains.
Death of the last life assured	• The chargeable gain is calculated in the same way as a full surrender and is assessable in the tax year that the death took place. The proceeds are treated as the surrender value at the date of death as opposed to the death benefit actually paid. • If a bondholder dies and there are still surviving lives assured, this is not a chargeable event as the bond can continue.
Assignment	• An assignment of a bond may take place where there is a gift or a trustee assigns the bond to an adult beneficiary. This is not treated as a chargeable event and instead the person receiving the bond is treated as if they have always owned it. • Assignments for money or money's worth are less common but are chargeable events that have their own specific rules.

Bond gains are aggregated with all other savings income and so the personal savings allowance is available. There is no relief under the chargeable event regime for an investment loss on a bond, and a loss on one bond cannot be set against a gain on another. When a chargeable event takes place, the insurance company will issue a chargeable event certificate, providing the details that need to be notified to HMRC.

- For non-taxpayers and basic-rate taxpayers, no further tax is due unless the gain takes them into the higher-rate bracket. If the gain takes an individual's income above the higher-rate threshold, then top-slicing relief can be used to reduce the amount of tax due. Note that top-slicing is not available to trustees or personal representatives.
- For higher and additional-rate taxpayers, any chargeable event will be subject to tax at the difference between the higher/additional rate and the basic rate so they may be liable to pay a further 20% or 25% respectively. Top-slicing relief may be available if the gain means that the personal allowance is tapered or it takes an individual's income into the additional-rate tax bracket.

If the investor chooses not to top-slice, the full chargeable gain is added to their other income in the tax year in which the gain arose, and tax is calculated in the normal way.

In calculating top-slicing relief, there are some important differences to the standard tax calculation rules:

- Investment bond gains are treated as the highest part of income.
- Both onshore and offshore bonds are deemed to have had tax treated as paid at 20% (this amount is reduced if any part of the bond gain falls within the personal allowance).
- Since 11 March 2020, the personal allowance used when calculating the tax on the averaged gain has been based on the income plus the average gain. So, it is the averaged gain that is added to other income to determine if income exceeds £100,000 and the personal allowance is to be tapered.

The five-step process adopted by HMRC is as follows:

Step 1	Calculate the total taxable income for the tax year and identify how much of the gain falls within the various allowances and relevant tax bands.
Step 2	Calculate the total tax due on the gain across each tax band and deduct the basic-rate tax treated as paid to find the individual's liability for the year. (Note: basic-rate tax is also deducted for offshore bonds for purposes of the top-slicing relief calculation.)
Step 3	Calculate the annual equivalent of the gain.
Step 4	Calculate the individual's liability to tax on the annual equivalent, recalculating the personal allowance where appropriate. Deduct basic-rate tax treated as paid on the annual equivalent and multiply the result by the number of complete policy years to give the individual's total relieved liability.
Step 5	Deduct the individual's relieved liability (the figure determined at step 4) from the individual's liability (step 2) to give the amount of top-slicing relief.

To explain these steps further, examples are shown below of the required calculation.

Gain Moves a Client into the Higher-Rate Tax Bracket

Assume that a client has earned income after personal allowances of £35,000 and encashed an investment bond that had been held for seven policy years and which gives rise to a chargeable event of £28,000. The gain arises in 2025–26 when the basic-rate band is £37,700.

In step 1, all income is added together to determine the entitlement to the personal allowance, personal savings allowance, and the starting-rate band for savings. Income tax is calculated using the normal order of income rules and unused allowances can be set against bond gains.

Step 1	Calculate the total taxable income for the tax year and identify how much of the gain falls within the various allowances and relevant tax bands.			
	Source	£	Rate/ Factor	£ Liability (tax due)
	Employment	35,000	20%	7,000
	Chargeable event gain:			
	• Personal savings allowance	500	0%	0
	• Basic-rate liability (Basic-rate band – earned income – personal savings allowance)*	2,200	20%	440
	• Higher-rate liability**	25,300	40%	10,120
	Total Liability			17,560

* The basic rate liability is calculated as follows: (37,700 – 35,000 – 500) x 20%.
** The higher rate liability is calculated as follows: (28,000 – 2,200 – 500) x 40%.

Step 2 brings forward the total tax due on the gain across all tax bands and then deducts the tax treated as paid to give the individual's total liability on the gain.

Step 2	Calculate the total tax due on the gain across each tax band and deduct the basic rate tax treated as paid to find the individual's liability for the year			
	Total tax due on the bond gain (A)			10,560
	Tax treated as paid on the gain (B)	28,000	20%	5,600
	Total liability on the gain (A–B)			4,960

Step 3 then converts the chargeable event amount into an annual equivalent of the gain.

Step 3	Calculate the annual equivalent of the gain.			
	The annual equivalent (total gain divided by the number of years the policy has been in force)	28,000	7	4,000

Step 4 calculates relieved liability. Taxable income plus the annual equivalent is taxed with the gain treated as the highest part of income this time. The relieved liability is the tax on the annual equivalent slice of income multiplied by the number of policy years.

Step 4	Calculate the individual's liability to tax on the annual equivalent, recalculating the personal allowance where appropriate. Deduct basic rate tax treated as paid on the annual equivalent, and multiply the result by the number of complete policy years to give the individual's total relieved liability.			
	Taxable income (A)			35,000
	Annual equivalent (B)			4,000
	A+B			39,000
	Tax on the top slice:			
	• Personal savings allowance amount	500	0%	0
	• Basic-rate tax (basic-rate band – earned income – personal savings allowance)	2,200	20%	440
	• Higher-rate tax (annual equivalent amount – personal savings allowance amount – basic-rate band amount)	1,300	40%	520
	Tax on the slice			960
	Tax treated as paid on the slice (annual equivalent amount at 20%)	4,000	20%	800
	Tax relieved liability (tax on the slice less tax treated as paid on the slice)			160
	Total relieved liability*	160	7	1,120

* The total relieved liability is calculated as follows: (960 – 800) x 7; where 7 is the number of policy years.

Step 5 then brings the earlier calculations back together to calculate the top-slicing relief due, which is the total liability calculated in step 2 less the relieved liability calculated in step 4.

Step 5	Top-slicing relief due (difference between the total liability on the gain and the total relieved liability)			
	Total liability on the gain (step 2)			4,960
	Total relieved liability (step 4)			1,120
	Top-slicing relief			3,840

The client's income tax liability can then be recalculated by deducting the top-slicing relief from the total liability calculated in step 1 and then deducting the basic-rate tax treated as paid on the gain.

Client's liability to income tax after top-slicing relief is:			
Total liability			17,560
Less top-slicing relief			3,840
			13,720
Basic-rate tax credit (surrender value at 20%)	28,000	20%	5,600
Overall liability is reduced to			8,120

Gain Means that the Personal Allowance is Reduced

The changes made to the way in which top-slicing relief is calculated affect the personal allowance available for use in the top-slicing calculation. When the relieved liability is calculated, it is the annual equivalent that is added to other income to determine if income exceeds £100,000 and the personal allowance is to be tapered.

The example below illustrates this for a client with employment income of £60,000 and a bond gain of £50,000 over ten years that arises in 2025–26, when the basic-rate band is £37,700 and the full personal allowance is £12,570.

In step 1, total taxable income is calculated using the full bond gain and so the personal allowance is reduced by £5,000 as total income exceeds the £100,000 threshold, leaving an available personal allowance of £7,570.

Step 1	Calculate the total taxable income for the year and identify how much of the gain falls within the relevant tax bands			
	Source		Rate	Tax due
	Employment income:			
	• Personal allowance amount	7,570	0%	0
	• Basic-rate income	37,700	20%	7,540
	• Higher-rate income	14,730	40%	5,892
		60,000		13,432
	Chargeable event gain:			
	• Personal savings allowance	500	0%	0
	• Higher-rate band	49,500	40%	19,800
	Total liability			33,232

Steps 2 and 3 follow the same basis of calculation as seen earlier.

Step 2	Calculate the total liability for the year			
	Tax liability on the gain			19,800
	Less basic-rate tax treated as paid (gain at 20%)	50,000	20%	10,000
	Total liability (tax liability on the gain less tax treated as paid)			9,800
Step 3	Calculate the annual equivalent			
	The annual equivalent is the total gain divided by the number of years the policy has been in force	50,000	10	5,000

In step 4, the relieved liability is calculated using the annual equivalent, which means the personal allowance is reinstated in full.

Step 4	Find the total relieved liability			
	Taxable income			60,000
	Plus annual equivalent			5,000
				65,000
	Tax on employment income:			
	• Personal allowance amount	12,570	0%	0
	• Basic-rate income	37,700	20%	7,540
	• Higher-rate income	9,730	40%	3,892
		60,000		11,432
	Tax on the top slice:			
	• Personal savings allowance amount	500	0%	0
	• Higher-rate tax (annual equivalent amount – personal savings allowance amount)	4,500	40%	1,800
	Tax on the slice			1,800
	Tax treated as paid on the slice (annual equivalent amount at 20%)	5,000	20%	1,000
	Tax relieved liability (tax on the slice less tax treated as paid on the slice)			800
	Multiplied by number of policy years	800	10	8,000

As before, the top-slicing relief due is then calculated in step 5.

Step 5	Top-slicing relief due (difference between the total liability and the total relieved liability)			
	Total liability			9,800
	Relieved liability			8,000
	Top-slicing relief			1,800

The client's income tax liability can then be recalculated by deducting the top-slicing relief from the total liability calculated in step 1 and then deducting the basic-rate tax treated as paid on the gain.

Client's liability to income tax after top-slicing relief is:			
Total liability			33,233
Less top-slicing relief			1,800
			31,432
Basic-rate tax credit (surrender value at 20%)	50,000	20%	10,000
Overall liability is reduced to			21,432

Example – Gain Means that the Client Moves into the Additional-Rate Tax Bracket

If a client has a sufficient gain on an investment bond to push them into the additional-rate tax bracket, they lose the personal allowance and the personal savings allowance. This time the personal allowance is reinstated at step 4, but the personal savings allowance is not available.

Offshore Bonds

Offshore bonds can be issued by life companies in countries that impose no tax on the income and gains of the underlying funds known as gross roll up. When an offshore bond is surrendered, the gain is chargeable to income tax in the same way as discussed above, but it clearly does not benefit from basic-rate tax credit, but top-slicing relief is available.

If we use example 1 from above, but assume that the bond was an offshore bond, the five steps would have been identical. The change would have been that no basic-rate credit is due so the client's liability after top-slicing relief would have simply been the total liability of £17,560 less the top-slicing relief of £3,840 to give a tax liability on the bond gain of £13,720.

Summary

When calculating top-slicing relief, the key points to remember are:

- Top-slicing relief aims to put the taxpayer back into the position they would have been if the gain had been taxed annually over the investment period.
- Top-slicing relief is only available where some part of the full gain is subject to tax at the higher or additional rate.

- The starting rate for savings and the personal savings allowance need to be considered.
- It is the personal allowance that is recalculated for step 4 only.
- Within the calculation of top-slicing relief, reliefs and allowances available must be set-off, as far as possible, against other income in preference to the bond gain.

2.3 Tax Reliefs for Venture Capital Schemes

Venture capital schemes offer tax relief to individuals to encourage them to invest in small unquoted trading companies or social enterprises who are looking to grow by attracting investment. They offer tax reliefs to individuals who buy and hold new shares, bonds or assets for a specific period of time and are sometimes known as tax advantaged venture capital schemes.

2.3.1 Venture Capital Schemes

There are four schemes that attract specific relief:

1. The Enterprise Investment Scheme (EIS).
2. Venture Capital Trust (VCT).
3. The Seed Enterprise Investment Scheme (SEIS).
4. Social Investment Tax Relief (SITR).

EISs and VCTs

EISs and VCTs have traditionally been grouped together because they encourage investment in small, unquoted trading companies and have certain legislative features in common. The EIS is designed to help these small companies raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies. The VCT scheme spreads the investment risk over a number of companies; they are similar to investment trusts and are listed on the London Stock Exchange.

The money raised must be used for a qualifying trade or research and development that is expected to lead to a qualifying trade. Most trades qualify, but some which are termed 'excluded activities' do not. For example, dealing in land or commodities, financial activities and property development are all excluded activities. A company can carry on some excluded activities, but these must not be 'substantial', which HMRC takes to mean as more than 20% of the company's activities.

A company can use the scheme provided it does not have gross assets worth more than £15 million and not more than £16 million afterwards and has fewer than 250 full-time equivalent employees. The maximum amount to be raised is £5 million in any one 12-month period. There are different limits for knowledge intensive companies – cap on total investment of £20 million and fewer than 500 employees.

SEIS

The SEIS was introduced from 6 April 2012 to encourage investment in new start-up companies. It enables companies to raise up to a maximum of £150,000 by issuing new shares subject to certain conditions.

2.3.2 Tax Reliefs

Depending on the scheme, the investor may be able to claim:

- Income tax relief against an investment in qualifying companies, enterprises or VCTs.
- Income tax relief against a loan or debt instrument to a social enterprise.
- Capital gains tax relief on any gains made on the investment.
- Capital gains tax relief when you reinvest a previous gain in a scheme.

Principles-Based Test

In the 2017 Budget, the UK government announced new qualifying conditions – a principles-based test which is used to determine if the company is a genuine entrepreneurial company.

The measure introduced a new condition to the EIS, SEIS and VCT rules to exclude tax motivated investments, where the tax relief provides most of the return for an investor with limited risk to the original investment.

The test takes a view as to whether an investment has been structured to provide a low risk return for investors and assesses whether the company has objectives to grow and develop over the long term and whether there is a significant risk of loss of an investor's capital greater than the net return.

The following table shows how the schemes compare for income tax relief:

Tax Reliefs				
	EIS	**SEIS**	**SITR**	**VCT**
Income Tax				
Maximum annual investment	£1 million	£200,000	£1 million	£200,000
Tax relief	30%	50%	30%	30%
Dividends	Taxable	Taxable	Taxable	Exempt
Minimum holding period	Three years	Three years	Three years	Five years
One-year carry back	Yes	Yes	Yes	No
Capital Gains Tax				
Gains	Exempt after three years	Exempt after three years	Exempt after three years	Exempt
Losses set off against income	Yes	Yes	No	No
Deferral relief	Yes	See below	Yes	No

Notes:

- The maximum investment in an EIS is £2 million if at least £1 million of that is invested in knowledge intensive companies.
- You can only claim relief against the amount of income tax you need to pay in the UK. You cannot carry forward unused income tax relief to future tax years.
- To qualify for relief, the investment must be retained for the holding period. You lose the relief if you sell the shares during this time, the company fails to meet the conditions for the scheme or you become connected with the company.
- For EIS, SEIS and SITR you can either claim relief in the tax year you make the investment or in the previous year. If you invest in a VCT, you can only claim tax relief in the year you invest.
- There is no CGT on gains on sale of shares in EIS, SEIS or SITR companies provided you have received income tax relief and held the shares for the minimum period. Gains on VCTs are exempt.
- If you sell your shares at a loss, you can choose to set the loss amount, less any income tax relief already given, against your income. You can do this for the tax year that you sold the shares or the tax year before. It does not apply to losses on VCTs.
- Gains on a sale of an asset to invest an EIS can be deferred until disposal of the EIS. For SITR, this is limited to investments up to £1 million. If you sell an asset to invest in a SEIS, the gain is exempt; you can get this CGT reinvestment relief on 50% of the investment up to £100,000 with a maximum amount of £50,000.
- SITR is no longer available for new investments made after 5 April 2023. This means that any investments in social enterprises made on or after 6 April 2023 will not qualify for the tax benefits previously offered under the SITR scheme.

2.3.3 EISs

The EIS is designed to help smaller, higher-risk trading companies to raise finance, by offering a range of tax reliefs to investors who purchase new shares in those companies. Companies that wish to issue shares under the scheme have to meet a certain number of rules regarding the kind of company they are, the amount of money they can raise, how and when that money must be employed for the purposes of the trade, and the trading activities carried on.

An investor receives tax advantages when investing in EIS companies, providing that they invest in fully paid ordinary shares that carry the full risk of ordinary shares and carry no preferential rights that protect the investor from the normal risks of investing in shares. Investment can be directly into the company, or through an EIS fund, which will invest on behalf of the individual in a number of qualifying companies.

EIS Reliefs	
Income tax relief	• The maximum investment is £1 million; this is increased to £2 million for investment in knowledge-intensive companies. • Relief is given at 30% of the cost of the shares which is set against the individual's income tax liability for the year of assessment in which the shares are issued. • There is a carry back facility which allows all or part of the cost of shares acquired in one tax year to be treated as if acquired in the preceding tax year, with relief then given against the income tax liability of that preceding year. • EIS shares must be held for three years from the date of issue or the start of trade if later; otherwise income tax relief will be withdrawn. Relief will also be withdrawn if the investor becomes connected with the company or the company loses its qualifying status.
CGT deferral relief	• Deferral relief can be claimed against any amount of chargeable gain arising on the disposal of any asset where the gain is invested in EIS shares. It can also be claimed when a gain previously deferred under the EIS is brought back into charge. • The investor can claim deferral relief on only part of the gain if desired. • The effect is to defer the tax liability until the EIS shares are sold or deemed sold. • The investment must be made within the period one year before or three years after the gain arose.
CGT disposal relief	• Any gain on disposal is exempt provided the investor has received income tax relief and this has not been withdrawn. It is also provided that the shares have been held for the required three year period. • An investor can claim a capital loss on disposal but in calculating the loss, the allowable cost is reduced by the income tax relief.
Income tax relief for losses	• If the shares are disposed of at a loss, the investor can elect that the loss is set against income instead of being offset against any capital gains. • The amount of the loss is less any income tax relief. It can be set against income of the year in which the shares were disposed of, or any income of the previous year.

2.3.4 VCTs

VCTs are companies listed on the LSE and are similar to investment trusts. They are designed to enable individuals to invest indirectly in a range of small higher-risk trading companies, whose shares and securities are not listed on a recognised stock exchange, by investing through VCTs.

Investment in VCTs attracts special tax advantages and so the companies need to gain HMRC approval to be treated as such. Once approved, VCTs are exempt from corporation tax on any gains arising on the disposal of their investments.

Tax reliefs are only available to individuals aged 18 years or over and not to trustees, companies or others who invest in VCTs.

VCT Reliefs	
Income tax relief	• A 'front end' tax relief is available at 30% of the cost of new ordinary shares subscribed for up to the permitted maximum of £200,000, to be set against the individual's income tax liability for the year of assessment in which the shares are issued. • The relief will be withdrawn, in whole or in part, if the shares are disposed of within five years of issue or where the VCT loses its approval. • A disposal between spouses or civil partners who are living together does not give a rise to a withdrawal of relief, nor does death of the investor.
CGT disposal relief	• There will be no chargeable gain or allowable loss for CGT purposes on selling ordinary shares in a VCT. • There is no minimum period for which the shares must be held.
Dividend relief	• Dividends received from VCT shares are exempt from income tax in respect of shares acquired within the permitted maximum of £200,000.

2.3.5 SEISs

6 April 2012 saw the launch of the EIS's and the VCT's little cousin, the Seed Enterprise Investment Scheme (SEIS). It complemented the EIS scheme and was predominantly designed to stimulate entrepreneurship and to help small, early-stage companies to raise equity finance.

SEIS Tax Reliefs	
Income tax relief	• Income tax relief is available on the initial investment at the rate of 50% of the aggregate amounts of shares issued in the tax year subject to a maximum of £100,000. So, for example, if you subscribed £50,000 for shares in four companies the total investment would be £200,000 but you are limited to claiming relief to a maximum of £100,000. • The shares must be held for at least three years.
CGT reinvestment relief	• Where an asset is disposed of to invest in a SEIS, reinvestment relief can be claimed. • Reinvestment relief enables an individual that has disposed of an asset – that would give rise to a chargeable gain – to treat a maximum of 50% of the gain as exempt from CGT, where they have reinvested all or part of the amount of the gain in qualifying SEIS shares. • You can claim reinvestment relief only of income tax relief is given.
CGT disposal relief	• If you dispose of SEIS shares and a gain arises, you can make a claim to treat 50% of the gain as exempt from CGT up to a maximum of £50,000. • If you make a loss on a disposal of your SEIS shares, you can set this loss against your chargeable gains. In computing the loss, you must reduce the cost of your shares by the amount of any income tax relief given and not withdrawn.

3. Capital Gains Tax (CGT)

CGT is a tax that is imposed on the gain that is made when an asset is sold or disposed of.

Individuals that are resident in the UK are known as chargeable persons for CGT purposes. Chargeable persons are potentially liable to CGT on capital gains made on the disposal of chargeable assets regardless of where in the world the capital gain arose. Liability to CGT was extended from April 2015 to make non-UK residents liable to CGT on the gains made when selling UK residential properties.

When an individual buys an asset and disposes of it at a profit, the difference between its acquisition cost and disposal value is taxed as a capital gain. Individuals pay CGT on their net chargeable gains – that is, the gains they have made less any losses realised – in a relevant tax year, less unrelieved losses brought forward from previous years and the annual exemption. Each tax year there is a tax-free allowance and certain additional reliefs that can be claimed before the tax becomes payable.

In the following sections, we will look at which assets are chargeable, what constitutes a disposal, and how a gain is calculated and the allowances and reliefs available.

3.1 Chargeable Assets

Individuals that are resident and ordinarily resident in the UK are known as 'chargeable persons' for CGT purposes. Chargeable persons are potentially liable to CGT on capital gains made on the disposal of chargeable assets regardless of where in the world the capital gain arose.

Most assets are liable to CGT when they are sold or disposed of. This includes shares, property, business assets and personal possessions whether they are in the UK or overseas.

Chargeable Assets	
Shares and bonds	• Disposals of shares, unit trusts, OEICs and similar investments are liable to CGT. • Certain types of bonds, such as **convertible bonds**, are also liable to CGT.
Property	• Most property is liable to CGT except for an individual's main home which qualifies for private residence relief. • The types of property liable to CGT include: ◦ a second home ◦ a rented property ◦ business premises, such as offices, a shop or a farm, and ◦ land such as agricultural or building land.
Personal possessions	• Most personal possessions worth more than £6,000 are liable to CGT. This applies to individual possessions and collections or sets worth £6,000 as a whole. • Personal possessions liable to CGT include works of art, collector's items and antiques.

Chargeable Assets	
Business assets	• Many business assets are liable to CGT including buildings, equipment, fixtures and fittings goodwill. • However, there are tax reliefs that can reduce the amount of CGT payable, such as business asset rollover relief and business asset disposal relief (formerly known as entrepreneur's relief).
Overseas assets	• Someone who is resident in the UK is liable to CGT on the disposal of overseas assets. • Typical overseas assets include a holiday home abroad, land and foreign shares.

Exempt Assets

Certain assets are exempt such as an individual's main home or car and so are not liable to CGT. Examples of exempt assets are shown below.

- Gilts and **qualifying corporate bonds (QCBs)**.
- Assets held in an ISA or an approved pension arrangement.
- EIS and VCT investments subject to being held for a qualifying period.
- An individual's nominated main or principal private residence.
- Jewellery, paintings, antiques and other personal effects that are individually worth £6,000 or less.
- Betting, lottery or pools winnings.
- Personal injury compensation.
- Foreign currency bought for personal use outside the UK.

As you can see from the above, certain types of bonds are chargeable to CGT while others are exempt. For example, gilts and most sterling corporate bonds that are 'qualifying bonds' are exempt and are known as qualifying corporate bonds. A qualifying corporate bond is one that meets certain qualifying conditions set by HMRC. Any profit on its sale or disposal is exempt from CGT and any loss is not an allowable loss. Most sterling bonds, securities, debentures, loan notes and **loan stock** are qualifying corporate bonds.

A bond is typically a chargeable asset where the instrument incorporates a provision that gives the holder a right to:

- convert the bond into the shares of the company
- subscribe for additional securities, and
- require **redemption** in a foreign currency.

3.2 Chargeable Disposals

CGT arises when a chargeable asset is disposed of. The following constitutes a disposal:

- A sale.
- The giving-away of an asset as a gift.
- The transfer of an asset to someone else.

- The exchange of an asset for something else.
- The receipt of compensation for an asset, such as receiving an insurance payout when an asset has been destroyed.

A sale of some shares will represent a disposal and whether a gain or loss arises will depend on the difference between the proceeds of sale and what the shares cost after allowing for costs. A sale of an asset is the most obvious way in which an asset is disposed of but as you can see the CGT rules also include other types of transactions within this definition.

Gifts constitute disposals and so may give rise to a chargeable gain. If someone gives away some shares to another person, this may constitute a disposal and the gain will be the difference between the value at which the shares were acquired and their market value at the time of disposal.

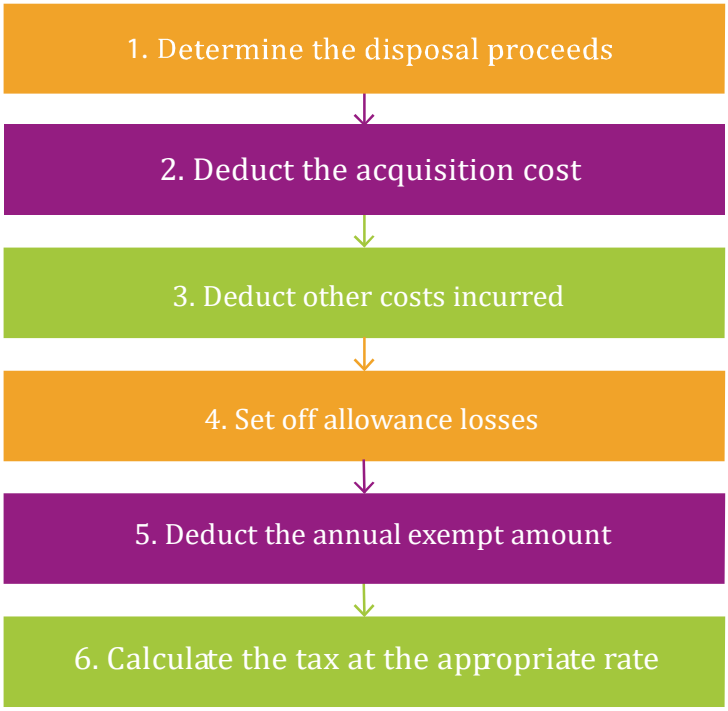
Where the transfer, however, is between spouses or civil partners the transfer is not a chargeable event. Disposals between spouses living together do not give rise to chargeable gains or allowable losses so the transfer gives rise to neither a gain nor a loss. The market value rules do not apply and instead, it is treated as if the asset had been transferred at its original cost.

There is also an exemption where gifts are made to charity. The other main occasion when a gain does not arise is on death.

3.3 Calculating CGT

To calculate whether CGT is payable the gain or loss arising on the sale of each investment is totalled and from this is deducted any allowable losses and the annual exemption. The steps involved in the calculation are shown below.

Calculating Chargeable Gains



3.3.1 Step 1: Determine the Disposal Proceeds

The disposal proceeds will normally be the price at which shares are sold and is the amount received after payment of broker's commission.

An exception is where the shares have lost all or most of their value, when it may be possible to make a claim that the shares are worthless or almost worthless. This is known as a 'negligible value claim'. Investors then use the amount specified in the claim. HMRC keeps a list of shares with negligible value[1].

For gifts and similar scenarios, the market value of the shares is used instead of the sale price. The market value is the price the shares might reasonably be expected to have fetched on a sale in the open market.

The market value of the shares is used instead of the sale price if, for example:

- the investor gives the shares away
- the investor intentionally sells or disposes of the shares for less than they are worth, or
- they sell or dispose of the shares to a 'connected person', such as a close relative or a company they control.

3.3.2 Step 2: Deduct the Acquisition Cost

Identifying the acquisition cost used to be a challenge due to the different regimes that have been in place over the years since CGT was introduced. This was simplified, however, with effect from 6 April 2008, when the concept of the 'Section 104 holding' was introduced.

Since then, all shares of the same class in the same company are treated as part of a Section 104 holding.

- The costs of all purchases are added together and each share is treated as if they were acquired at the same average cost.
- There is, therefore, a single pool of expenditure usually representing the actual cost of the shares.
- The exception is any shares held on 31 March 1982. Any investments held at that date are revalued at market value as at 31 March 1982 to create a single pool of shares. The Section 104 holding then consists of assets valued at 1982 plus actual costs for subsequent purchases.
- The pool is then adjusted for every subsequent purchase or sale or corporate action if relevant.

As an example, let us assume that a client has shares in ABC ltd that have been acquired over many years and that the share history (ignoring brokers commissions and costs) is:

- prior to 1982, the client had made a number of purchases and had a total of 5,000 shares which were valued at 150p per share at 31 March 1982
- the client acquired 1,000 shares in 1999 at 350p per share, and
- in 2005, the client acquired a further 500 shares at 400p per share.

1 HMRC, April 2024. Negligible Value Agreement list index. Retrieved from https://www.gov.uk/guidance/negligible-value-agreements#negligible-value-agreement-list-index (Accessed: July 2024)

The Section 104 holding would be calculated as follows:

Date	Number of shares	Acquisition cost
31 March 1982	5,000	£7,500
1999	1,000	£3,500
2005	500	£2,000
Section 104 holding	6,500	£13,000

The client has 6,500 shares with an acquisition cost of £13,000 and so the average cost per share is £2 per share (ie, 13,000/6,500).

When shares are disposed of, the capital gain or loss cannot be worked out until the shares disposed of are matched with the shares acquired.

An investor is treated as disposing of shares in the following order:

- First, shares acquired on the same day as the disposal (the 'same day' rule).
- Second, shares acquired in the 30 days following the day of disposal ('bed and breakfasting' rule).
- Third, shares in the Section 104 holding.
- If the above rules fail to exhaust the shares disposed of, the remaining shares are matched with later acquisitions, taking the earliest one first.

These rules were introduced to prevent a process known as 'bed and breakfasting' where an investor sold their holding one day and bought the shares back the next. Doing this allowed an investor to use their annual allowance in crystallising a profit at that point, without actually getting rid of their holding altogether and was used for years as an effective tax planning tool.

3.3.3 Step 3: Deduct Other Costs Incurred

The transaction costs incurred in buying and selling shares or investment funds are allowable expenditure that can be taken into account in a CGT calculation. A purchase of shares will potentially involve the following costs:

- Broker's commission charged for arranging the purchase or sale.
- Stamp duty, which is charged at 0.5% on the purchase cost, rounded up to the nearest £5.
- Stamp duty reserve tax (SDRT) which is charged at 0.5% on the purchase cost.
- Panel on Takeovers and Mergers (PTM) levy of £1 on trades over £10,000.

For purchases of unit trusts and OEICs, an initial charge may be made and on a sale a unit trust or OEIC may charge an exit fee. Both are again allowable items of expenditure as they are integral to the transaction.

3.3.4 Step 4: Set Off Allowable Losses

In order to calculate the CGT position for a tax year, it is necessary to repeat that calculation for each disposal. Any losses that arise are set against the gains for the same tax year to come up with a net overall gain or loss figure.

From this figure is deducted the annual exempt amount and if there is still a net chargeable gain, allowable losses from previous years can then be set off against this figure.

If there is an overall loss it can be carried forward to be used in future tax years.

Using Losses

1. Deduct any allowable losses from gains made in the same tax year.
2. If there are still gains check whether the gains are more than the annual exempt amount:
    - If the gains are below this amount, there is no CGT to pay.
    - If the gains are more than this amount and there are unused losses from a previous tax year, deduct these losses from the gains.
3. Use just enough of the losses to reduce the gain to the annual exempt amount.
4. Use allowable losses from the 1996/97 tax year and later tax years before using losses from 1995/96 and earlier tax years.
5. If there are still unused losses left carry them forward to future tax years.

An investor needs to tell HMRC about losses before they are allowed to deduct them from their gains in future years. Losses are claimed by including them on a Self Assessment tax return and must be claimed within five years from 31 January after the end of the tax year in which the loss was made.

3.3.5 Step 5: Deduct the Annual Exempt Amount (AEA)

Where an overall gain is made, there is an annual allowance, called the annual exempt amount (AEA). Any gains within this amount are exempt from CGT. The AEA for 2025–26 is as follows:

Annual Exempt Amount	
Individuals, personal representatives and trustees for disabled people	£3,000
Other trustees	£1,500

Non-residents who dispose of a UK residential property are liable to CGT and, in most cases, can claim the AEA in the same way as UK residents.

3.3.6 Calculating the Tax Due

Once all of the individual gains and losses for each asset sold or disposed of have been worked out, it is possible to calculate the overall gain or loss to see the tax due.

From 6 April 2025 onwards, gains are then taxable at the following rates:

- For individuals, where their total taxable income and gains after all allowable deductions are less than the upper limit of the basic rate income tax band, the rate of CGT is 18% (excluding carried interest gains).
- For individuals, where their total taxable income and gains after all allowable deductions exceed the upper limit of the basic rate income tax band, the rate of CGT is 24% (excluding carried interest gains).

- For individuals, on gains arising from carried interest, the rate of CGT is 32%, irrespective of income levels.
- For trustees, on chargeable gains, the rate of CGT is 24%.
- For personal representatives of someone who has died, on chargeable gains (excluding carried interest), the rate of CGT is 24%.
- For personal representatives of someone who has died, on gains arising from carried interest, the rate of CGT is 32%.
- For gains qualifying for Business Asset Disposal Relief (BADR) and Investors' Relief, the rate of CGT is 14% for disposals made on or after 6 April 2025.

Business Asset Disposal Relief (BADR)

A different rate of tax may apply when an individual sells or disposes of all or parts of a business.

BADR (previously known as entrepreneurs' relief) reduces the amount of CGT on disposal of qualifying business assets, as long as qualifying conditions are met and up to a lifetime limit.

Spouses/civil partners are separate individuals and may each make a claim. They are each entitled to BADR up to the maximum amount available for an individual, provided that they each satisfy the relevant conditions for relief. BADR is also available to some trustees of settlements.

However, it is not available to companies or in relation to a trust where the entire trust is a discretionary settlement. Personal representatives of deceased persons can only claim if the disposal took place while the deceased person was alive.

Business Asset Disposal Rate (BADR)	
Disposals	Applies to disposals of: • a sole trade and its assets • partnership interests and assets • shares in your own company • joint venture interests, and • business assets held by some trusts.
Lifetime limit	• Qualifying gains for individuals are subject to a lifetime limit of £1 million.
Qualifying conditions	• BADR reduces the amount of CGT as long as the qualifying conditions are met throughout a one-year qualifying period either up to the date of disposal or the date the business ceased. • To qualify for relief on sale of all or part of a business, you must be a sole trader or business partner and have owned the business for at least two years up to the date of sale. • To qualify for relief on selling shares or securities, for at least two years before the date of sale, you must be an employee or office holder of the company and the company's main activities should be in trading (rather than non-trading activities such as investment). • There are further conditions for a disposal to connected persons, disposal of assets after the cessation of business and associated disposals.

Tax rates:

- For disposals made before 6 April 2025, if someone is entitled to BADR, qualifying gains up to the lifetime limit are charged to CGT at the rate of 10%.
- For disposals made on or after 6 April 2025, the BADR rate will increase to 14%.
- For disposals made on or after 6 April 2026, the BADR rate will further increase to 18%.

4. Inheritance Tax (IHT)

IHT is often thought of as a tax which is levied when someone dies; however, this is something of a misnomer as it can apply when assets are transferred in a variety of ways, for example on death or in the form of gifts during life. If this were not the case, people would avoid IHT simply by giving away their assets before they died.

IHT is primarily a tax on wealth. Usually this means wealth that is left to someone else on its owner's death, but it also applies to gifts given up to seven years before death and to certain lifetime transfers of wealth.

IHT is different from income tax and CGT:

- With income tax and CGT, the key question is: how much money has the taxpayer made?
- With IHT, the key question is: how much have they given away?

Therefore, it is the amount which the taxpayer has transferred that is taxed. You can also see this as the amount by which they are worse off. If a taxpayer has to pay IHT on a lifetime gift, they will be worse off by the amount of the gift plus the tax; this must be taken into account when calculating the cost of making a gift.

4.1 Chargeable Transfers

IHT is a tax on gifts or transfers of value. There are two main chargeable occasions:

1. Gifts made during the lifetime of the donor (lifetime transfers).
2. Gifts or transfers on the death of the donor, for example, when property is left to someone in a will (the death estate).

IHT cannot arise unless there is a transfer of value, which means any gratuitous disposition made by someone resulting in their being worse off – that is, they diminish the total value of their estate. The sale of an asset at its open market (arm's length) value will, therefore, not give rise to an IHT charge. (It might, however, give rise to a CGT charge if the seller makes a gain on the asset.)

The measure of a gift is always the loss to the transferor (the reduction in value of their estate), not the amount gained by the transferee. In most cases, these figures will be the same, but this may not always be the case. Individuals and trustees of settled property (trust property) are chargeable persons for IHT purposes – that is, they may be liable to IHT.

All transfers of assets (worldwide) made by people who are domiciled in the UK – essentially, people who regard the UK as their permanent home – whether during their lifetime or on death, can be liable to IHT. For individuals not domiciled in the UK, only transfers of UK assets are caught within the IHT 'net'.

Autumn Budget 2024 changes (from 6 April 2025)

- **Worldwide assets** – long-term residents (those who have been UK tax resident in 10 or more of the preceding 20 tax years) are subject to UK IHT on their global estate, including assets held outside the UK.
- **IHT tail** – when an individual ceases to be UK resident, the period for which they will continue to be within the scope of UK IHT on non-UK assets will depend on how long they had been resident.
- **Transitional rules** – there are transitional rules for individuals who are non-UK tax residents in the 2025-26 tax year and are not UK domiciled on 30 October 2024.
- **UK assets** – for individuals who are not long term residents, only transfers of UK assets are caught within the IHT 'net'.

4.2 IHT Liability

IHT is charged on transfers of assets. The person making the transfer is known as the donor or transferor and the person receiving the transfer as the done or transferee. The transfer of assets is known as a chargeable transfer and this can take place during someone's life or on death. Certain transfers of value are exempt while reliefs apply to others. IHT is payable on transfers of value in excess of what is known as the nil-rate band (NRB) which is £325,000; and the Autumn Budget 2024 has frozen it at this level until April 2030. Additionally, the residence nil-rate band (RNRB) will stay at £175,000, and the RNRB taper will continue to start at £2 million until April 2030.

Rates of IHT	
Portion of Value	Rate %
£0–£325,000	0%
Over £325,000	40%

The standard IHT rate is 40%. It is only charged on the part of the estate that is above the NRB. The first £325,000 of transfers is taxed at 0% and is, therefore, effectively IHT-free. In some circumstances, there can be a lower charge to IHT when someone dies – for example, an estate can pay IHT at a reduced rate of 36% on some assets if the deceased leaves 10% or more of the 'net value' of their estate to charity in their will.

A lifetime transfer of value may be immediately chargeable, potentially exempt or exempt.

- A chargeable life transfer (CLT) such as a gift into some types of trust is immediately chargeable to IHT at the lifetime rate of IHT of 20% on the value of the transfer in excess of the NRB.
- An outright gift to another person during someone's life is described as a potentially exempt transfer (PET). It will not become chargeable if the donor survives seven years from the date of transfer.
- Some transfers may be exempt such as gifts to a spouse or civil partner.
- There are also a number of specific exemptions for lifetime transfers (see section 4.3.1 below).

IHT is charged based on a cumulative method which assesses the addition of successive transfers of value in order to determine the rate of tax to apply to the latest transfer.

- All CLTs are added up to form a cumulative total and tax is payable once the cumulative total exceeds the NRB.
- A PET drops out of the cumulative total once it is more than seven years old.
- On death, IHT is charged on the cumulative total plus the value of the estate at death. Any assets caught by the gifts with reservation principle are deemed to be part of the deceased's estate immediately before death.

4.3 Exemptions and Reliefs

There are various exemptions available to eliminate or reduce the chargeable amount of a lifetime transfer or property passing on an individual's death:

- Some exemptions apply to both lifetime transfers (ie, transfers of value made during the individual's lifetime) and property passing on death.
- Other exemptions apply only to lifetime transfers including PETs which become chargeable on death within seven years.

4.3.1 Exemptions Applying to Lifetime Transfers

There are a number of exemptions applying to lifetime transfers of value that are summarised below.

Exemptions Applying to Lifetime Transfers	
Small Gifts Exemption	• Outright gifts to individuals totalling £250 or less per donee in any one tax year. If a gift totals more than £250, the whole of it is chargeable. • A donor can give up to £250 pa to each or as many donees as they wish. • The small gifts exemption cannot apply to gifts into trusts.
Annual Exemption	• The first £3,000 of value transferred in a tax year (however, you cannot use your £3,000 annual exemption and your £250 small gifts exemption to give the same person a total of £3,250). • The annual exemption is used only after all other exemptions such as for transfers to spouses/civil partners or to charities. • If several gifts are made in a year, the £3,000 exemption is applied to earlier gifts before later gifts. • Any unused portion of the annual exemption is carried forward for one year only.
Normal Expenditure Out of Income	• IHT is a tax on transfers of capital, not on dispositions of income. A transfer of value is exempt if: ◦ it is made as part of the normal expenditure of the transferor ◦ taking one year with another, it was made out of income, and ◦ it leaves the transferor with sufficient income to maintain their usual standard of living. • This exemption can also cover regular payments out of income under deeds of covenant, and the payment of life assurance premiums on a policy for someone else.

Exemptions Applying to Lifetime Transfers	
Gifts in Consideration of Marriage	• Gifts in consideration of marriage or civil partnership are exempt up to: ◦ £5,000 from a parent of one of the parties to the marriage or civil partnership ◦ £2,500 from a grandparent or a remoter ancestor of one of the parties to the marriage or civil partnership ◦ £1,000 from any other person. • The limits apply to gifts from any one donor for any one marriage or civil partnership.

4.3.2 Exemptions Applying to both Lifetime Transfers and on Death

Certain exemptions are available both for lifetime transfers and on death.

Transfers of Value between Spouses and Civil Partners

Transfers of value between spouses and civil partners are exempt providing that the transferee is domiciled in the UK at the time of the transfer. The exemption:

- applies whether or not the spouses or partners are living together, and
- ceases to apply on divorce/dissolution.

Where the transferor is domiciled in the UK, but the transferee spouse/civil partner is neither domiciled nor deemed domiciled in the UK, the exemption is restricted.

Individuals domiciled outside the UK, who have a UK-domiciled spouse, can elect to be treated as domiciled in the UK for IHT purposes, so enabling them to benefit from the exemption. It is important to note that an election has effect only for IHT purposes; it does not affect an individual's domicile status for income tax or CGT tax purposes. There are conditions applying to the election and the timing of when it is made.

A decision as to whether an election should be made needs careful consideration. This is because, once made, it has the effect of bringing the elector's entire estate within the scope of IHT. In some circumstances, this could be beneficial; in others it could be particularly disadvantageous. Ultimately, whether an election should be made will depend on a variety of factors some of which will not be known until the date of the UK domiciled spouse/civil partner's death, eg, the location and value of the couple's assets at the time of their respective deaths. There is also the opportunity to defer the election until just before the two-year deadline for a death election when the potential benefits should be clearer.

As ever, the wealth manager needs to have a firm grasp of the client circumstances and applicable tax rules in order to make effective use of exempt transfers as part of the client's tax planning and may need to engage legal and tax specialists to assist.

Other Exemptions

Other exemptions that apply are summarised below.

Other Exemptions	
Gifts to Charities	• Transfers to charities whether outright or by settlement. • This applies to transfers to qualifying charities established in the UK and in the EU and certain other countries. • Where the deceased left at least 10% of their net estate to charity, the rate of IHT on death is reduced to 36%.
Gifts to Political Parties	• Gifts to a qualifying political party are exempt. Such a party qualifies if, at the general election preceding the transfer of value, either: ◦ at least two members were elected to the House of Commons, or ◦ one member was elected to the House of Common and the party polled at least 150,000 votes.
Gifts for the National Benefit	• Certain gifts for the national benefit. They include gifts to museums, libraries, universities and the National Trust. Gifts of land to housing associations are also exempt.
Maintenance Settlements	• Maintenance settlements can be made IHT-free if they are for the upkeep of historic property.

4.4 Lifetime Transfers

As mentioned earlier, lifetime transfers can be either a potentially exempt transfer or a **chargeable lifetime transfer (CLT)**.

4.4.1 Potentially Exempt Transfers (PETs)

A lifetime transfer made by an individual to another individual is known as a potentially exempt transfer (PET). Although a transfer into a trust is normally a chargeable lifetime event, a transfer into an absolute trust or to a trust for a disabled person gives rise to a PET.

A PET is treated as being exempt from IHT when made and will remain so providing that the transferor survives for at least seven years after the date on which they make the gift. If the transferor dies within seven years of making the gift, it will become chargeable to IHT and is referred to as a failed PET. The liability to IHT falls on the donee.

There is taper relief if the donor survives for at least three years which provides a reduction in the amount of tax payable. Taper relief works by reducing the amount of tax due according to the length of time between the donor's death and the date the PET was made.

Taper Relief	
Years Between Gift and Death	**Percentage of IHT Payable**
0–3 years	100%
3–4 years	80%
4–5 years	60%
5–6 years	40%
6–7 years	20%

Although the taper relief reduces the amount of tax payable, it does not reduce the value of the transfer for the purposes of the donor's cumulative total. The full value of the transfer is included in the donor's cumulative total for the purpose of calculating tax on any later PETs and the IHT on the estate.

4.4.2 Chargeable Lifetime Transfers (CLTs)

A CLT is one that is not exempt and not potentially exempt. The most common chargeable transfers occur on lifetime gifts to trusts other than trusts for a disabled person or a transfer into an absolute trust.

However, a transfer of value into a discretionary trust is deemed to be a CLT and may be subject to an IHT charge if it causes the donors cumulative total of lifetime gifts to exceed the nil-rate band at the date the transfer is made. Tax is payable at 20% on the excess over the nil-rate band.

No further IHT is payable if the donor survives for the next seven years. If, however, the donor dies within seven years of making a CLT, tax at the death rates will apply retrospectively to that transfer.

- The tax is recalculated using the value of the gift and the previous seven years' cumulative total at the date of the transfer, but using the death rates of tax in force at the date of death.
- Where no lifetime tax was paid because the transfer was wholly within the nil-rate band, there would usually be no extra tax to pay on death. This is because it would still be within the nil-rate band.
- However, tax would arise if a previous PET within the seven years before death had retrospectively become chargeable and thereby increased the cumulative total to bring it over the IHT nil-rate band.
- Where tax has been paid at the time of the lifetime transfer, it is allowed as a credit against the tax payable at the death rates and taper relief is available.

4.4.3 Gifts with Reservation and Pre-Owned Assets

There are rules to stop people avoiding IHT by making gifts with reservation – that is, incomplete lifetime gifts when the donor continues to enjoy the 'gifted' asset.

If these rules were not in place, people would make incomplete gifts so as to escape the charge to IHT. They would then be making a PET; they would also be reducing their estate at death. In theory, the value of the assets could, therefore, escape tax entirely, despite the original owner deriving some benefit from them – possibly right up to their death. An obvious example is a gift of a home to the donor's children – but with the donor continuing to live in it rent-free. Another example is a gift of income-producing assets to someone else, with the income continuing to be received by the donor.

Gifts with Reservation	
Gifts Treated as Being with Reservation	• Property given subject to a reservation is property when: ◦ it is not enjoyed to virtually the entire exclusion of the donor, or ◦ possession and enjoyment of the property transferred is not bona fide assumed by the donee. • The term 'to virtually the entire exclusion' will, for example: ◦ include cases where a donor is allowed occasional brief stays in a property they have given away, without creating a reservation ◦ not include cases where they spent most weekends in the property. This would create a reservation.
Gifts not Treated as Being with Reservation	• A gift will not be treated as being with reservation if: ◦ full consideration (ie, payment) is given for any right of occupation or enjoyment retained or assumed by the donor, and the property is land or chattels; for example, an individual might give away their property and continue to live in it, but pay a full market rent for doing so ◦ the circumstances of the donor change in a way that was unforeseen at the time of the original gift and the benefit provided by the donee to the donor only represents reasonable provision for the care and maintenance of the donor, being an elderly or infirm relative. This exception only applies to interests in land.

If a gift with reservation is made, it is treated in the same way as any other gift at the time it is made (as a PET or a CLT, as appropriate). However, special rules apply on the death of the donor:

- If the reservation still exists at the date of the donor's death, the asset is included in the donor's estate at its value at that time (not its value at the date the gift was made). So, any attempt to 'peg' the value of the assets for IHT purposes at an earlier – and therefore probably lower – value will fail.
- If the reservation ceases within the seven years before death, then the gift is treated as a PET made at the time the reservation ceased. The charge is based on its value at that time and the annual exemption cannot be used in calculating the value of this PET.

Pre-Owned Assets Tax (POAT)

From 6 April 2005, an income tax charge applies if an individual has the benefit of the free or low-cost use of an asset that they previously owned; this is known as the **pre-owned asset tax (POAT)** charge. The intention behind the charge is to counter schemes which avoid IHT on gifts with reservation. The charging provisions will apply to land (including buildings), chattels and gifts into trusts of intangible assets.

The charge for land is based on the rental value. The charge for chattels is calculated by applying a statutory rate of interest to the value of the asset (reduced by any payments made for its use). The charge for intangible assets is calculated by applying a statutory rate of interest to its value, reduced by any CGT payable. There is no charge if the value of the benefit is £5,000 pa or less.

Transitional provisions allowed individuals to elect for the POAT charge not to apply, but this would have had the effect that the property, chattel or intangible asset would be included in the individual's estate for IHT purposes.

4.5 Transfers on Death

When someone dies, their assets and liabilities need to be dealt with and distributed to those entitled. The administration of the estate of a deceased person is carried out by one or more personal representatives. These may be either:

- executors in cases where the deceased left a valid will (died testate); the executors will obtain a grant of probate, or
- administrators where the deceased left no valid will (died **intestate**); the administrators will obtain letters of administration.

The personal representatives of a deceased person are responsible for payment of any IHT arising on death. They are also responsible for the settlement of any outstanding income tax liabilities of the deceased in respect of their income up to the date of death and accounting for tax liabilities arising during the administration period running from the date of death until ascertainment of the residue of the estate.

The following table summarises the calculation of IHT on death.

IHT on Death	
Step 1	Look back seven years from the date of death to see if any CLTs have been made. If so, these transfers use up the NRB available for the death estate. Additionally, consider the 14-year rule for CLTs made between seven and 14 years prior, as they may impact the NRB available for PETs made within the last seven years. Finally, calculate the remaining NRB after accounting for these transfers.
Step 2	Calculate the gross value of the death estate.
Step 3	Any part of the death estate covered by the NRB is not taxed. Any part of the death estate in excess of the NRB is charged at 40% unless it is exempt. Deduct any relevant reliefs from the death tax.
Step 4	If relevant, divide the tax due between personal representatives, the person in possession of a gift subject to a reservation and trustees.

4.5.1 Probate Value of Assets

The executor or administrator needs to compile an inventory of the assets and liabilities for the estate of the deceased. This involves identifying each and contacting the financial institution involved to find out its value as at the date of death.

For bank and savings accounts, the value that has to be reported as part of the application for a grant is the balance of the account as at the date of death plus interest that has accrued up to the date of death. For other assets, it will be their value at the date of death. For quoted securities and collective investment schemes, the probate value is calculated as set out in the sub sections that follow.

Probate Value of Quoted Shares and Other Securities

- For UK-quoted shares, the market value should be calculated from the prices quoted in the LSE's Daily Official List, which is a publication giving the closing bid and offer prices of all quoted securities.
- IHT valuations are made on the basis of the 'quarter up rule', taking the bid (lower) price plus a quarter of the difference between it and the offer price. For example, if the bid and offer prices for a particular day are 300p and 304p respectively, the IHT valuation is 300 + (304 – 300)/4 = 301p.
- The other way of valuing securities is to use the marked bargains price. Each day, certain trades on the stock exchange will be marked, and the valuer may take the average of the highest and lowest marked bargains, ignoring bargains marked at special prices.
- The rule for valuation of quoted securities is, therefore, to take the lower of:
  - the value on the quarter up rule basis, and
  - the average of the highest and lowest marked bargains for the day, ignoring those marked at special prices.
- Valuations for transfers on death must be cum-dividend or cum-interest, including the value of the right to the next dividend or interest payment.

Probate Value of Unit Trusts and OEICs

For unit trusts and open-ended investment companies (OEICs), the market value should be based on:

- **Unit trusts** – the bid price. Any exit, redemption or withdrawal fees should be ignored.
- **OEICs** – the single price quoted by the fund.
- Where the price was not published at the date for which the valuation is required (eg, if the date occurred over a weekend or on a Bank Holiday), then you should use the price on the latest day before.

For private companies, there are no quoted shares, therefore no easily identifiable value. The HMRC Shares and Assets Valuations (SAV) is a specialist team with which the taxpayer must negotiate. If agreement cannot be reached, the case may go to the special commissioners and then to the courts.

For other assets, the value of any property for the purposes of IHT is the price which the property might reasonably be expected to fetch if sold in the open market at the time of the transfer.

4.5.2 Exempt Gifts and Reliefs

As we saw earlier, transfers between spouses and civil partners are exempt, so any part of the estate that passes to the surviving spouse or civil partner will not be liable to IHT.

Certain other gifts are also exempt as shown in the following table.

Other Exempt Gifts on Death	
Gifts to Charity	• In general, transfers to qualifying charities or registered clubs, established in the UK, European Union and certain other specified countries are wholly exempt. • Where the deceased died on or after 6 April 2012 and left at least 10% of their net estate to beneficiaries that qualify for charity exemption, the rate of IHT on death is reduced to 36%.
Armed Forces or Emergency Service Personnel	• The estates of members of the armed forces are completely tax-free on death, if they die because of wounds received or diseases contracted on active service. Similarly, the estates of members of the emergency services and humanitarian aid workers who die as a result of responding to emergency circumstances are exempt, as are the estates of police constables and armed service personnel who die as a result of being attacked because of their status.
Diplomatic and Consular Immunity	• Exemption from IHT is granted on the death of a member of a diplomatic mission to the UK who is not a national of, or permanently resident in, the UK and on the death of a member of their family forming part of their household. The exemption is limited to moveable property which is in this country solely by reason of the deceased's presence here as a member of the mission or as one of the family of a member of the mission.

The value of certain assets, such as business and agricultural property, is also reduced by the application of business property relief or agricultural property relief. Recent changes limit the full relief to the first £1,000,000 of the combined total of these two reliefs per estate, with any excess qualifying for only 50% relief.

Business Relief

The value of certain business-related assets will be reduced when calculating IHT liabilities, whether a transfer is made during life or on death. Examples include the following:

Type of Asset	Reduction
A business or interest in a partnership	100%
An unquoted shareholding (including AIM)	100%
A controlling shareholding in a publicly listed or quoted company	50%
Land, property and machinery used in a business	50%

With respect to unquoted shares, ie, those not listed on a stock exchange, shares listed on AIM are counted as being unquoted. But such shares must have been held for at least two years to qualify for the relief.

Agricultural Property Relief

Agricultural property relief is similar to business property relief. Where the donor has vacant possession, the reduction is up to 100%. To be eligible for the relief, the donor must have occupied the property for agricultural purposes for the last two years, or have owned it for seven years where it was occupied for agricultural purposes by the donor or someone else.

Woodlands Relief

Woodlands relief relates to forestry and woodlands devoted to growing timber. IHT can be deferred until the timber is cut and sold.

Quick Succession Relief

Quick succession relief is designed to reduce the burden of IHT where an estate includes assets received within the previous five years under an earlier transfer on which tax was (or becomes) payable. Relief is provided by reducing the tax payable on the death by a proportion of the tax payable on the earlier transfer. The proportion tapers at 20% intervals from 100% if the previous transfer took place within 12 months of the death, to 20% if it took place between four and five years before the death.

A similar relief in respect of settled property is given subject to conditions where property is chargeable to tax within five years of a previous charge.

4.5.3 IHT on Death

IHT is chargeable on death on the value of the estate at death plus the cumulative total of lifetime transfers and potentially the value of any gifts with reservation or settled property.

The nil-rate band is £325,000 and as mentioned earlier, there can be a higher nil-rate band as the regulations permit the transfer of an unused nil-rate band between spouses and a residence nil-rate band applies when the family home is left to direct descendants.

Transfer of Unused Nil-rate Band between Spouses

As we saw above, married couples and registered civil partners are allowed to pass assets to each other during their lifetime or when they die without having to pay IHT. If someone leaves everything they own to their surviving spouse or civil partner in this way it also means they have not used any of their own nil-rate band.

Since 2007, it has been possible to transfer the unused allowance from a late spouse or civil partner to the second spouse or civil partner when they die. This can increase the IHT threshold of the second partner from £325,000 to as much as £650,000, depending on the circumstances. The following example shows how this operates.

Example

A man died a number of years ago, leaving his entire estate worth £400,000 to his wife. At the time, no IHT was payable and, therefore, the nil-rate band of £300,000 was not used. His wife dies in the current tax year, leaving an estate of £600,000. The personal representatives of the wife can, therefore, transfer 100% of the husband's unused nil-rate band to increase hers. As no nil-rate band was used when he died, they can now transfer 100% of the nil-rate band in force at the time of her death – £325,000. This increases her available nil-rate band to £650,000, meaning no IHT is payable.

The unused IHT nil-rate band can only be transferred on the second death, which must have occurred on or after 9 October 2007 when the rules changed. It does not matter when the first spouse or civil partner died unless it was before 1975 when the full nil-rate band may not be available to transfer as the amount of spouse exemption was limited then.

Residence Nil-Rate Band (RNRB)

On 6 April 2017, the RNRB was introduced due to the growing concern that more and more people were paying IHT on their estates because of increasing property prices.

This measure introduced an additional nil-rate band when a residence is passed to a direct descendant on death, and any unused nil-rate band can be transferred to a surviving spouse or civil partner. For deaths in the following tax years, the RNRB is:

- £100,000 in 2017–18
- £125,000 in 2018–19
- £150,000 in 2019–20, and
- £175,000 in 2020–21.

As announced in the Autumn Budget 2024, the RNRB has been frozen at the 2020–21 level of £175,000 and will remain at that level up to and including the 2029–30 tax year.

The RNRB is available when a person downsizes or ceases to own a home on or after 8 July 2015. Assets of an equivalent value up to the value of the additional nil-rate band are passed on death to direct descendants.

There is a tapered withdrawal of the additional nil-rate band for estates with a net value of more than £2 million. This occurs at a withdrawal rate of £1 for every £2 over this threshold.

The RNRB, when combined with the standard NRB, allows married couples and civil partners to potentially pass on up to £1 million free of IHT to their direct descendants.

4.5.4 Settled Property

The chargeable estate of a deceased person will include any property settled on the person – in simple terms, a trust.

Settled property is where the deceased had a life interest in a trust. A life interest gives an individual the right to receive income from the trust, but not to receive the capital. On the death of the person holding the life interest, the capital of the trust is paid to another person who holds the reversionary interest – the remainderman.

Although the person holding the life interest is only entitled to receive the income from the trust, not its capital value, the capital value of the assets in the trust are still brought into the value of the estate of the person holding the life interest on their death, for life interests created before 22 March 2006. Since that date, transfers within interest-in-possession trusts have been treated the same way as in discretionary trusts.

For these earlier trusts, any IHT due on the trust assets as a result is paid by the trustees out of the trust assets, thus reducing the capital value of the estate handed over to the remainderman.

Property owned directly by the deceased person and not representing the capital value of a life interest is referred to as the free estate.

The following example for a pre-March 2006 trust illustrates how the IHT due is allocated according to the percentages shown between the free estate and the settled estate.

IHT Due	£
Free estate	650,000
Settled estate	120,000
Total estate	770,000
Nil-rate band	(325,000)
Chargeable estate	445,000
IHT due (£770,000 – £325,000) x 40%	178,000
Tax payable out of free estate (84.42%)	150,268
Tax payable out of settled estate (15.58%)	27,732

Since the free estate represents 84.4% of the total estate (ie, £650,000 / £770,000) then 84.4% of the IHT liability is payable from the free estate. The balance is paid from the settled estate, which represents the remaining 15.6% of the total estate (ie, £120,000 / £770,000).

4.5.5 Deeds of Variation and Disclaimers of Interest

A deed of variation (or deed of family arrangement) is a document that enables the distribution of an estate to be altered by agreement of all of the beneficiaries. The purpose of such a deed is for the beneficiary under a will to vary the rights to which they are entitled under the will in favour of somebody else – perhaps because to inherit directly will give them a tax problem, or perhaps because they want someone else to benefit.

In these circumstances, it may be possible for a deed of variation to be used. If this is done, the deed will be treated as if it were an original part of the will and hence, will have no adverse tax impact. The deed must be made within two years of death.

If a surviving spouse/civil partner redirects some of the estate to dependants to make maximum use of the NRB for the deceased spouse/civil partner, this will reduce the chance of the surviving spouse having an estate in excess of the nil-rate band, when he or she dies. Such an arrangement will not usually need to occur if proper tax planning has been done before the death of the first spouse/civil partner.

For a deed of variation to be valid, it must:

- relate to a valid will, to an intestate estate or to a trust
- be signed by all the parties who would have benefited had the variation not been made (all of whom must be over 18 and must be of sound mind)
- be executed within two years of the date of death, and
- not be made for any consideration (ie, no one should have received money or value as encouragement for them to sign).

The deed must also contain a statement to the effect that it is intended that the IHT effect of the variation will be the same as if the deceased had made that variation themselves.

A disclaimer of interest is a document that allows an individual to put their inheritance back into the estate, meaning it will pass to the next eligible beneficiary (while a deed of variation can actually divert property to any persons nominated by the individual who inherited under the will). The disclaimer also must be made within two years of death.

5. National Insurance (NI)

National Insurance (NI) is intended to provide a contributory system of insurance against illness and unemployment as well as providing retirement pensions and other benefits. It is paid by employees and employers and the self employed and the amount paid may determine the amount of benefit an individual is entitled to.

Individuals pay NI to qualify for certain benefits and the state pension.

- National Insurance contributions (NICs) are required to build up an entitlement to a state pension and other social security benefits. How much is paid depends on how much is earned.
- There are different classes of NI and the type you pay depends on your employment status and how much you earn.

- If you are employed, provided earnings exceed a certain amount an employer deducts Class 1 NICs from wages through the PAYE system.
- Employers also pay the employer NICs based on earnings and any benefits which come with a job, for example a company car.
- Self-employed are liable to pay their contributions directly.
- HMRC keeps track of contributions through an individual's NI number. This is allocated once you first start work and acts as a reference number for the whole social security system. Once issued, the NI number never changes.
- Employees stop paying NICs as soon as they reach state pension age. If you are self-employed, you stop paying Class 2 contributions as soon as you reach state pension age and Class 4 contributions from the start of the tax year after the one in which you reach state pension age.
- The state pension age is the earliest age you can start receiving your State Pension. It is worked out based on when you were born.
- Some people also pay voluntary Class 3 NICs to fill gaps in their National Insurance record.

The amount of NI paid depends on employment status and how much is earned.

Employers and employees pay Class 1 National Insurance depending on how much the employee earns.

Class 1 NI 2025–26	
Employees	• Employees do not pay NI where their earnings are below the lower earnings limit (LEL) of £125 per week or £542 per month yet they still build up NI benefits. • If employees earn above the LEL but below the Primary Threshold (PT) of £242 per week or £1,048 per month, they are exempt from paying NI, however, they still qualify for benefits. • Between PT and Upper Earnings Limit (UEL) of £967 per week or £4,189 per month), the rate payable is 8%. • Employees with income above the UEL pay a lower rate of 2%.
Employers	• Employers start paying employers NI when the employee's earnings are above £175 per week or £758 monthly; the employers' rate is 15%. • Secondary threshold – the threshold at which employers start paying National Insurance is £5,000 per year. • Employment allowance – the allowance which allows eligible employers to reduce their NI liability is £10,500.

The self employed pay two types of NI depending on their profits.

- Class 2 NICs are payable if your profits are £6,845, or more a year (small profits threshold). The rate is £3.45 a week.
- Class 4 NICs are payable if your profits are £12,570, or more a year. The rate is 6% on profits between £12,570.
- £50,270, and 2% on profits over £50,270.

You might be an employee but also do self-employed work. In this case your employer will deduct your Class 1 National Insurance from your wages, and you have to pay Class 2 and 4 payments for your self-employed work.

Any individuals whose work or personal situation means that they do not currently have to pay National Insurance contributions, or are not entitled to receive National Insurance credits, may still be able to make voluntary contributions to fill in any gaps in their National Insurance record. Voluntary contributions count towards some state benefits and can also increase the amount of benefit they receive. Voluntary National Insurance contributions are normally Class 3 contributions at a rate of £17.75 per week.

6. Value Added Tax (VAT) and Corporation Tax

In this section, we will look briefly at VAT and corporation tax as clients may operate their own businesses and so wealth managers need to be aware of the broad outlines of how these taxes may affect their client's interests.

6.1 VAT

VAT is a tax that is charged on most goods and services that are provided by VAT-registered businesses in the UK.

Any business that provides goods or services must register for VAT if their VAT taxable turnover is more than £90,000 unless it only sells exempt goods or services. VAT taxable turnover is the total value of everything the business sells that is not exempt from tax. A business must register for VAT if their turnover exceeds the threshold over a rolling 12-month period.

Even if a business does not have a legal requirement to register, it may voluntarily decide to register for VAT. You can register voluntarily which can be beneficial if the value of the turnover is uncertain or the business anticipates that turnover will exceed the limit. Being VAT registered may help give the impression that the company is larger than is actually the case, and may improve its image with clients. In addition, a VAT registered company can claim back VAT paid on any business purchases.

VAT is charged when a VAT-registered business sells to either another business or to a non-business customer. When VAT registered businesses buy goods or services they can generally reclaim the VAT they have paid.

If a business is VAT-registered, the VAT added to the sale price of goods or services is called the output tax. The VAT paid by a business when buying goods and services for the business is called input tax. VAT registered businesses will fill in a VAT return at regular intervals – usually quarterly – and file them with HMRC. The return shows both the output tax and the input tax. If the amount of output tax is more than the input tax, then the difference has to be to be sent to HMRC with the return. If the input tax is more than the output tax, a claim is made for a VAT repayment on the return.

There are three rates of VAT, depending on the goods or services the business provides.

VAT Rates for Goods and Services		
Rate	**%**	**What the rate applies to**
Standard	20%	Most goods and services
Reduced rate	5%	Some goods and services such as children's car seats and home energy
Zero rate	0%	Zero-rated goods and services such as most food, public transport, books and newspapers and children's clothes

Some items are exempt whilst others are outside of the scope of VAT. The difference between exempt and zero-rated is that the latter count as taxable supplies even though no VAT is added to the selling price and they still have to be reported to HMRC.

6.2 Corporation Tax

Corporation tax is a tax on the taxable profits of limited companies and some organisations including clubs, societies, associations, cooperatives, charities and other unincorporated bodies. Taxable profits for corporation tax include:

- profits from taxable income such as trading profits and investment profits, and
- capital gains – known as chargeable gains for corporation tax purposes.

A UK-based company will pay corporation tax on all of its taxable profits, wherever in the world those profits come from. If a company is not based in the UK but operates in the UK – for example through an office or branch (known to HMRC as a permanent establishment) – corporation tax will only be payable on any taxable profits arising from its UK activities. Non-resident companies without a permanent establishment in the UK are not eligible for the small profits rate or marginal relief and must use the main rate of 25%.

A number of adjustments are made to a company's profit to calculate the profit on which corporation tax is due in accordance with HMRC rules. This taxable profit is termed the profits chargeable to corporation tax. The main adjustments comprise the following:

- **Adding back depreciation** – as the depreciation charge can be subjective, depreciation is removed from reported pre-tax profit and replaced by capital allowances. Capital allowances are standardised rates of depreciation that are applied to tangible fixed assets, on a reducing balance basis. Capital allowance rates are set by HMRC; they differ according to the size of the company and the type of fixed asset to which they are applied.
- **Removing dividend income received from other UK companies** – dividend income received from other UK companies is known as franked investment income (FII). As it is received net of UK corporation tax, no further tax is due from the recipient company. Therefore, it should not be included in the calculation of taxable profit. Unfranked investment income (UFII), such as interest income that is received gross, is subject to corporation tax.

- **Adding back any provisions made** – provisions are by their very nature subjective, so are not allowed to reduce taxable profit.
- **Adding back any book losses and deducting any book profits in respect of asset sales** – as UK companies are subject to corporation tax on any capital gains made during the accounting period and are given relief for capital losses, any book gains and losses recorded in the income statement should be replaced by the appropriate capital gains or losses figure.

Once a company's taxable profit has been calculated, the appropriate corporation tax rate is then applied to this figure to determine the corporation tax liability.

Companies pay tax for their accounting period which is normally the period covered by its accounts. On incorporation of a company, this would run from the date it is incorporated until 12 months later. The main rate of corporation tax is 25% (for companies with profits over £250,000) and the small profits rate (for companies whose profits do not exceed £50,000) is 19%. These rates are applicable from 1 April 2023. For companies with profits between £50,000 and £250,000, there is a system of marginal relief, with the effective tax rate calculated using a specific formula.

If the company has associated companies, the profit limits (£50,000 and £250,000) are reduced proportionately.

If the company's accounting period does not coincide with the financial year but instead straddles two financial years, each with different corporation tax rates, the rate applied to the taxable profit figure will be a weighted average of the two rates. For accounting periods that include 1 April 2023, profits are time apportioned, with different rates applying before and after this date.

If, as a result of making the necessary adjustments to the reported pre-tax profit, a loss is arrived at, this may be carried back one year (or three years for losses incurred due to COVID-19, subject to specific rules), so that a corporation tax repayment may be received, or carried forward indefinitely to be offset against future taxable profits.

Corporation tax returns must be submitted after the end of the accounting period and before the statutory filing date which is normally three months after the company receives the Notice to Deliver which HMRC will issue immediately after the end of the accounting period. Corporation tax is then normally due to be paid nine months after the end of the accounting period although larger companies have to pay their tax by quarterly instalments.

UK resident companies are still taxed on their worldwide profits, but can elect for profits of their foreign branches to be exempt from UK corporation tax under certain conditions.

6.2.1 Global Minimum Corporate Tax

In October 2021, more than 130 countries signed up to a new global minimum tax framework, previously agreed in principle by the G7, during talks chaired by the UK Chancellor of the Exchequer in London. The framework will ensure that large international corporations pay at least 15% tax rate on profits in each country in which they operate, helping to tackle avoidance and ensure a more level playing field for UK businesses.

The reform is a two-pillar package[2]:

- Pillar One aims to reallocate taxing rights on profits exceeding $125 billion annually to market jurisdictions. Developing countries are expected to gain a larger share of revenue compared to more advanced economies, relative to their existing revenues.
- Pillar Two introduces a global minimum corporate tax rate of 15% that will be applicable to companies with revenue exceeding €750 million.

In July 2022, HMRC released the draft Pillar Two legislation which will first apply to accounting periods beginning on or after 31 December 2023. This measure will introduce a new tax on UK parent members within a multinational enterprise group – HMRC defines a UK parent member as an entity within the multinational enterprise group that holds a direct or indirect ownership interest in a foreign entity. A top-up tax will be charged on UK parent members when a subsidiary is located in a non-UK jurisdiction, and the group's profits arising in that jurisdiction are taxed at below the minimum rate of 15%[3].

In June 2023, HMRC released partial draft guidance concerning multinational top-up tax and domestic top-up tax, which were introduced in the Spring 2023 Finance Bill. The guidance offers further details on the groups subject to these taxes and their administration and charges. Stakeholders are encouraged to provide feedback on this draft guidance, with the consultation period ending on 12 September 2023[4].

6.3 Tax Incentives and Relief for Businesses

Several tax incentives encourage a business to operate in a more environmentally friendly way or do good. They can provide considerable tax savings for businesses.

6.3.1 Environmental Tax Incentives: Electric Vehicles

There are several tax incentives available for Electric vehicles (EVs), such as cars and vans. For example, where a business incurs expenditure on, or after, 1 April 2021, and up to 31 March 2026 a 100% first-year allowance is available for zero-emission cars. This means the entire cost of the car may be set against profits.

Furthermore, both the employer and employee (driving the electric car) benefit by saving tax on a reduced car benefit charge. However, the benefit-in-kind rules do not apply to sole trade or partnership businesses. There also are tax incentives for electric charging points – for example, the workplace charging scheme, which is a voucher-based scheme that provides support towards the up-front costs of the purchase and installation of EV charge points.

The grant covers up to 75% of the total costs of the purchase and installation of EV charge points (inclusive of VAT), capped at a maximum of £350 per socket, 40 sockets across all sites per applicant.

2 https://web-archive.oecd.org/2021-10-20/612898-international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm
3 https://www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax
4 https://www.gov.uk/government/consultations/draft-guidance-multinational-top-up-tax-and-domestic-top-up-tax

6.3.2 Environmental Tax Incentives: Cycle to Work

The UK government introduced the cycle to work scheme to reduce the number of vehicles on the road. There are several variations to the scheme – for example, employers can operate a salary sacrifice option, whereby they will pay for the bicycles (including electric ones) and additional equipment on behalf of the employees, and then an agreed amount will be deducted from the employees' gross monthly pay. Employees may have the option to buy the bikes from the company at second-hand value later.

Providing a company bicycle is an exempt non-cash benefit so the employee will not be taxed on it. In addition, both employers and employees will benefit from reduced NI contributions. The purchase of bicycles and equipment is considered capital expenditure so will qualify for capital allowances. If the company is VAT registered, then a full VAT relief is available.

The industry guidance published in 2024 helped simplify employer participation and clarified end-of-hire valuation processes.

6.3.3 Homes for Ukraine Sponsorship Scheme

Companies, partnerships with corporate members, and collective investment schemes (collectively referred to as non-natural persons or NNPs) that purchase and own UK residential property valued at over £500,000 are entitled to an Annual Tax on Enveloped Dwellings (ATED) and the 15% rate of Stamp Duty Land Tax (SDLT) Relief under the Homes for Ukraine Sponsorship Scheme.

This measure will ensure that those wishing to offer accommodation to Ukrainian refugees fleeing the war do not face any unfair obstacles or immediate tax burdens in the form of ATED and a 15% rate of SDLT.

ATED and the 15% rate of SDLT are charged on NNPs who purchase and own an interest in UK residential property. The 15% rate of SDLT is charged on the acquisition of residential property located in England and Northern Ireland by such entities where the purchase price paid is more than £500,000. ATED is charged annually on the ownership of UK residential property valued at more than £500,000 held by such entities. The provisions on ATED were effective from 1 April 2022 and on SDLT from 31 March 2022.[5]

On 20 July 2022, the government introduced legislation covering these reliefs in the draft Finance Bill 2022–23. In the accompanying policy paper, it is stated that HMRC will not collect any tax that would otherwise be due pending the enactment of retrospective legislation in the Finance Act 2022–23.

7. Tax Avoidance and Tax Evasion

Tax evasion is the illegal avoidance of taxes by individuals, companies and trusts, but what is tax avoidance?

Tax avoidance used to be described as the legal use of tax laws to reduce your tax burden but changing social attitudes and a government drive against aggressive tax avoidance schemes has blurred what

5 https://www.gov.uk/government/publications/homes-for-ukraine-sponsorship-scheme-tax-exemptions-and-reliefs/annual-tax-on-enveloped-dwellings-and-the-15-rate-of-stamp-duty-land-tax-relief-under-the-homes-for-ukraine-sponsorship-scheme

constitutes tax avoidance. Whilst there is certainly no widely accepted definition of what constitutes tax avoidance, what is certainly true is that the stance on tax avoidance has shifted both in public perception and government practice. The austerity introduced with expenditure cuts to tackle the economic effects of the Global Financial Crisis led to public anger at what were seen as antisocial tax avoidance practices used by companies and wealthy individuals. 'Dodging taxes' more or less sums up the media and public view of its disapproval of people and companies failing to pay the taxes they 'ought' to.

Public intolerance of tax avoidance created a climate where the Treasury introduced a succession of anti-avoidance measures having the aim of counteracting and deterring tax avoidance strategies across a range of taxes and gave even greater powers to HMRC. Government guidance published by HMRC in the General Anti Abuse Rules (GAAR) explicitly rejects previously accepted court rulings that taxpayers may use any lawful means to reduce their tax bills. Their explanation of what constitutes tax avoidance is as follows.

> *'Tax avoidance involves bending the rules of the tax system to gain a tax advantage that Parliament never intended. It often involves contrived, artificial transactions that serve little or no purpose other than to produce this advantage. It involves operating within the letter, but not the spirit, of the law'.*

To learn more about HMRC Tax Avoidance: https://www.gov.uk/topic/dealing-with-hmrc/tax-avoidance

HMRC publish data on the 'tax gap' – the difference between the amount of tax that should, in theory, be collected by HMRC, and what is actually collected. The tax gap arises for a number of reasons and HMRC data attempts to break this down into identifiable behaviours which includes avoidance. As an example, the estimated avoidance tax gap was £32 billion for 2020–21 according to statistics issued by HMRC in June 2022.

The UK's estimated tax gap for the tax year 2023–24 stands at 5.3% of total theoretical tax liabilities, equivalent to £46.8 billion in absolute terms. This means HM Revenue & Customs (HMRC) successfully collected 94.7% of all the tax expected to be paid.

Over the longer term, the tax gap has decreased from 7.4% in 2005–06 to around 5.1% in 2017–18 and has been broadly stable near this level, fluctuating around 5.5%, until the current estimate of 5.3%.

By tax type, some key figures for 2023–24 include:

- The corporation tax gap has grown as a share of the total and now accounts for the largest portion, approximately 40% of the overall tax gap.
- The gap related to income tax, National Insurance Contributions (NICs) and CGT collectively accounts for around 31%.
- The VAT tax gap has decreased substantially over time and now represents about 19% of the total tax gap.
- The tax gap for excise duties is estimated at around 5.8%.

In terms of customer groups contributing to the tax gap:

- Small businesses represent the largest share, accounting for 60% of the overall gap, highlighting compliance challenges in this sector.
- Wealthy individuals account for a much smaller proportion (5%) of the tax gap.

- The shares attributed to mid-sized businesses, large businesses, criminals, and individuals have shifted somewhat, with small business non-compliance being the principal driver.

HMRC uses a combination of statistical and operational data to estimate these figures, including compliance checks, sampling, and economic modelling. Estimates are frequently reviewed and revised as new data and methodologies improve.

This tax gap figure both informs HMRC's ongoing compliance and enforcement efforts and shapes government policy aimed at improving tax compliance across all sectors.

For more detailed breakdowns and further data: https://www.gov.uk/government/statistics/measuring-tax-gaps/1-tax-gaps-summary

Finding the balance between legitimate tax planning and unacceptable tax avoidance is an issue on which the tax profession cannot currently agree. One of the reasons for this is that the clear intention of Parliament is not always obvious.

Wealth managers should ensure they understand HMRC guidance in this area and stay abreast of the changes that are still in train.

7.1 General Anti-Avoidance Rules

The UK has followed other countries, such as Canada, Australia and New Zealand, in introducing a statutory General Anti-Avoidance Rule (GAAR).

The GAAR, which came into force in July 2013, is one part of the government's approach to managing the risk of tax avoidance. It has been introduced to strengthen HMRC's anti-avoidance strategy and help HMRC tackle abusive avoidance. The GAAR legislation defines what are, for its purposes, tax arrangements that are abusive. However, just because something is not covered by the GAAR, it does not mean it will not be tackled in another way. HMRC will continue to tackle tax avoidance using existing anti-avoidance methods as well as the GAAR, where appropriate.

The GAAR applies to the following taxes:

- Income tax and National Insurance Contributions.
- Corporation tax (including amounts chargeable or treated as corporation tax).
- CGT.
- IHT.
- Petroleum revenue tax.
- Stamp duty land tax (SDLT).
- Annual tax on enveloped dwellings.

The fundamental approach of the GAAR is that the levying of tax is the principal mechanism by which the state pays for the services and facilities that it provides for its citizens, and that all taxpayers should pay their fair share. Parliament has decisively rejected the approach taken by the courts in a number of old cases to the effect that taxpayers are free to use their ingenuity to reduce their tax bills by any lawful means, however contrived those means might be and however far the tax consequences might differ from the real economic position.

Instead, it has imposed an overriding statutory limit on the extent to which taxpayers can go in trying to reduce their tax bill. That limit is reached when the arrangements put in place by the taxpayer to achieve that purpose go beyond anything which could reasonably be regarded as a reasonable course of action. Using acceptable methods of tax planning are still acceptable.[6]

Examples provided by HMRC include the following:

- A taxpayer deciding to carry on a trade through a limited company rather than as a sole trader. Once such a company starts to earn profits a decision to accumulate most of the profits to be paid out in the future by way of dividend, rather than immediately paying a larger salary, is something that should in any normal trading circumstances be outside the target area of the GAAR.
- Decisions to invest in an ISA.
- Giving away assets to a child without retaining a benefit in the gifted asset, with a view to reducing the amount of IHT payable on the transferor's death.
- Using statutory incentives and reliefs to support business activity and investment in a straightforward way such as business relief, EIS and SEIS, or capital allowances.

Where taxpayers set out to exploit some loophole in the tax laws, for example, by entering into contrived arrangements to obtain a relief but suffering no equivalent economic risk, they will fall into the target area of the GAAR.

It is recognised that under the UK's detailed tax rules taxpayers frequently have a choice as to the way in which transactions can be carried out, and that differing tax results arise depending on the choice that is made. The GAAR does not challenge such choices unless they are considered abusive.

The GAAR only comes into operation when the course of action taken by the taxpayer aims to achieve a favourable tax result that Parliament did not anticipate when it introduced the tax rules in question and, critically, where that course of action cannot reasonably be regarded as reasonable.

7.2 Tax Avoidance Schemes

As a result of the more recent interpretations by the judiciary, a distinction is now being drawn between tax avoidance and tax mitigation. Under this more recent interpretation, certain forms of tax avoidance may no longer be acceptable, and there have been instances where measures that previously were not likely to lead to penalties and possibly prosecution are now at risk of doing so.

In practice the distinction is sometimes clear, but often difficult to draw. Relevant factors to decide whether conduct is avoidance or mitigation include:

- whether there is a specific tax regime applicable
- whether transactions have economic consequences; confidentiality, and
- tax-linked fees.

In 2004, the government introduced the Disclosure of Tax Avoidance Schemes (DOTAS) regime aimed at minimising tax avoidance. The primary purpose of the scheme is to alert HMRC of the schemes which individuals or corporations use to avoid tax so that they can investigate to determine whether to challenge the arrangements.

6 https://www.gov.uk/government/publications/tax-avoidance-general-anti-abuse-rules

Changes to regulations in February 2016 have significantly broadened the DOTAS rules, which could conceivably capture more standard tax planning strategies:

- A scheme promoter is required to disclose the main elements of the scheme to HMRC. Special rules apply where disclosure is not made by a promoter, in those cases a scheme user must make disclosure.
- HMRC will then issue the scheme with a DOTAS number.
- A scheme user will have to notify HMRC that it is using the scheme by inserting the number in its tax return.
- HMRC will monitor the scheme's use and if necessary legislate to terminate it.
- Financial penalties are levied on those who fail to comply with the regime.
- If an obligation to disclose exists, notification must be made within five days of the arrangements first being made available.

The rules are long and complex but in summary, a tax arrangement must be disclosed to HMRC when:

- it will, or might be expected to, enable any person to obtain a tax advantage
- that tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement, and
- it is a tax arrangement that falls within any description ('hallmarks') prescribed in the regulations.

The regulations introduced new hallmarks. In particular, it introduced a financial products hallmark, which could be very wide reaching. Any tax advantage obtained where a share, loan, or other prescribed financial product with unusual terms or abnormal steps is used, should at least consider whether this hallmark is met.

In 2017, a hallmark was introduced to catch IHT avoidance schemes but not the straightforward use of reliefs and exemptions or ordinary tax planning arrangements. The latter includes descriptions of disclosable arrangements which are designed to reduce the value of an estate on death or those which seek to avoid certain other IHT charges in addition to 'entry charges' on relevant property trusts.

If a client enters into a tax avoidance scheme, they can face the following from HMRC:

- HMRC will fully investigate their tax affairs.
- It may require payment up front of the tax that they are trying to avoid.
- If tax is not paid, HMRC will take legal action and if successful, the client would face having to pay the tax, penalties and interest as well as legal costs.
- HMRC will treat the client as a high risk taxpayer and closely scrutinise all of their tax affairs in the future.

HMRC has a Wealthy Team that targets avoidance by the wealthy[7].

The team is a specialist division that handles the tax affairs of the UK's richest people. HMRC defines wealthy individuals as people with incomes of £200,000 or more, or assets equal to or above £2 million in any of the last three years. There are about 800,000 wealthy individuals, according to HMRC.

7 https://www.gov.uk/government/collections/collecting-the-right-tax-from-wealthy-individuals

7.3 Tax Evasion and Unexplained Wealth Orders

The Criminal Finances Act 2017 makes companies and partnerships criminally liable if they fail to prevent tax evasion by either a member of their staff or an external agent, even where the business was not involved in the act or was unaware of it.

Both the domestic and foreign tax evasion facilitation offences encompass three stages:

- **Stage one** – criminal tax evasion by a taxpayer (either an individual or a firm) under existing law
- **Stage two** – criminal facilitation of the offence by a representative of the firm, as defined by the Accessories and Abettors Act 1861, or
- **Stage three** – failure of the firm to prevent its representative from committing the criminal act outlined at stage two.

The rules target deliberate and dishonest behaviour. Firms have to ensure that they undertake risk assessments of their products, services, client data and internal systems that could be used to facilitate tax evasion. They also have to put in place appropriate monitoring and training of staff at all levels.

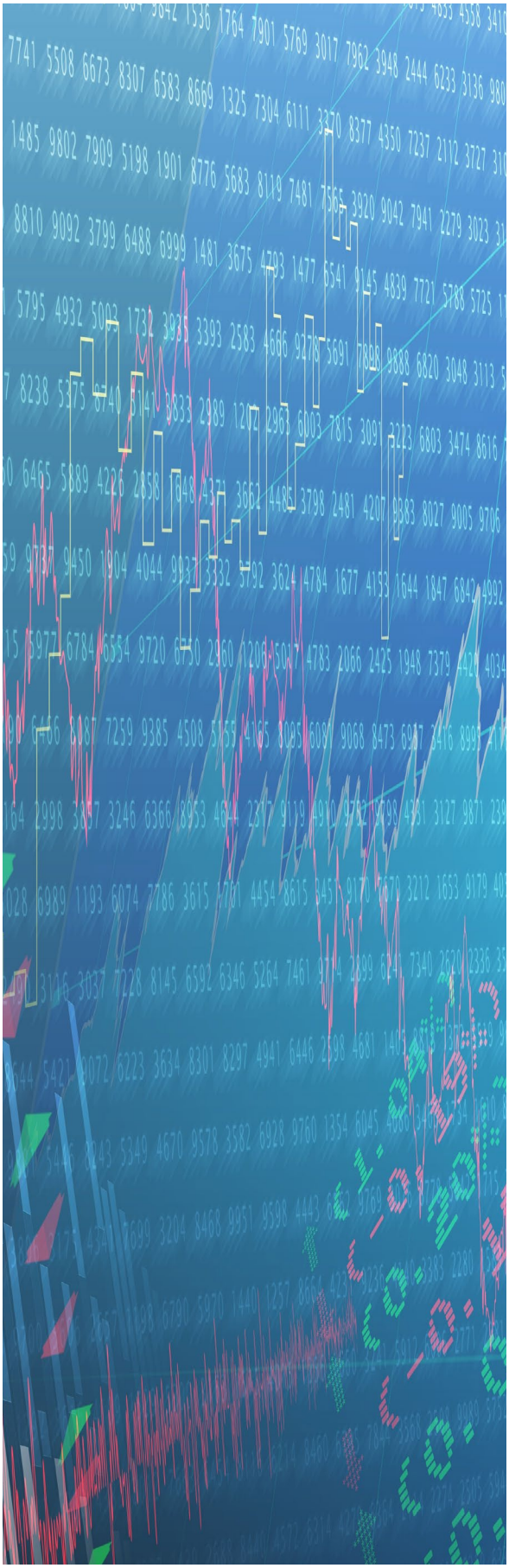
The Act effectively makes owners and managers responsible for preventing their staff and external agents and consultants from committing tax evasion. And the larger and more complex the business, the greater the risk that an activity may occur that could be caught.

A further measure in the Act allows for Unexplained Wealth Orders to be served on individuals suspected of a serious crime to explain the sources of their wealth; any proceeds of crime can be seized by the authorities. The Act also covers a raft of other provisions, including further powers to investigate suspected money laundering or terrorist financing, and new orders to require someone to disclose information they may have on money laundering.

Chapter Seven

Managing Clients' Wealth

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In this chapter, we will cover additional essential elements of managing clients' wealth that were not covered or only touched upon in previous chapters.

These elements include projections for cash management, the emergency liquidity reserve, short- and long-term funding, risk-adjusted returns strategies like bond portfolio laddering, ISAs, estate issues (such as inheritance tax and wills), trusts for wealth transfer, later life (eg, long-term care and pension drawdown) and more.

1. Liquidity Management

As part of managing a client's wealth, the adviser needs to consider how the client's need for funds will be dealt with or how surplus funds will be managed.

Cash deposits generally comprise bank, building society and national savings products, all of which are targeted at retail investors, although companies and financial institutions also make short-term cash deposits with banks. One of the key reasons for holding money in the form of cash deposits is liquidity, which is the ease and speed with which an investment can be turned into cash to meet spending needs.

Managing the cash element of a client's assets is fundamental to wealth management, so in the next sections, we will look at the features of a cash management programme, the factors to consider in selecting suitable accounts, and managing funding needs and surplus funds.

1.1 Cash Management Programme

A cash management programme needs to address several key factors.

To begin with, it needs to analyse the cash requirements of the client in conjunction with expected inflows and outflows, by developing cash flow projections that drill down to a level that is appropriate to the client's circumstances and needs.

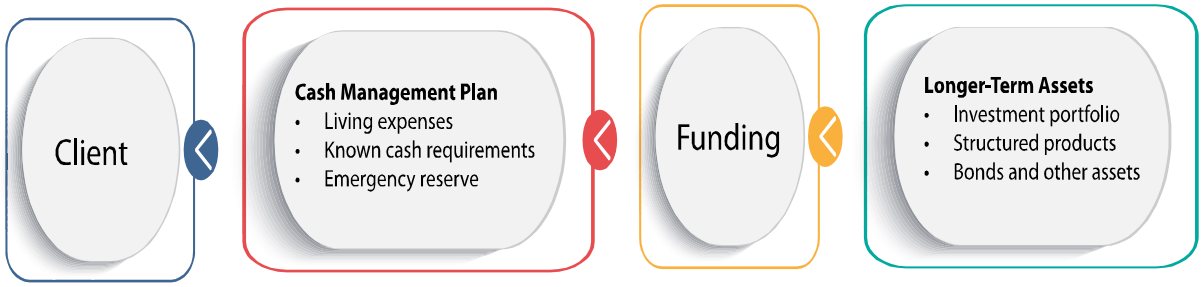
The client's circumstances should then be analysed to identify the types of accounts that will be required to provide an emergency liquidity reserve, and whether accounts are needed to provide sources of short- and long-term funds or to capture surplus income and channel this for investment. Accounts are then selected to meet these needs and which are suitable in terms of security, liquidity and return.

These then need to be brought together into a cash management plan that reflects the client's financial position and stage in life.

Where the client is retired, then a sound cash management plan will need to recognise that retirement often signals the move from a reliance on regular earnings to reliance on earnings from savings and investments. A cash management plan will, therefore, need to provide an emergency liquidity reserve, take account of predicted cash requirements and incorporate how the cash reserve the client needs will be supplemented in both the short and long term.

This is shown diagrammatically as follows:

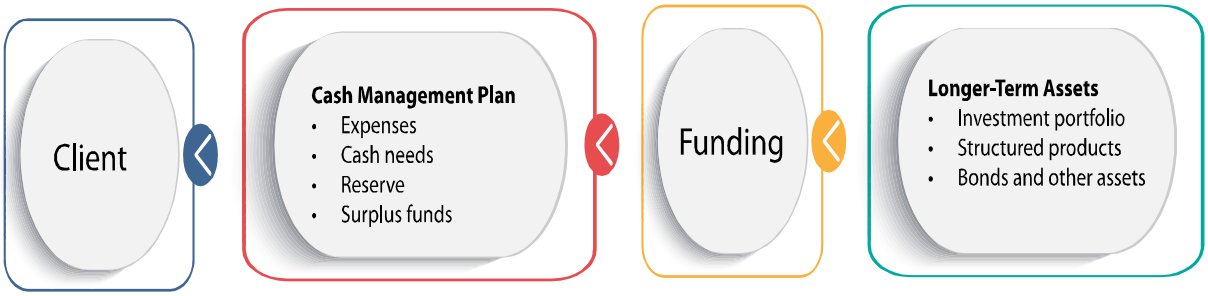
Cash Management – Managing Funding Needs



Where the client is working, a sound cash management plan will instead need to plan how to channel surplus income into long-term investments. It will need to do so by taking into account the need to fund payment of living expenses and known cash requirements, and an emergency cash reserve.

Again, this is shown diagrammatically below.

Cash Management – Managing Surplus Funds



A sound cash management programme, therefore, needs to satisfy several needs:

- Facilitate periodic payment of living expenses and other known cash requirements.
- Consider an emergency cash reserve.
- Fund short-term and long-term needs or marshal excess funds before they are committed to long-term investments.

1.2 Cash Flow Projections

Sound financial management means knowing the cash flow for your client, forecasting their cash needs, planning a funding strategy so that they have cash when they need it and having financial records that track inflows and outflows. Even wealthy individuals can have cash flow problems and it is often due to poor financial planning.

Cash flow projections should be prepared for short-term and long-term planning purposes so as to differentiate between living expenses and anticipated cash needs or surpluses. As they are used for different purposes, they are usually prepared differently.

The following table shows suggested time horizons for cash flow projections and their respective purposes.

Cash Flow Projections	
Time Horizon	**Purpose**
Short-Term (Up to 3 years)	• Estimates of expected inflows. • Estimates of expected outflows. • Plan use of surplus funds. • Identify shortfalls that require funds.
Long Term (3–5 years)	• Identification of potential future cash needs. • Drive development of a strategy to fund long-term needs. • Provide input to need for short-term assets within investment portfolio.

The short-term cash flow projection will be used to determine the expected income and expenditure of the client. The results of this will identify whether the client has an expected deficiency that needs to be funded out of investment income or a surplus that can be directed into longer-term investments. A suggested format for capturing this is as follows.

Cash Flow Projections													
	J	F	M	A	M	J	J	A	S	O	N	D	Total
Income:													
Fixed Expenses:													
Controllable Expenses:													
Net Income													

The long-term cash projections will identify surpluses and deficits, the amount, the timing and the reason.

Again, a suggested format that could be used is shown below.

Long-Term Cash Flow Projections					
	1st year	2nd year	3rd year	4th year	5th year
Expected Cash Receipts:					
Expected Cash Outgoings:					
Surplus or Deficiency					

This projection will allow a plan to be developed on how to use surpluses and how to fund any deficits cost-efficiently. For example, a deficit in the third year could be funded by surpluses in years one and two which could be invested in short-term deposits. Otherwise, there is a risk that the client might commit early surpluses to long-term investments that are not readily realisable without incurring losses.

For some clients, the projections may show a consistent series of surpluses such as for professionals and business owners until they can retire. Alternatively, it may show deficits until receipt of an anticipated amount or where a client has retired and is now drawing on accumulated savings.

The role of the wealth manager is to determine whether there will be surpluses or deficits, whether assets are sufficient to carry any short-term deficits and then plan to manage long-term surpluses or cash funding needs. The adviser can then look at how to present this to the client in a way that makes the projection clear to understand by using graphs or other presentation methods.

Making projections can be challenging. It is worth remembering that sound financial projections will tell your client a lot about your ability and your experience. Some factors to bear in mind when preparing these are:

- Do not try to be overly creative. Balance simplicity with comprehensiveness.
- Be conservative when projecting inflows.
- Account for seasonal or periodic fluctuations in income and expenditure.
- Make allowances for inflation.
- Be aware of the economic cycle and its impact on income, expenditure and attitudes.
- Consider using graphs to effectively illustrate movements.

It is essential to recognise that these are projections and as such, need to be regularly revisited, assessed for accuracy and usefulness and the assumptions updated for use in subsequent periods.

1.3 Selecting Suitable Accounts

Having established cash flow projections that are reflective of the client's circumstances and needs, the next step is to consider what factors need to be considered in selecting suitable homes for the client's cash.

There is an often bewildering choice of cash accounts and money market funds to select from. Wealth managers and advisers therefore need a systematic approach that can be adopted in selecting appropriate accounts and funds to meet the client's objectives and attitude to risk.

Corporate treasurers have a methodology that can usefully be adapted to aid with the necessary filtering. Their methodology is known by its acronym of SLY – security, liquidity and yield. In simple terms, it says that you should first assess the provider for security and only those that pass that test are then assessed on liquidity or the ability to readily realise the funds. Only the providers that pass those filters should then be considered and it is only at this last stage that yield should be considered.

This approach provides a basis for the security of the cash deposits and although it may not withstand a systemic failure, it can prevent the failure of one provider proving overly damaging and catastrophic to the overall liquidity of the client's portfolio.

Let us consider the steps of this process in more detail.

1.3.1 Security

The primary consideration should be the safety of the client's capital. Cash deposits will probably represent the emergency funds needed by a client and so risks should not be taken with these even if the client has an adventurous attitude to risk for the remainder of their investments.

Assessing the risks to capital requires the wealth manager to assess the risk of default of the deposit taker. This requires an assessment of the creditworthiness of the bank or building society to be made and the extent to which any compensation scheme will protect the deposits as discussed in.

The global financial crisis of 2007–08 proved these to be real risks and so the wealth manager should consider setting a limit on the amount placed with any one institution and then seek a second level of protection by diversifying cash investments among other providers and money market funds.

1.3.2 Liquidity

Liquidity refers to the ease or otherwise in which cash funds can be readily realised. The types of accounts that are chosen will be driven by the cash needs of the client derived from the cash flow projections. Immediate cash needs will need a combination of current and instant access accounts as, by definition, ready access is required and tying the funds up would be inappropriate. Short-term reserves, however, can more realistically be tied up and term or notice accounts selected that tie in with projected cash flows.

For term and notice accounts, the wealth manager should establish whether these funds can be accessed immediately on payment of a penalty. Where such accounts are less liquid, then the wealth manager should also take into account the need for diversification of risk and ensure appropriate limits are designed and applied to minimise the concentration of risk with one provider and for any undue exposure to maturity dates.

Alternatively, the need can be met by liquid money market funds. Although some have greater risk because of the maturity profile of their underlying investments, in normal circumstances the managers are normally able to offer ready access to funds. The inherent risk, however, needs to be borne in mind especially in times of market volatility.

A lesson from the credit crunch, that took place during the global financial crisis of 2007–08, is that in times of uncertainty, the wealth manager should actively review the suitability of providers and, as importantly, limit the funds out by the provider and the amounts on term or notice.

1.3.3 Yield

Yield should come last in priorities; the results of the bank failures seen during the financial crisis of 2007–08 emphasise this point.

The balance of instant access and term funds will be driven by the client's circumstances, their needs and the expected cash flows. It should balance the need for security and liquidity against the returns which can be expected.

1.4 Managing Funding Needs

Managing the funding needs of clients involves ensuring that they have an adequate emergency liquidity reserve and developing a strategy to deliver a reliable supply of funds to top up that emergency reserve and provide both the short-term and long-term funding that has been identified as part of the ongoing cash management programme.

1.4.1 Emergency Liquidity Reserve

The function of an emergency liquidity reserve is to provide a readily available source of funds to meet unexpected events. It needs to meet two criteria therefore, availability and a suitable amount.

One of the most difficult things to determine is what amount is needed just in case something happens. Assessing this can be quite difficult and it is useful to apply some rigour to the assessment process. The need for an emergency reserve will usually revolve around the home, health and job and can be quantified by using these as discussion points with the client. A suitable amount can only be determined in conjunction with the client but in doing so it is worth considering the following:

- When assessing what may take place, it is usual to take into account damage to home, contents or car. When doing so, insurance cover should be taken into account as this may provide most if not all of the funds that might be needed.
- Where medical situations are considered, the availability of any medical insurance needs to be incorporated into the planning process and if not available, then the published cost of relevant private medical services should be established.
- If loss of job is a concern, then the standard is to plan for the fact that it might take six months to find a new role as it can take a significant time to find another job and it may involve relocation. Whether this actually needs to be six months' income, however, needs to be investigated as significantly less may be needed such as an amount to cover living expenses only.
- It is not practical to plan for all events and so you should consider using short-term loans to fund truly unexpected emergencies.
- Finally, the amount set aside for the emergency reserve should also provide sufficient time to assess existing investments and market conditions to identify investments that can be readily realised.

Having decided on a suitable amount, it is important to then find a suitable home for the funds. One function of an emergency reserve is availability, but this does not necessarily dictate that the funds need to be committed to an instant access account. Notice accounts of a reasonable duration or term accounts where the funds can be accessed on payment of a penalty or even short-dated bonds may be suitable.

What amount is appropriate is, however, subjective and it is important therefore that it is both realistic and passes the client's test of being sufficient to provide them with a sense of security.

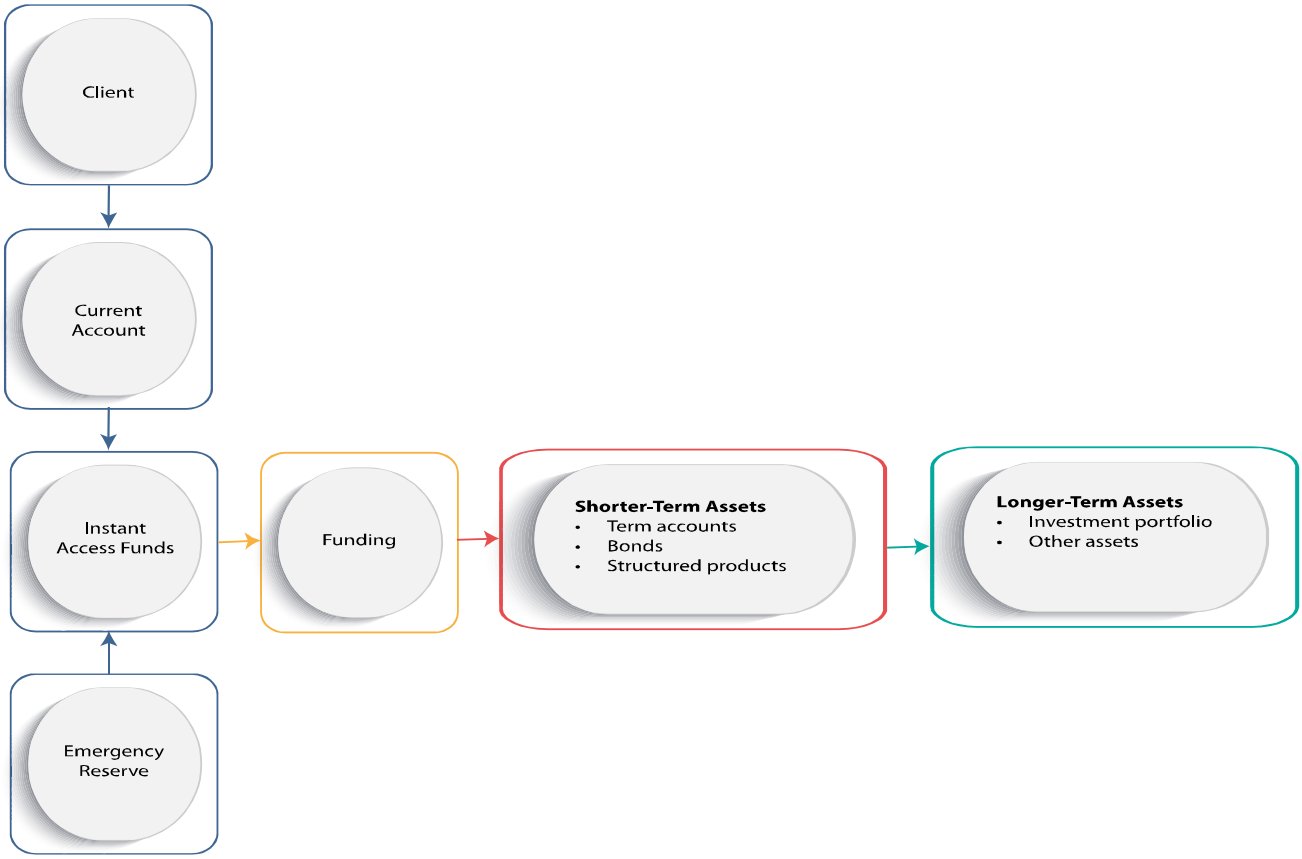
1.4.2 Short- and Long-Term Funding

Once a client ceases full-time employment, they will usually move from a position of directing surplus income into savings and investments to having to utilise the funds they have built up to finance the lifestyle they wish to follow in retirement.

Typically, they will have income, possibly significant income, but this may be insufficient to meet their ongoing expenses and desired standard of living. It will usually be necessary to develop a strategy to access capital by a structured withdrawal of funds from the long-term portfolio to meet both their short- and long-term needs.

This is shown diagrammatically below.

Cash Management – Managing Short- and Long-Term Funding Needs



There is a wide range of assets that can be used to finance the short-term funding needs of the client and this wide variety of choices enables investments to be tailored to an individual's financial objectives, their income needs and their risk attitude.

It should also be remembered that the client's attitude to risk for this part of their assets may be different than for their longer-term investments. A client may have an adventurous attitude to risk for their long-term portfolio but a cautious attitude for shorter-term assets. Establishing this is key to a selecting suitable solution.

The range of assets that can be utilised to meet these needs include straightforward products such as fixed term accounts, national savings certificates and guaranteed growth bonds. These can be structured so that there is a regular flow of products maturing to 'top up' the client's cash reserve or emergency reserve.

Depending upon the client's attitude to risk, structured products could be incorporated into this portfolio mix to give exposure to stock market returns over, say, three and five years, especially if they carry some guarantee of capital return.

A bond portfolio could also be constructed using a laddering strategy which involves buying securities with a range of different maturities. As each matures, funds can become available for the investor to withdraw or can be reinvested in later maturities. This is, of course, dependent on the returns available.

If the maturity proceeds are to be reinvested and interest rates have fallen since the original investment, then it would be necessary to reinvest the proceeds at a lower rate, but the remaining stocks would be paying an above market return. Conversely, if rates rise then the portfolio will be paying a below market return but investment into higher rates can be made as soon as the next maturity takes place.

This laddering strategy reduces the bond portfolio's sensitivity to interest rate risk by not concentrating the funds on the maturities that have the highest yields but at the price of a lower overall yield.

The benefits of this strategy can be seen by looking at the alternatives of investing in short-dated securities only or long-dated only. If only short-dated securities were selected, then the bond portfolio would have a high degree of stability as these securities would be least affected by changes in interest rates. The price of this stability would be giving up the higher yield that could be obtained from longer dated stocks. If longer dated stocks only were selected, then the investor would gain the higher yield but a cost of greater volatility and exposure to potential losses if the stocks have to be sold before maturity.

Constructing a laddered portfolio would therefore balance out some of these risks. The return would be higher than if only short-dated securities were bought and the risk would be less than if just long-dated stocks were bought.

None of the above options are mutually exclusive and instead, a combination of these strategies designed to fit the client's objectives and attitude to risk is likely to offer the best mix of risk and reward for the client.

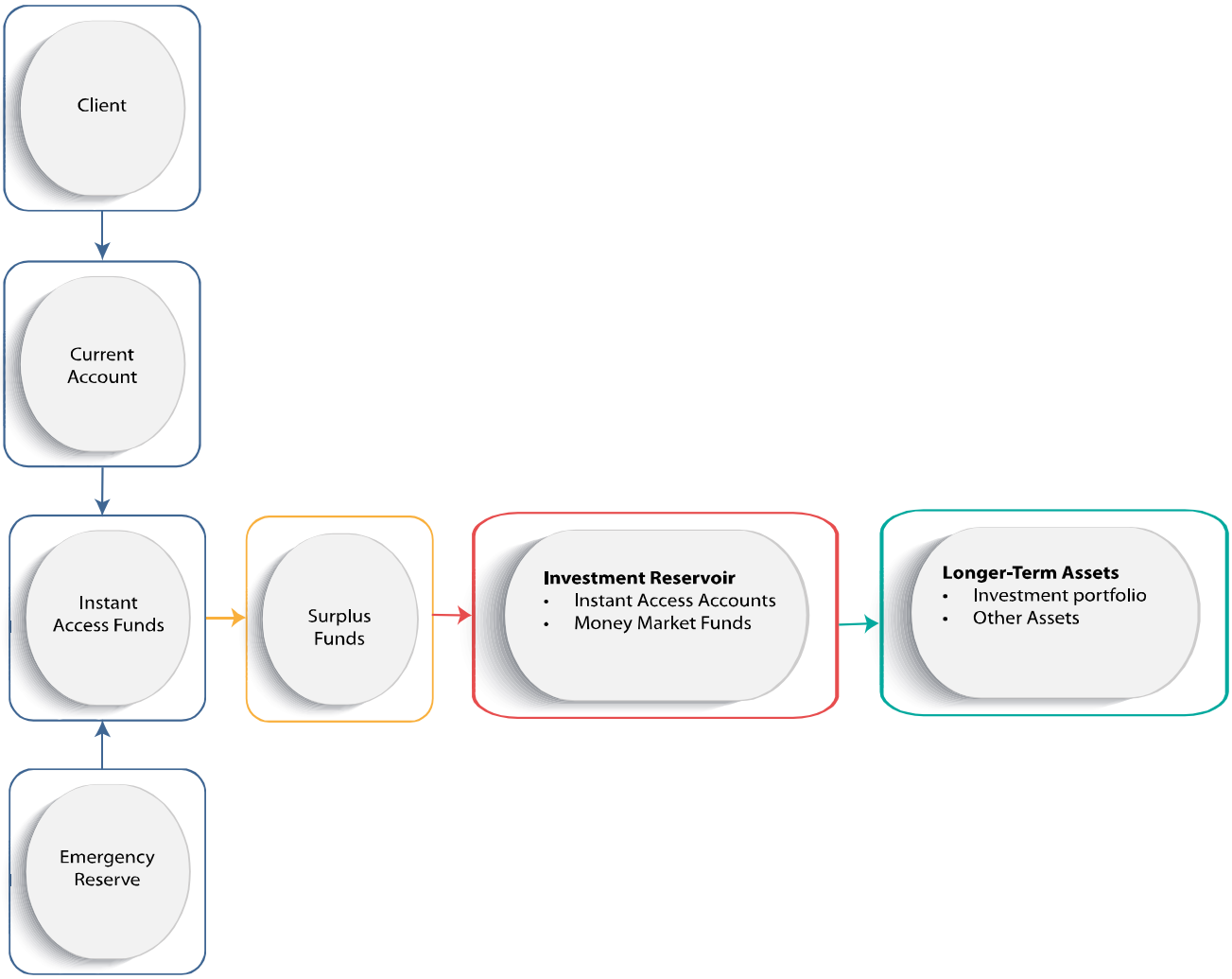
1.5 Managing Surplus Funds

Depending upon a client's stage in life, they may not have a need for funds and instead may have surplus income and other funds that instead need to be channelled effectively into longer-term investments.

After setting aside funds for living expenses and an emergency reserve, surplus funds should be directed into an investment reservoir prior to being invested into longer-term investments. The investment reservoir is simply an account that can be used primarily as a matter of logistical convenience to efficiently transfer surplus funds from the client to the long-term investment portfolio.

An investment reservoir allows surplus funds to be invested in accordance with the investment plan and without delay but also without decisions having to be made too frequently or over amounts that are too small. This is shown diagrammatically below.

Cash Management – Managing Surplus Funds



The diagram shows that the principle of an investment reservoir is to move the cash through the system and into the investment reservoir and then out for investment as quickly and automatically as possible. The accounts used for the investment reservoir therefore need to enable ready access to the funds and where possible there should be an automatic sweep of surplus funds above an agreed amount.

As the purpose of the investment reservoir is to get funds invested, then the wealth manager should place a trigger point to avoid funds sitting in the account for too long. This trigger point could be, say quarterly, if the cash flow is large or it could be value driven if the surplus cash flow is small, say when it reaches £20,000.

2. Managing ISAs

Individual Savings Accounts (ISAs) are a vehicle that offers tax advantages for investors to save. They were introduced in 1999 and have since been one of the main vehicles for saving and investing tax efficiently. Wealth managers, therefore, need to be aware of their main features and knowledgeable on particular aspects such as eligibility, allowable investments and the planning opportunities presented by Junior ISAs, lifetime ISAs and the ability to retain the tax-advantaged status following the death of an investor.

ISAs can only be offered by an authorised ISA manager and an individual is not allowed to run an ISA other than through such a manager. Authorisation is provided by HMRC and the manager is responsible for managing the account in accordance with HMRC rules, making any claims for repayment of tax and providing HMRC with statistical information about the ISAs they manage.

2.1 Types of ISAs

Investors can subscribe in each tax year to the following types of ISA:

Types of ISA	
Cash ISA	• This is the most common type of ISA and includes deposits with banks and building societies, and some cash-type products. • Cash ISAs are the tax-free equivalent of traditional savings accounts.
Stocks and shares ISA	• Most bonds, equities and collective investment funds can be held in a stocks and shares ISA, except cash-like and limited redemption funds. • They also include life assurance policies (but not pensions) which, before 2005/06, formed a separate component.
Innovative finance ISA	• This ISA enables peer-to-peer lending to be included within an ISA wrapper. • Peer-to-peer lending aims to match lenders with borrowers so each enjoys better rates.
Lifetime ISA	• The Lifetime ISA is designed to help eligible investors to simultaneously save for a first home and for retirement without having to choose one over the other. • People between 18–40 can open a Lifetime ISA and contribute up to £4,000 in each tax year. The government will provide a 25% bonus on these contributions at the end of the tax year up to £1,000 per year. Any contributions will sit within the overall ISA contribution limit. • Individuals can continue to contribute to their Lifetime ISA and receive a government bonus on contributions up until age 50. If the investor buys the first home, reaches age 60 or is terminally ill (with less than a year to live), they can withdraw their savings tax free. • For any other reason, investors will have to pay a 25% charge on the amount withdrawn.

Source: https://www.gov.uk/individual-savings-accounts

In addition, there is a Junior ISA (JISA) which is a tax-free savings vehicle aimed at children aged up to 18. It is similar to mainstream stocks and shares ISAs and cash ISAs, but with different rules surrounding eligibility, account management and subscription limits.

Junior ISAs are designed for children under 18 and both a cash Junior ISA and a stocks and shares Junior ISA are available. Their characteristics are similar to those available to adult investors, but with some key differences:

- Unlike adult ISAs, where the investor can open and subscribe to new ISAs in each tax year, a child can only hold up to two Junior ISAs – no more than one of each type.
- The annual subscription limit for Junior ISAs is £9,000 for the tax year 2025/26 (unchanged for several years), which can be divided between subscriptions to a cash Junior ISA and a stocks and shares Junior ISA.
- On reaching the age of 18, the child's account ceases to be a Junior ISA, but any investments held at that date remain in the tax-free wrapper until the account is closed or is converted into an adult ISA.
- A child could have a cash Junior ISA and open a normal cash ISA when they reach age 16, and continue subscribing to both.

Junior ISAs replaced child trust funds (CTFs) in 2011. It is not possible to open a Junior ISA if a CTF has already been opened and instead subscriptions can be made to this account. Although, no further government contributions have been made since 2011, existing CTFs continue. Subscriptions can still be made to existing CTFs, and the subscription limit is aligned with the Junior ISA limit. Existing CTFs can be transferred to a Junior ISA and may be transferred even if – at the time that the transfer is made –the child would not be eligible for a JISA, for example, because they are no longer resident in the UK.

2.2 Characteristics of ISAs

2.2.1 Eligibility

As ISAs benefit from preferential tax treatment, there are rules surrounding who may apply for an account and how much can be invested. In order to be eligible to subscribe to an ISA, the investor must be:

- aged 18 years or over to subscribe to a cash ISA
- stocks and shares ISA or an innovative finance ISA
- aged 18 years or over and meet other age rules to subscribe to a Lifetime ISA, for example, an investor may only open a Lifetime ISA under the age of 40, but they may subscribe to that ISA until they reach 50, or
- resident in the UK for tax purposes.

Investors must declare in their ISA application that they meet the residence qualification. The residency qualification requires an investor to be resident in the UK to be eligible to subscribe to an ISA. Residency in the UK refers to England, Wales, Scotland and Northern Ireland. It does not include anywhere else outside the UK, and specifically, it does not include the Channel Islands or the Isle of Man.

Crown employees are exempt of the requirement to be resident in the UK.

- A Crown employee is typically a member of the armed forces or a diplomat.
- Someone who is married to or in a civil partnership with a Crown employee can also be exempt from the requirement.
- To be able to utilise this exemption, they must be serving overseas and be paid out of public revenues.

Investors are under an obligation to notify the ISA manager if they cease to meet the residence qualification because they have become non-resident, have ceased to perform duties as a Crown employee serving overseas, or have ceased to be married to, or in a civil partnership with, such a person.

Once an investor ceases to meet the residency qualification, no further subscriptions can be made, but the account need not be closed.

The key points to note from the perspective of the investor are:

- An investor cannot make subscriptions once they are no longer a UK resident.
- The investor can, however, retain their ISA and if the investor subsequently returns to the UK, they can subscribe again and will need to complete a new application form.

2.2.2 ISA Subscriptions

In each tax year, ISA investors may subscribe to:

- a cash ISA
- a stocks and shares ISA
- an innovative finance ISA, and
- one Lifetime ISA.

Clients may subscribe to multiple ISAs of the same type in the same tax year with more than one provider. The only exceptions are Lifetime and Junior ISAs.

Investors can subscribe up to £20,000 in the 2025–26 tax year (frozen until 2030). The subscription limit can be split amongst a cash ISA, a stocks and shares ISA, an innovative finance ISA and a lifetime ISA as the investor wishes. This is provided that the maximum subscription limit is not breached, no more than the maximum Lifetime ISA payment limit of £4,000 is subscribed and the investor does not breach the 'one ISA of each type per year rule'.

Investors can choose to invest in separate ISAs with potentially different providers subject to the overall annual maximum limit, or subscribe the maximum amount to just one type of ISA.

Investors can subscribe cash into any of the types of ISA. It is not possible to transfer existing shares that an investor owns directly into an ISA, except for shares from an employee share scheme. An ISA manager may offer a share exchange scheme where it arranges for the shares to be sold and for the proceeds of the sale to be invested in the ISA.

Shares can be directly transferred into an ISA if they have been acquired by the investor from an approved save as you earn (SAYE) option scheme or a share incentive plan. Shares cannot be directly transferred into an ISA in any other circumstances. The rules only allow shares or depository interests to be transferred into an ISA; other investments, such as loan notes, cannot be transferred. Investors have 90 calendar days in which to transfer emerging shares into a stocks and shares ISA.

There are special rules covering how subscriptions are treated in the event that the ISA manager goes into default and for certain other scenarios such as reinstatement of funds into a lifetime ISA or Help to Buy ISA where a property purchase falls through.

2.2.3 Charges

For some investors, there is an attraction in having charges levied outside of an ISA as it allows them to maximise the amount that is invested in the tax-free wrapper. The ISA rules differentiate between the types of charges which may be made by the ISA manager in terms of:

- those which may be charged outside of the ISA and not count towards subscription limits, and
- those which must be met from within the ISA.

HMRC Rules on Charging	
Charges that can be taken outside an ISA	• Fees related to the administration of the ISA can be paid outside the ISA wrapper. • These include charges for opening, maintaining or closing an ISA, or arranging for the investor to receive copies of annual reports and accounts or to attend general meetings. • These can be paid from funds held outside the ISA if the investor wishes and the ISA manager agrees.
Charges that must be applied within the ISA	• Charges related to the purchase and sale of ISA investments must be applied within the ISA. • These include items such as dealing commission charges, stamp duty and the initial charge made when buying an OEIC or unit trust.

To be able to decide what charges fall within each category, HMRC recommend a simple test is made – this is to ask whether the charge would still be levied (at the same or another rate) had the investor made the purchase or sale outside the ISA.

- If it would, the charge is part of the cost of acquiring or disposing of the investment and must be met from funds within the ISA.
- If it would not, the charge is part of the cost of managing the ISA and can, therefore, be paid from funds held outside the ISA.

2.2.4 ISA Transfers and Withdrawals

An investor has the right to withdraw all or part of the cash and investments held in an ISA, as it is their funds, and the terms and conditions for the account make clear that the investor retains beneficial ownership. Any withdrawal will be subject to the terms and conditions for the account, such as satisfying notice periods and withdrawal rights in relation to non-cash innovative finance ISA investments are available only as set out in the terms and conditions of the account.

Cash withdrawn from an ISA in error by the investor (or the investor's agent) cannot normally be reinstated but there are two exceptions:

1. Where funds are withdrawn in error from an ISA as part of a transfer to another ISA manager.
2. Where cash is withdrawn in error from an ISA because the ISA manager misinterpreted the investor's instructions.

ISAs can, however, be established as flexible ISAs.

- A flexible ISA is an ISA whose terms and conditions allow the investor to replace cash they have withdrawn, without the replacement counting towards their annual subscription limit.
- Where a withdrawal is made, any subsequent subscriptions in the same tax year that would otherwise count towards the subscription limit, will do so only to the extent that previously withdrawn amounts have been fully replaced.
- Flexibility can be offered only in respect of cash – for cash ISAs and any cash held in a stocks and shares or an innovative finance ISA (including from the sale of investments).
- Offering flexibility is optional for ISA managers. It is not available for Junior ISAs, Help to Buy ISAs or Lifetime ISAs.

It is possible to transfer between ISA providers and to transfer the balance of a cash ISA to a stocks and shares ISA, and vice versa. Although it is a legal requirement for ISA providers to permit transfers out, there is no corresponding rule on accepting transfers.

2.2.5 Tax Treatment

The aim behind the introduction of ISAs was to encourage people to save by providing tax relief on income and growth, and so raise the level of long-term savings in the economy. The incentive for investment in an ISA is that the investments held within an ISA account are free of income tax and capital gains tax.

There are a number of tax advantages to ISAs:

- Interest on cash ISAs can be paid free of tax.
- There is no additional income tax liability on dividends.
- All gains are free of capital gains tax (CGT).
- Interest, including interest payments, on fixed interest securities in the stocks and shares component is free of income tax.
- There is no personal reporting to HMRC, so investors do not need to include details of their ISAs on their tax return.

- Gains made on stocks and shares are tax free. As a result of the annual tax-free allowance, few ordinary investors pay any CGT but the ability to shelter gains from tax can be very attractive for wealthier investors. The annual exempt amount allows taxpayers to make a certain amount of gains tax-free each year. For the tax year 2025–26, there is an annual tax-free allowance of £3,000. Any net gains in excess of this are chargeable at either 10% or 20% depending on the amount of the individual's total taxable income and gains (there are different rates for gains on the sale of second homes and for trusts).

2.3 Permitted Investments

Wealth managers need to be aware of the rules surrounding what investments qualify for inclusion within each type of ISA.

2.3.1 Cash ISAs

The most obvious example of investments that qualify for inclusion in a cash ISA are savings accounts that are designated as cash ISA accounts offered by savings institutions, such as banks and building societies. The rules, however, also allow for other investments to be held as well. Included in the list of permissible investments are:

- Money market funds and short-term money market funds.
- Alternative financial arrangements – products such as **Sharia** accounts that do not pay interest.
- Securities, other than National Savings Certificates (NSCs), premium savings bonds, national savings stamps and gift tokens, issued under the National Loans Act 1968 or the National Savings Bank Act 1971, on terms that provide for them to be held in the cash component of an ISA.
- Collective investment schemes, insurance policies and qualifying shares that were acquired before 1 July 2014 and failed the 5% test for inclusion in a stocks and shares ISA[1].

2.3.2 Stocks & Shares ISAs

The ISA Regulations contain rules on which investments are eligible for inclusion in a stocks and shares ISA and so can benefit from tax exemption.

Qualify Investments for Stocks & Shares ISAs	
Cash	• As described in section 2.3.1.
Shares	• Shares issued by a company that is incorporated anywhere in the world and which are officially listed or are admitted to trading on a recognised stock exchange (ie, ones which are included in the Official List maintained by the FCA). • Except when acquiring shares from approved share schemes, qualifying shares do not include: ◦ shares that are not officially listed on a recognised stock exchange ◦ nil-paid rights purchased in the market by the ISA manager ◦ warrants to subscribe for shares except as part of new investment trust launches, and ◦ futures and options.

1 An HMRC's guidance saying that for each fund that meets the ISA requirements there must be no guarantee or agreement that investors will receive 95% or more of their purchase price back within five years.

Qualify Investments for Stocks & Shares ISAs	
Securities	• The ISA Regulations define 'securities' as bonds issued by: ◦ Government including gilts and gilt strips. ◦ Multilateral organisations, such as the World Bank and the IMF, if they are listed on the official list of a recognised stock exchange. Companies anywhere in the world, whether secured or unsecured, such as loans, loan stocks, debentures, and **eurobonds**. This includes core capital deferred shares.
Investment Funds	• A range of investment funds qualify for inclusion in a stocks and shares ISA, including authorised investment funds and investment trusts. • Authorised investment funds include retail schemes and recognised schemes include UCITS funds and NURS. Qualified investor schemes and other UCIS are not permitted investments. • Shares in a recognised investment trust are also eligible for inclusion. A company is an 'investment trust' if it is recognised by HMRC as a trust for the purposes of Section 1158 of the Corporation and Taxes Act 2010.
Insurance Policies	• Eligible life insurance policies made on or after 6 April 2005 qualify to be held in a stocks and shares ISA if they meet certain conditions and satisfy the 5% test. • A policy must be on the life of the ISA investor alone. Joint life, multiple life and life of another policies are not permissible as a qualifying investment for the ISA.
Others	• Shares emerging from approved schemes – shares acquired by employees that have emerged from an approved SAYE option scheme or a share incentive plan are qualifying investments and may be transferred directly into a stocks and shares ISA. This applies even where the shares would not otherwise be qualifying investments, for example, because they are not listed on a recognised stock exchange. • Depositary receipts (DR) – can be held in an ISA providing the underlying shares represented by the DR are in the beneficial ownership of the holder and are ISA qualifying. • Shares may also be acquired within an ISA as a result of a new issue or a corporate action and may be held provided they are qualifying investments otherwise they must be either sold or transferred to the investor.

Non-qualifying investments may not be held in a stocks and shares ISA. It is possible these may be acquired as a result of a takeover, de-merger or other type of corporate action and where that happens, the ISA manager should either sell the investments within 30 days or return them to the investor.

2.3.3 Innovative Finance ISAs

Qualifying investments for an innovative finance ISA (IFISA) are peer-to-peer loans, crowdfunding debentures and cash.

- Eligible peer-to-peer loans are those facilitated by an operator authorised under FSMA 2000 (as amended) who has the appropriate regulatory permission to act as such.
- All loans must be made using cash held by the ISA manager and must be entered into for genuine commercial terms and not as part of a scheme or arrangement the main, or one of the main purposes of which is the avoidance of tax.
- Where a borrower defaults and the loan is assigned or novated in exchange for a payment(s) to the lender, the payment(s) will no longer qualify but will be eligible to remain in the ISA wrapper provided the loan was an eligible agreement when the lender entered into it.

Peer-to-peer loans held outside of the ISA wrapper cannot be sold and repurchased inside an IFISA except where the loans are sold and are made available for purchase (using cash held by the ISA manager), at the same price, by any lender in the open market. In other words, the loans must be available for purchase by more than one prospective purchaser.

Crowdfunding debentures include crowdfunded debt securities issued by companies and bonds issued by registered charities. The ISA investor must be treated as 'the client' of the person operating the crowdfunding platform so that the investor has FCA regulatory protections and recourse to the Financial Ombudsman Service (FOS). The platform must receive payments, make payments and exercise rights under or in respect of the debentures.

An investor's cash subscription and any other cash held in an IFISA may be held only in sterling and must be deposited in an account with a deposit-taker, or a deposit account or a share account with a building society that is designated as an ISA.

2.3.4 Lifetime ISAs

Qualifying investments for the Lifetime ISA (LISA) are those which qualify for a stocks and shares ISA or cash ISA but not those which qualify for an IFISA.

2.4 Death of an Investor

The ISA rules contain specific provisions that apply on the death of an investor and importantly, enable a transfer of the value of the ISA to take place to a surviving spouse or civil partner without losing their tax-free status.

2.4.1 Tax Treatment on Death

The rules surrounding the treatment of an ISA changed from 6 April 2018 to allow ISA income tax and capital gains tax advantages to continue to apply to funds held within ISA accounts (other than junior ISA accounts) after the death of an account holder. The intention behind the rules is to reduce the tax chargeable on savings income after the death of an ISA saver and simplify the tax-advantaged transfer of ISA savings on death.

The changes specify that investments held in an ISA after the death of the account holder are 'administration-period investments' held in a 'continuing deceased's account' until the administration of the estate is finalised or three years after the account holder's death, whichever occurs first.

The impact of these rules is as follows:

- Funds held in such accounts continue to benefit from ISA tax advantages so any interest, dividends or gains are exempt from tax.
- The investments held in the account can continue to be managed subject to the account's terms and conditions.
- No subscriptions, including replacement flexible subscriptions, can be made.
- No switch from a cash to a stocks and shares ISA can be made by personal representatives.
- The personal representatives cannot request a transfer to an alternative ISA manager.

If, after a period of three years, the administration of the estate is still ongoing and the account has not been closed, then the ISA will cease to be a continuing account of a deceased investor. On the next working day after the three-year anniversary, the ISA manager must remove the ISA wrapper from the account and all subsequent income and gains will then become taxable in the hands of the estate. There are no exclusions or exceptions to this regulation and this action will be required even where the administration of the deceased's estate has not been completed.

2.4.2 Transfers on Death to Surviving Spouses or Civil Partners

From April 2015, spouses and civil partners can inherit their partner's ISA assets when they die. Prior to this, when someone died the savings in their ISA lost their tax-free status and although these may have passed to their spouse or civil partner under their will or intestacy, that partner would then start paying tax on any income or gains that subsequently arose. The change was widely welcomed as it allows the surviving spouse or civil partner to inherit the ISA and keep its tax-free status. This change does not impact the survivor's ability to subscribe their normal annual ISA allowance.

HMRC refer to this as an additional permitted subscription (APS) allowance. Key points to note about the APS:

- The allowance is available to the surviving spouse or civil partner and is in addition to the annual subscription limit.
- It is available whether or not the surviving spouse or civil partner inherited the deceased's ISA assets.
- For deaths on or after 6 April 2018, the APS allowance can be either the value of the deceased investor's ISA at the date of death or the value at the point the account ceases to be a continuing account.
- Subscriptions can be made by the surviving spouse or civil partner in cash or inherited non-cash ISA assets to any type of ISA provided that it takes place within specific time limits.
- The additional subscriptions can be made to a cash ISA, a stocks and shares ISA, an innovative finance ISA or a Lifetime ISA. Subscriptions to a Lifetime ISA can be made if the investor is resident in the UK, but will count towards the Lifetime ISA payment limit but not the annual overall ISA subscription limit.
- Subscriptions can be made with the manager who held the deceased's ISA or another manager who agrees to accept the subscriptions and count as previous year subscriptions for all other ISA purposes.

3. Legal Persons

Wealth managers need to have an understanding of the concept of legal persons and the impact this has on contractual relationships with clients.

A legal person has rights, protections, privileges, responsibilities and liabilities under law, just as natural persons do.

The term 'natural person' refers to a living human being, with certain rights and responsibilities under the law. A natural person is different from a legal person, which might be a company, trustees, a partnership, or some other group.

The concept of legal personality is perhaps one of the most fundamental legal fictions. It is pertinent to jurisprudence and the philosophy of law, as well as to corporate law.

In the common law tradition, only a person could sue or be sued. This was not a problem in the era before the accelerated growth of commerce, when the typical business venture was either a sole proprietorship or partnership – the owners were simply liable for the debts of the business. A feature of the corporation, however, is that the owners/shareholders enjoyed limited liability – the owners were not liable for the debts of the company. Thus, when a corporation breached a contract or broke a law, there was no remedy, because limited liability protected the owners and the corporation was not a legal person subject to the law. There was no accountability for corporate wrongdoing.

To resolve the issue, the legal personality of a corporation was established to include five legal rights:

1. The right to a common treasury or chest (including the right to own property).
2. The right to a corporate seal (ie, the right to make and sign contracts).
3. The right to sue and be sued (to enforce contracts).
4. The right to hire agents (employees).
5. The right to make by-laws (self-governance).

The following are examples of legal persons:

- Companies or corporations are, by definition, legal persons. A corporation sole is a corporation constituted by a single member, such as the Crown in the Commonwealth realms. A corporation aggregate is a corporation constituted by more than one member.
- Business enterprises are usually corporations, although some companies may take forms other than a corporation, such as associations, partnerships, unions, trusts, and funds.
- Cooperatives (co-ops), which are business organisations owned and democratically operated by a group of individuals for their mutual benefit, are legal persons.
- Sovereign states are legal persons.
- Municipalities, as creatures of statute, are legal persons. Other organisations or types of organisations may be created by statute as legal persons, including UK Economic Interest Groupings (UKEIGs).
- In the international legal system, various organisations possess legal personality. These include intergovernmental organisations (the United Nations, the Council of Europe) and some other international organisations (including the Sovereign Military Order of Malta, a religious order).

However, not all organisations have legal personality. For example, the board of directors of a corporation, a legislature, or governmental agency are not legal persons, in that they have no ability to exercise legal rights independent of the corporation or political body which they are a part of.

One very simple definition of a legal person is an individual or organisation that is legally permitted to enter into a contract and be sued if it fails to meet its contractual obligations.

Legal personality allows one or more natural persons to act as a single entity (a composite person) for legal purposes. In most jurisdictions, legal personality allows such a composite to be considered under law separately from its individual members or shareholders. A legal person may sue and be sued, enter into contracts, incur debt, and have ownership over property. Entities with legal personality may also be subject to certain legal obligations, such as the payment of tax.

An entity with legal personality, such as a limited liability corporation, can shield its shareholders from personal liability in the case of the failure of the corporation or the imposition of damages. However, in practice, the managers of corporations may be liable for any loans that they have been required to personally guarantee, for example, with a bank.

Also increasingly important is the notion that the officers and directors of a corporation, as opposed to the non-executive shareholders, have legal liabilities for certain misconduct of the corporation. For example, corporate manslaughter charges were brought against key executives at a rail operating company following a serious train crash in which the operating company was deemed to be negligent.

Wealth managers need to be aware of the characteristics of the main types of legal persons that they may do business with so that they can correctly identify who is in a position to commit the organisation to a contract and provide instructions.

3.1 Law of Contract

A contract is an agreement with specific terms between two or more persons or entities in which there is a promise to do something in return for a valuable benefit known as consideration. Since the law of contracts is at the heart of most business dealings, it is one of the three or four most significant areas of legal concern and can involve variations on circumstances and complexities.

The existence of a contract requires finding the following factual elements:

- An offer.
- An acceptance of that offer which results in a meeting of minds or an agreement.
- A valuable consideration (which can be a promise or payment in some form).
- An intention to create legal relations.
- The legal capacity of the parties to enter into a contract.
- Certainty of terms.

A unilateral contract is one in which there is a promise to pay or give other consideration in return for actual performance. As a simple example, a fine art dealer may enter into a contract with a collector in which it is agreed that £5,000 will be paid upon receipt of a specified painting. The consideration is the payment of the sum of £5,000 and the performance by the collector would be the timely delivery of the work of art in accordance with any other conditions agreed in the contract.

A bilateral contract is one in which a promise is exchanged for a promise. As an example of a bilateral contract, one could amend the previous example such that the art dealer also conducts auctions and undertakes to promise to display the work of art and present it for sale, and, if the painting finds a buyer, then the dealer promises to pay the collector a net amount (after commission) where there may be a minimum amount set, known as a reserve.

Contracts can be either written or verbal – often referred to as an oral contract. If parties agree the terms of the contract by verbal statements and do not memorialise this in written form, the binding terms of the contract are more difficult to ascertain. In such cases, a court will look to the history of the statements made by the parties and the performance of the parties to obtain assistance in determining what was actually agreed by them.

Draft contract documents, emails, letters and order forms may lend assistance in deciding the terms of a verbal agreement, and courts have used similar agreements with third parties to apply a standard of reasonableness in determining the terms of an agreement or contract made in the absence of an executed written document.

A contract will often consist of several documents, such as a series of letters, orders, offers and counter-offers.

There are essentially three broad types of contract:

- **Conditional** – the agreement is dependent upon a specified event occurring.
- **Joint and several** – several parties make a joint promise to perform, but each is wholly responsible for the undertaking should some or none of the other parties be able to perform.
- **Implied** – the courts will determine if there is a contract in effect or implied based on the circumstances.

Contracts for illegal purposes are not enforceable at law.

Wealth managers need to be aware of who can enter into a contract, such as for the provision of investment services.

- For natural persons, a minor, that is an individual under the age of 18, does not have capacity to enter into a contractual agreement. Contracts signed by drunks, the mentally ill, the certifiably insane can all be declared void by a court of law.
- Legally, to bind a company to a contract, it must be signed by a person who has the authority to do so. This would normally be achieved by affixing the common seal of the company and signed by two directors or one director and the company secretary.
- When dealing with local authorities, it may be necessary to obtain the 'seal' of the corporation to the contract. The seal of a local authority binds the relevant local authority, in the same way that having the signatures of the board of directors would in the case of a limited company.
- For a partnership, deeds should be signed by all partners and witnessed or signed by one or more partners who have been granted authority by deed to execute on behalf of the partnership and witnessed.
- For limited partnerships, the deed should have the common seal affixed and be signed by two members.
- A trust is not a legal entity in its own right and cannot enter into contracts. Instead, it is the trustees that legally own the assets of the trust and who can enter into contracts to bind the trust.

Wealth managers should check whether the individual has the authority to legally represent the company. Whether or not an individual is a statutory director can be checked via the Companies House website.

3.2 Agency

In legal terms, an agent is one who agrees and is authorised to act on behalf of another, a principal, to legally bind that individual in particular business transactions with third parties pursuant to an agency relationship. The agent is acting in a fiduciary capacity.

A fiduciary relationship is one in which one person places special trust, confidence and reliance in, and is influenced by, another who has a fiduciary duty to act for the benefit of that person. In discharging their responsibilities, the fiduciary must be absolutely open and fair and act with loyalty, honesty and in a manner consistent with the best interests of the beneficiary of the fiduciary relationship.

Fiduciary relationships are generally treated as including:

- agent and principal
- director and company
- lawyer and client
- banker and customer
- stockbroker and client, and
- trustees and beneficiaries.

As a result, a fiduciary relationship can be seen to exist between an adviser and a client, whether it is acting as agent, banker, stockbroker or trustee, or in any other capacity.

The responsibilities that a financial adviser must follow, therefore, include the following:

- Act in the utmost good faith for their client.
- Not make a profit from the trust placed in them.
- Not placing themselves in a position where their own interests conflict with their duty to the client.
- Refrain from misusing confidential information for their own advantage or the benefit of a third person without the fully informed consent of the principal.

This list is far from comprehensive, but it gives a good indication of the conduct expected of someone such as a financial adviser.

The principal/agent relationship can sometimes give rise to cases of conflict of interest and is at the heart of some important issues in business ethics. As a simple example of this, an investment bank which is acting as an agent to its clients (in this case the client is the principal) may also be acting as a principal in its own dealings. This issue was the subject of a congressional investigation in 2010 and a civil lawsuit brought by the US government against the firm Goldman Sachs. One of the allegations made is that the firm faced clear cases where, when acting as an agent and executing instructions from a client, it became aware of privileged information which would be of benefit to its proprietary trading desks. The allegation is that this may have led to front-running, ie, where Goldman Sachs traded on the knowledge of the client's intentions to secure a position ahead of the execution of the client's order to benefit its own account.

4. Marriage and Civil Partnerships

Wealth managers need to be aware of the law surrounding marriage, civil partnerships and living together as they have an impact on aspects of financial planning.

4.1 Marriage and Civil Partnerships

Marriage is the process by which two people make their relationship public, official, and permanent. Marriages can be conducted through either a civil ceremony, or a religious ceremony; a religious ceremony is also possible if the religious organisation has agreed to solemnise marriages of same sex couples according to its rites.

The formation of a civil partnership is an entirely civil event; where the civil partnership is formed on religious premises, the ceremony may be religious as long as the actual formation remains secular. A civil partnership is a legal relationship entered into by a couple which is registered and provides them with similar legal rights to married couples. Civil partnerships were introduced in 2005 to provide legal recognition and protection for same sex couples and since 31 December 2019, couples of the opposite sex have been able to enter into a civil partnership in England and Wales.

There are few notable differences between marriage and a civil partnership. Marriage is formed by vows, whereas a civil partnership is formed by signing the civil partnership document; and marriages are ended by divorce, whereas civil partnerships are ended by dissolution, although the process is fundamentally the same. While civil partnerships do not come with the same traditional and religious connotations, the rights and obligations are almost identical to those of marriage. This extends not only to the available financial provision upon separation but also in respect of the rules of inheritance and available tax entitlements.

4.2 Living Together

Couples who live together but have not married or formed a civil partnership have no special rights and the only claims that can be made are governed by historical laws of property. Some of the differences include:

- There is no right to share assets or to request ongoing financial assistance by way of maintenance for themselves, even if one party has given up work to look after children.
- If one partner dies without leaving a will, the surviving partner will not automatically inherit anything unless the couple owned property jointly. The surviving partner may have to go to court to claim from the estate under the Inheritance (Provision for Family and Dependents) Act 1975.
- If someone inherits money or property from an unmarried partner, they are not exempt from paying inheritance tax in the same way as married couples and civil partners.

It is possible to formalise aspects of living together arrangement by entering into a cohabitation contract which outlines the rights and obligations of each partner towards the other. It sets out how each party will support their children beyond legal duties to provide care and support, as well as defining how they will split any bank accounts, pension schemes, debts and joint purchases like vehicles. A cohabitation agreement can also outline who owns which assets while the parties live together and explain their joint finances, such as how much each pays towards the mortgage, rent or bills.

4.3 Pre-nuptial and Post-nuptial Agreements

A pre-nuptial/pre-civil partnership agreement is a contract entered into before marriage or civil partnership respectively, which outlines how a couple wish to divide their money and property if they get a divorce or dissolution. A post-nuptial/post-civil partnership agreement is similar but entered into after marriage or civil partnership.

Although these agreements are not yet legally binding in England, a Supreme Court ruling in 2010 saw the introduction of a presumption that family courts should hold spouses or partners to such agreements, if both parties understood the implications of entering into the agreement.

5. Powers of Attorney

The appointment of an attorney or a deputy will involve a change of control of the assets of the person to whom it relates.

One of the main reasons why someone would create a **power of attorney** is as protection in case they lose their mental capacity. Once an individual loses the mental capacity to act, it is no longer possible for a financial institution to accept their instructions and instead, a deputy must be appointed to act on their behalf. This involves an application to the Court of Protection which can be time-consuming and expensive.

A further reason for creating a power of attorney is for clients with business interests. The sudden illness of a business owner, or if they become unable to make decisions for any reason, could have severe ramifications for a business, potentially causing difficulties in accessing bank accounts and making decisions affecting the business.

5.1 Types of Powers of Attorney

A power of attorney is a legal document whereby a person gives another person or persons the power to take decisions with regard to their financial affairs and/or health and personal welfare. An attorney is someone who is appointed to act on behalf of another person and they are appointed by a legal document known as a power of attorney, which gives the attorney the power to act on behalf of the donor with regard to their financial and other affairs.

The most common types of power of attorney you are likely to encounter in England and Wales are an Ordinary Power of Attorney (OPA), an **Enduring Power of Attorney (EPA)** or a **Lasting Power of Attorney (LPA)**.

Types of Power of Attorney	
Ordinary power of attorney	• These give the attorney power to look after the financial affairs of the donor or undertake a specific task on their behalf. • It is often created when the donor is going abroad or is unable to act for some other reason and the donor needs someone to have the authority to act on their behalf. The authority granted can be general or limited to specific affairs. • It will usually end either at a specified time or upon the request of the donor at any time using a Deed of Revocation. • It will automatically be revoked if the donor loses mental capacity. • There is no requirement for an Ordinary Power of Attorney to be registered with the Office of the Public Guardian.
Enduring Power of Attorney (EPA)	• Until October 2007, it was possible to make an Enduring Power of Attorney to appoint someone to act when the donor could no longer manage their financial affairs. • These are still valid and can be used while someone still has mental capacity provided that the donor consents to its use. • Once the donor starts to lose their mental capacity, the attorney needs to register the EPA with the Office of the Public Guardian.
Lasting power of attorney (LPA)	• LPAs replaced the enduring power of attorney in October 2007 as part of the Mental Capacity Act 2005. • An LPA allows someone to choose a person to take decisions on their behalf if they subsequently lose mental capacity. • The biggest difference between the two is that an LPA can extend to personal welfare matters as well as to property and related affairs. There are, therefore, two types – a property and affairs LPA and a health and welfare LPA.

An LPA is not created unless the document has been registered by the **Office of the Public Guardian (OPG)**. The registered LPA document will be stamped on every page by the OPG so its validity can be checked by ensuring that each page has been stamped and that there are no missing pages, or unintentional additional pages attached. Once the LPA has been registered, the attorney can register this with financial institutions who can then accept the attorney's instructions for dealing with assets.

The attorney is required to abide by a code of practice which includes having a duty of care, acting in the best interests of the donor, and not to take advantage of their position. For a property and financial affairs LPA, the attorney also has a responsibility to keep accounts and keep the donor's money separate from their own. You should also note the need to keep the donor's money separate when setting an account title.

A Deed of Revocation can be used to cancel:

- an OPA, at any time after the power has been granted
- an EPA, at any time prior to registration of the power and while the donor is still mentally capable, or
- an LPA, at any time while the donor still has mental capacity.

There are significant differences between powers of attorney in England (and Wales) and Scotland, including different terminology. In England, the person giving another person the power to act on their behalf is called the donor; in Scotland, they are called the granter.

The person or persons to whom the powers are granted are called attorneys. Both jurisdictions allow you to set up either a temporary power of attorney, for a specific transaction or limited period of time, or something more permanent such as the case where one may, due to failing health, want to appoint another to conduct one's business affairs.

The most common types of power of attorney that can be found in Scotland are as follows:

Powers of Attorney in Scotland	
General Power of Attorney (GPA)	• A GPA is usually created for a defined period of time where the granter wishes for someone else to have the authority to act on their behalf. The authority granted can be general or limited to specific affairs. • A GPA will usually end either at a specified time or upon the request of the granter at any time using a Deed of Revocation, and will automatically be revoked if the donor loses mental capacity. There is no requirement for a GPA to be registered.
Continuing Power of Attorney (CPA)	• A CPA allows the granter to appoint a legally authorised person to look after their property and financial affairs should they become incapable of doing so at some point in the future. • It remains valid after the granter has become mentally incapable and must be registered to be effective. • A CPA may be revoked using a Deed of Revocation at any time, either before or after registration, while the granter still has mental capacity or in the event that they regain it.
Welfare Power of Attorney (WPA)	• A WPA allows a granter to appoint attorneys to make decisions about the health and welfare of the donor in the event of mental incapacity. • It may be revoked using a Deed of Revocation at any time, either before or after registration, while the granter still has mental capacity or in the event they regain it.

5.2 Deputies

When someone becomes mentally incapable of managing their financial affairs and they have not made an LPA, a deputy needs to be appointed. In such cases, an application can be made to the Court of Protection to appoint a deputy to make ongoing decisions on behalf of that person. The Mental Capacity Act 2005 introduced deputies in place of the previous system of receivers.

The deputy must be someone who is trustworthy and with the skills to carry out their duties. They have a duty to always act in the best interests of the person and only to make those decisions authorised by the order of the court.

The OPG will assess each case and place it in a band where it will receive a low, medium, intermediate or high level of supervision. In addition, the Court of Protection places numerous obligations on the Deputy, as a safeguard for the person lacking capacity. These include obtaining a **security bond**, complying with supervision by the court and filing annual reports and accounts.

The Deputy Order will set out the extent of the powers granted to the deputy, which might relate to finances or personal welfare. This needs to be registered with banks and other financial institutions who will want to see the original document, or an official copy certified by a solicitor.

A separate deputy's account should be opened to hold the funds or assets and the identity of the deputy confirmed. The terms of the order should be checked as it can have a time limit on it, so it is important to check how long it lasts. A check should also be made to ensure that the order permits the type of transaction being undertaken and that there are no restrictions that would prevent the transaction taking place.

6. Estate Planning

Estate planning is concerned with ensuring that a client takes appropriate steps to ensure that their accumulated wealth passes to their intended beneficiaries, and in a tax-efficient way.

Estate planning can be a complex subject but essentially involves determining who is to inherit the assets of the client and which steps can be taken to reduce any estate taxes that will arise on death.

The steps that can be taken vary significantly from individual to individual and are dependent on their country of domicile or residence. Some jurisdictions allow complete freedom to individuals to leave their estate to whoever they choose, while in others, certain people will have a right to a specific share of the estate.

Estate planning can encompass:

- Advising on, drafting and execution of a will.
- IHT planning to ensure that available allowances are utilised to mitigate the amount of tax payable.
- International estate planning where clients hold assets in different countries to take account of local inheritance laws and so that their estate is not subject to tax in multiple jurisdictions.
- Setting up and administering trusts to manage property or investments for specific people or purposes.
- Considering wealth holding structures so that assets are managed in accordance with the client's wishes and succession planning for businesses to be effectively continued.

Estate planning also sits alongside making plans for later life. This includes planning for incapacity by executing a power of attorney, a living will and planning for care home fees.

6.1 Wills and Intestacy

A will is a statement by an individual of how they wish their property to be divided after their death. A person making a will is referred to as a testator. If a person dies without executing a will, then he or she dies intestate.

The estate of the deceased has to be used first of all to pay off their debts, the cost of the funeral and inheritance tax (IHT), if applicable. After these expenses, the wishes of the testator can be enacted.

6.1.1 Wills

Writing a will with a solicitor can, for very simple estates, be relatively inexpensive, with fees unlikely to exceed a few hundred pounds. Obviously, dealing with more complex estate planning will be considerably more expensive. A do-it-yourself approach is dangerous; completing the will wrongly could mean the will is invalid, leaving the estate ruled by the laws of intestacy or open to challenge.

The formalities governing a valid will are contained in the Wills Act 1837 which provides that in order for a will to be legally valid, it must be:

Formalities for a Valid Will	
In writing	• The will can either be handwritten in ink or in pencil, or typed in electronic format, provided the remainder of the formalities are complied with. It is advisable that if the will is handwritten, ink is used. • A combination of writing in ink and pencil raises a rebuttable presumption that the testator did not intend the words in pencil to be final.
Signed by the testator	• Typically, the signature must be at the end of the last page of the will to rebut any presumption that any text appearing after the signature was placed without the testator's knowledge or intent. • It is preferable for a testator to sign with their usual signature to avoid uncertainty however anything which they intended to be a signature will suffice. • It is possible for another person to sign for the testator provided it is in the testator's mental and physical presence and by their direction; for example, this may be necessary where a testator is too weak to sign unaided. • The testator must have intended to give effect to their will by their signature; a lack of intention will invalidate a will.

Formalities for a Valid Will	
In the presence of witnesses	• The signature must be made or acknowledged in the presence of at least two witnesses present at the same time. • It is essential that all witnesses see the testator signing/executing the will. If one of the witnesses does not see the actual signing of the will, the will is considered invalid. It is therefore important that the witnesses are aware of, and see, the testator signing the document. • It is not necessary for the witnesses to be aware of the contents of the will, but they must know it is a will. After attesting to and witnessing the signing of the will, the witnesses must attest the will by signing and acknowledging their signature in the presence of the testator. • An important point to note is that the witnesses should not be anyone who is a beneficiary under the will or married to or in a civil partnership with any beneficiary under the will.

Failure to follow the proper formalities can expose the will to challenge and lead to expensive and time-consuming disputes. In circumstances where the validity of a will is challenged, evidence may be required to show that the testator had knowledge of and approved the contents of the will. Witnesses should therefore take steps to satisfy themselves of this by requiring the testator to read the will immediately before signing it, or conducting an explanation or discussion as to its content in the presence of the witnesses.

Where a will is left, it will set out who is to benefit from the estate. The will may leave gifts of either money or specific items such as jewellery. A gift of cash is known as a general legacy and a gift of a specified item as a specific legacy. The remainder of the estate after payment of debts, expenses and legacies is known as the residue of the estate and is payable to the named beneficiaries who are known as residuary legatees.

Under English law, the person making a will is free to leave their estate as they think fit subject to it not being for illegal purposes. This freedom is constrained, however, where the deceased is seen to have had a duty to make reasonable financial provision for someone.

Under the Inheritance (Provision for Family and Dependants) Act 1975 certain individuals can apply to court for the terms of the will (this also applies to intestacy, which is covered in the next section) to be set aside. Applications must be made within six months of the issue of the grant of representation and can be made by:

- a surviving spouse or civil partner, and a former spouse or civil partner who has not remarried,
- children of the deceased or those treated as children of the deceased, or
- non-family members who have been maintained by the deceased, eg, a cohabitee.

It is up to the court to determine whether financial provision should have been made and if it determines it should have been, then the court can issue an order varying the terms of the will or distribution on intestacy.

6.1.2 Intestacy

Where someone dies without leaving a will they are described as dying intestate and the distribution of their estate takes place in accordance with the rules on intestacy as shown in the table below.

Distribution on Intestacy	
Where the deceased dies leaving:	
Surviving spouse but no issue	• Surviving spouse or civil partner entitled to whole estate.
Surviving spouse and Issue	• Surviving spouse or civil partner entitled to: ◦ Statutory legacy of £322,000 which is index-linked and will increase at least every five years in line with the consumer price index (CPI). ◦ Personal chattels. ◦ Half of the residue absolutely. • The rest of the estate goes to the issue (children or their descendants) on the statutory trusts. • Property held on such statutory trusts is divided equally among such children as are living at the intestate's death and who either attain the age of 18 years. • Where a child predeceases the intestate, but leaves issues living at the intestate's death, then those issues will take the share in the residuary estate which the deceased's child would have taken if they had survived the intestate. • The issue, therefore, takes 'per stirpes' (each branch of the family receives an equal share of the deceased's assets).
No surviving spouse	• Where the intestate leaves no surviving spouse, one of the following eight classes take in this order: ◦ Issue on the statutory trusts as in the previous section. ◦ Parents (equally if more than one). ◦ Brothers and sisters of the whole blood on the statutory trusts. ◦ Brothers and sisters of the half blood on the statutory trusts. ◦ Grandparents (equally if more than one). ◦ Uncles and aunts of the whole blood on the statutory trusts. ◦ Uncles and aunts of the half blood on the statutory trusts. ◦ The Crown, as bona vacantia.

Personal chattels cover all tangible movable property held by the deceased, except for – money or securities for money, property used at the death of the intestate solely or mainly for business purposes, and property held at the death of the intestate solely as an investment.

The Inheritance Act 1975 also protects children from the risk of losing an inheritance from a parent in the event that they are adopted after the death of that parent. It also amends the rules that currently disadvantage unmarried fathers when a child dies intestate and removes some arbitrary obstacles to family provision claims.

If one dies without executing a will (known as dying intestate) there are serious risks that the deceased's estate may end up in the wrong hands, ie, not those that the deceased would have wanted and, furthermore, there can be significant negative taxation consequences.

According to The National Wills Report 2024, 53% of UK adults have made a will, with uptake higher among older age groups and those who are married or have children. The proportion rises from 41% among 18–24-year-olds to 69% for those over 55. Notably, 61% of individuals with children have a will, compared to just 39% of those without. The report highlights persistent gaps as many people – especially the young or single – continue to delay making a will, often believing their estate is too simple or that they are too young or healthy to need one.[2]

You will see that where a couple is married or in a civil partnership, the whole estate passes on intestacy to the surviving spouse/civil partner where there are no children and simplifies the sharing of assets where the deceased is survived by spouse and children. Even with the changes, the deceased's estate could pass contrary to his or her wishes and, therefore, executing a will should be seen as essential.

People living with their partner outside marriage or civil partnership are most at risk. If there are no close relatives then the entire estate goes to the Crown under intestacy rules, regardless of any unmarried partner who may have lived with the deceased – risking leaving the deceased partner homeless unless the property is owned jointly. This could mean extensive legal costs for their beneficiaries, as they will have to incur potentially significant costs for an inheritance claim to the courts.

Dying intestate rules out gifts to charities or bequests to friends, and the ability to give one child more than another – or to deal with more complex, but common, family arrangements such as stepchildren. Also, the absence of a will also precludes the possibility of other personal wishes being honoured, such as the exact form of funeral arrangements, whether one wishes to be buried or cremated, and various other issues such as who should inherit particular property or items of worth.

6.1.3 Personal Representatives, Probate and Letters of Administration

The will and the estate of the deceased are administered by his or her personal representatives, who arrange for any debts and IHT to be paid and distribute the estate to beneficiaries. If appointed in the will, the personal representatives are referred to as executors. If they are appointed by the court, they are referred to as administrators.

Probate is a legal document issued by the court, giving evidence that the will has been registered and administration has been granted to the executor. This documentary evidence enables the executor to perform their duties.

2 The National Will Register, October 2024. The National Wills Report 2024. Retrieved from: https://www.nationalwillregister.co.uk/app/uploads/2024/10/The-National-Wills-Report-2024.pdf (Accessed: July 2025)

If an executor has not been appointed in the will or an individual dies intestate, the principal beneficiary of the will may apply to court to be appointed as administrator. The appointment is made by means of letters of administration. If there is no dispute about representation for an estate or over whether a will is valid, the application for grant of representation is referred to as non-contentious or common form. If there is a dispute, it is referred to as contentious or solemn form.

An application for grant of representation in common form must contain a representative's oath. This is a document where the applicant swears as to the date of death and the fact that they are best entitled to act as administrator or are named as executor. In addition, the applicant must lodge an account of the deceased's estate for IHT purposes which will be provided to HMRC, and the will, if applicable.

Once the Probate Registry has vetted the application it will issue the grant of probate or letters of administration. This is a legal document that bears the seal of the court and formally confirms the appointment of the executors or administrators. As part of the application for the grant, the executor or administrator will also ask for copies of the grant to be provided. These are known as office copies of the grant and bear an imprint of the court's seal.

The grant is then registered with each financial institution by sending the original grant or an office copy. The firm should record the details, take a copy and return the original or office copy to the executor or administrator. The grant is official proof of the appointment of the executor or administrator, and the firm can now take instructions from them as to how they wish to deal with the assets.

6.2 IHT Planning

There are a number of steps a wealth manager can take in order to help their client mitigate IHT liability.

A useful first step is to calculate what potential IHT liability may arise and what exemptions are available. The simple table below shows an outline of what information might be collected.

Calculating Potential IHT Liability

Assets	£
Main home	
Household contents and personal effects	
Cars, boats, etc.	
Bank and building society accounts	
Investments	
Life insurance policies (not held under trust)	
Pensions lump sums	
Other assets	
Previous lifetime gifts	
Total Assets	

Liabilities	
Loans, hire purchase, credit cards	
Mortgages	
Other loans	
Other liabilities	
Total Liabilities	
Net Estate	

Potential IHT Liability		£
Net estate		
Less:	• Available nil-rate band (NBR) • Transferable unused nil-rate band from deceased spouse • Residence nil-rate band (RNBR), if available	
Less exempt assets:	• Assets subject to business property relief • Assets subject to agricultural property relief	
Less exempt gifts:	• Gifts to charities, political parties, national benefit and maintenance settlements	
Chargeable estate		
Potential IHT Liability		

With a clearer picture of the client's estate, it is then possible to move on to consider potential mitigation steps.

There are a number of exemptions available that should be considered. However, this needs to be balanced with the fact that individuals are now living longer and need access to capital to meet their day-to-day living costs and potential future care costs.

For clients with more complex financial circumstances, a wealth manager may be able to add value by helping clients structure their finances to mitigate any future IHT liability. When doing so, it is essential to consider a client's overall assets, the history of their previous gifts and the order in which any new gifts are made. Gifting in the wrong order can have serious tax consequences. Straightforward arrangements should be considered first, as other arrangements that create large chargeable lifetime transfers or potentially exempt transfers (PETs) could impact on these arrangements.

6.2.1 Using Available Exemptions

A good starting point is to ensure that the spouse or civil partner exemption is available to use. This allows all assets to pass from one spouse or civil partner to the other without any IHT liability.

Beyond that, there are a number of simple actions that a client can take to mitigate a potential IHT liability – beyond spending their capital during their lifetime so that their estate is not in excess of the NRB on death. These actions include the £3,000 annual gifts exemption, the small gifts exemption, wedding gifts, and gifts from surplus income, among others – see chapter 6.

6.2.2 Writing Policies in Trust

Writing a policy in trust means that the client is making a gift for IHT purposes and the policy will normally not form part of their estate, so no IHT is payable provided they survive for seven years after setting up the trust.

Writing a policy in trust can ensure that the death benefit is payable without the need for a grant of probate or letters of administration. As trustees are the legal owners of the assets in the trust, they can claim the monies due under the policy on production of the death certificate and distribute the funds earlier than might otherwise be the case.

One of the most straightforward ways to set up a trust for a policy is to use the standard forms provided by the insurance company. The forms are designed to work with that company's policies, to ensure the description of the benefits in the policy documents matches those used in the trust document. Life offices normally have a number of templates that can be used to set up a trust or they may need to seek legal advice where there is a need for a specific trust to be drawn up in more complex situations.

Most trusts provided by life companies are either fixed trusts, power of appointment trusts (flexible trusts) or discretionary trusts.

- A **fixed trust** is another term for a 'bare trust' or 'absolute trust'. The beneficiaries and how much they will receive is fixed when the trust is set up and cannot be changed in the future.
- A **power of appointment**, or 'flexible', trust still has named beneficiaries – known as default beneficiaries – but, importantly, there is flexibility for the trustees to change these if circumstances change. Clients name the potential or default beneficiaries and the trustees then have power to change how the proceeds are distributed.
- A **discretionary trust** is similar to a flexible trust except there are no default beneficiaries but rather a list of potential beneficiaries and the trustees have total discretion as to who will get the proceeds from the life insurance policy put in trust.

It is important to remember that in most cases, once a policy is written in trust, the trust is generally irrevocable; and in most cases, it is not possible to simply cancel the trust.

When considering more than one type of trust, then the order in which the arrangements are entered into is important. Trusts should be established on separate days to avoid them being related settlements, as the values of related settlements are aggregated when computing charges to IHT.

6.2.3 Business Property Relief

As we saw in the previous chapter, IHT rules provide relief for certain types of business or business property included in either a lifetime transfer or the deceased's death estate. Relief is available for business property anywhere in the world.

For deaths and transfers, on, or after, 6 April 1996, the categories of property which are capable of qualifying as relevant business property are broadly as follows:

Property consisting of a business or interest in a business	100% relief
Control holdings of unquoted securities in a company	100% relief
Unquoted shares in a company	100% relief
Control holdings of quoted shares in a company	50% relief
Land, buildings, machinery or plant used by a company controlled by the transferor or by a partnership of which the transferor was a member	50% relief
Settled land, buildings, machinery or plant in which the transferor had an interest in possession and used in their business (this applies to lifetime transfers only)	50% relief

To qualify for relief, the business or investment must have been held for two years and meet certain qualifying conditions.

Many entrepreneurs have an exit strategy that involves selling their business during their lifetime, but for others, the plan is for it to pass down to the next generation of the family. For those, business property relief is a useful tax concession which can allow a valuable asset to pass on to the next generation with little or no tax.

Another route that is used to exploit the availability of business property relief is AIM shares. Many AIM-listed shares are therefore exempt from IHT after they have been held for two years. Private investors can create a portfolio of AIM stocks which could be held in an ISA wrapper if appropriate; collective investments holding similar assets do not qualify.

A practical difficulty is that not all AIM companies qualify for business property relief and there is no definitive business property relief list to check against, and to make matters worse, HMRC only makes a judgment on whether a company is IHT-exempt when tax is due. This means it is important to only buy companies that engage in actual trading rather than passively invest in land or other assets, which entails avoiding investment trusts and their REITs as well as resource exploration companies which are deemed land companies. Companies are also disqualified from relief if they have listings both on AIM and on another market elsewhere.

AIM companies, however, can be expected to be riskier propositions but may be an option for those who are prepared to accept the volatility of AIM shares in return for the IHT benefit.

6.2.4 IHT Loss Relief

Wealth managers should be aware of the availability of IHT loss relief on the sale of shares or property to reduce the actual amount of IHT payable on death as it may present a planning opportunity.

IHT share loss relief allows an executor to substitute the sale value of shares with the ones used for probate and claim a refund of the IHT payable; loss relief cannot be claimed if there is no IHT payable on the estate.

The claim for relief must be made within four years of the end of the 12-month period during which qualifying sales are made and four basic conditions must be met as noted below.

Conditions for IHT Relief for Loss on Sale of Shares	
Sales must be within 12 months of death	• The relief only applies to qualifying investments that are sold in the 12 months immediately following the date of death. • Special rules apply to investments that cannot be sold.
They must be qualifying investments	• Qualifying investments include listed shares and securities including those that are listed on a foreign stock exchange and collective investment schemes. • Shares traded on AIM and unlisted shares are not qualifying investments.
There must be an overall loss	• Relief is only available if the gross sale proceeds of all shares sold by the appropriate person within 12 months of death is less than the date of death value for those shares. In other words, there must be an overall loss on all sales. • All sales of qualifying investments have to be included in the claim – not just those that have fallen in value.
The sales must be made by the appropriate person	• To qualify for relief the shares must be sold by the appropriate person. • The appropriate person is the person who is liable for the tax, and this will usually be the personal representatives for the free estate and trustees for any investments held in a settlement. • There is no relief available if the executors transfer the shares to the beneficiaries.

In the event of a market downturn following death, the availability of the relief may present a planning opportunity. Instead of transferring the shares to the beneficiaries who may sell and then have unused losses to carry forward, the shares can be sold by the personal representatives, and the cash proceeds and IHT repayment paid to the beneficiaries for investment in a portfolio that is in line with their objectives and risk profile. A calculation will need to be made to determine whether the IHT repayment is more valuable than the potential unused losses for CGT.

The RNRB can also be affected by a share loss relief claim. The substituted share value will be used to determine whether the £2 million taper threshold has been breached. So, as well as reclaiming IHT, there could be a further tax saving if some or all of the RNRB is reinstated.

A separate relief is available for sales of land within four years of death, with a time limit for submission of the claim of seven years from the date of death. Unlike the relief for loss on sale of shares, relief cannot be claimed if the difference in value of a property is less than the lower of £1,000 and 5% of the value on death. All sales of land within three years of death must be included in the claim but sales at a profit in the fourth year are ignored.

Where land is sold for less than the value at the date of death, relief for the loss is granted by replacing the probate value with the later sale value in the calculation of inheritance tax.

In a typical case, where the only interest in land is the deceased's residence and the executors sell to an unconnected person for less than its probate value, the claim should be straightforward. The lower sale price is substituted for the death value and following a recalculation, a tax repayment is made to the executors. However, the rules for claiming sale of land relief can be complex and can produce disadvantageous results where there are other sales and purchases or where the property sold has changed in some way.

6.2.5 Deeds of Variation

A deed of variation is a legal document used to change the distribution of an estate as set out in the will of the deceased or under the laws of intestacy.

There are numerous reasons why beneficiaries may choose to redirect money they stand to inherit, including:

- **Changing the distribution of the estate as set out in the will**:
  - Equalising the distribution between beneficiaries.
  - Clearing up any uncertainties in the will.
- **Making provisions for someone who does not benefit**:
  - If the deceased has not updated their will and inadvertently left someone out.
  - Providing for someone who was not included in the will, such as a grandchild who was born after the will was made.
  - Providing for someone who the rules of intestacy do not apply to, such as a partner or stepchild.
- **Inter-generational planning**:
  - Redirecting assets to future generations for example, where a parent disclaims their entitlement in favour of their children or grandchildren.
- **Tax planning**:
  - If the will is not written in the most tax-efficient way.
  - Reducing the amount of IHT or CGT payable.
  - Moving the deceased's assets into a trust.

Anyone who receives an asset via a will or intestacy can execute a deed of variation providing they have mental capacity and are considered legally competent to do so. All parties who hold a beneficial interest in the asset that is to be redirected must be party to the agreement. If these include children or unborn beneficiaries, then the approval of the court will be needed. It also follows that if the legacy under the will is to a discretionary trust then, unless all the beneficiaries of the trust are over 18 and ascertained, no variation will be possible without the court's approval; the trustees of the trust have no power to effect a variation.

A variation may take effect from the date of the document or, if certain conditions are met, it can be treated for IHT and CGT purposes as if it took effect from the date of death. IHT is worked out taking account of the variation being made. For CGT purposes, the variation is not a disposal and in computing future gains, the new beneficiaries are treated as if they acquired the assets from the deceased at the date of death and at the value agreed on death.

To be valid and accepted by HMRC, certain conditions must be met:

- It must be in writing.
- It must be executed within two years of the death.
- It must be signed by all beneficiaries who would lose out as a result of the change.
- It must clearly state the parts of the estate being altered and who will benefit.
- If the redirection increases the amount of tax due on death the personal representatives must join in.
- It must not be made for any consideration in money or money's worth.
- It must include a statement of intent for tax purposes.

6.3 International Estate Planning

A wealth manager needs to be fully aware of the tax rules in their own country and how these will affect their clients. But it is also important to be particularly careful when they are dealing with a client who has significant overseas assets.

Where a client holds assets in multiple countries, then it is important that they take specialist legal advice from lawyers in that territory or UK lawyers who specialise in the international aspect of estate planning. This is especially the case if they own land abroad as succession to immovable property such as land that is governed by the law of the country or state where the land is situated. This law may contain strict provisions as to whether a person is obliged under his or her will to leave the land to particular blood relatives.

Normal advice is that a client should look to have one will that deals with their worldwide assets and another that deals with immovable property in each country where they own land. The main advantages of separate wills are as follows:

- Each will can be dealt with independently in the jurisdiction concerned.
- A will of immovable property can take account of the local law.
- Each will can be drafted to take account of the local tax position and may avoid unnecessary taxation resulting from a single will, which may be tax-effective in one country but not in another.
- Each will can be drafted to include administrative powers and provisions which are appropriate to the territory concerned and which can be readily interpreted according to the local law.
- Each will can clearly define the responsibilities of each set of executors, for example, in relation to payment of particular taxes and expenses.

6.3.1 Key Features of Estate Taxes

In many countries, tax is imposed on the assets that someone owns and the tax due may arise during their lifetime or on death. These types of taxes go by various names such as death duties, estate taxes, IHT, gifts tax and a wealth tax. These may be separate taxes or combined into one charge Estate taxes are a common feature of most developed countries and some of the common characteristics of estate taxes that are encountered include the following:

- Some form of estate tax is payable either on lifetime gifts or the value of the estate that passes on their death.

- Tax is usually charged at a percentage rate on the gift or the value of the estate at death and this may be either a flat rate or one that increases progressively with value.
- Most countries have a series of exemptions or allowances that can be claimed that reduce the liability to tax. One common feature is that transfers between spouses are exempt.
- There tend to be complex tax laws that are designed to counter some ways of avoiding estate taxes making estate and tax planning a complex subject.
- Tax may be chargeable either on the estate of the person who has died or on the recipient of the bequest.
- Liability to pay estate taxes is based on the domicile or deemed domicile of an individual. Individuals treated as domiciled in a country are liable on their worldwide assets whilst those that are treated as non-domiciled are liable on the assets situated in that country.
- Where someone dies owning overseas assets, any liability to pay estate taxes in that country is either the subject of a double taxation treaty or is allowed as a set off against the liability in their own country.

6.3.2 Impact of Residency and Domicile on Estate Taxes

The liability to some form of estate taxes usually depends upon the domicile or residency of the individual and the location of the assets they own. It is important that wealth managers who are dealing with clients from another country have an understanding as to how these taxes operate as this may impact the arrangements they put in place for their client, and as an inappropriate arrangement can lead to an unintended tax liability.

Domicile or residency is a deciding factor in the liability to estate taxes. There are also complex rules that can result in someone having a deemed domicile or residency in a country and, therefore, becoming liable to pay estate taxes.

Where an individual has overseas assets, it is important to consider which country that asset is deemed to be in, as this can determine whether a liability to estate taxes will arise on that asset.

- For example, if an individual who lives in France owns a property in the UK you can readily see that they own a UK asset and that they may be liable to estate taxes.
- What is less obvious, however, is the scenario where someone owns an asset that has some overseas connection.
    - If a person owns shares in, say, HSBC – where is that asset located? HSBC is a UK registered company and has its head office in London but maintains share registers in different countries.
    - What if your client is an author and has royalties from books that have been published. In which country is the right to receive royalties located?

Countries will have a set of rules to determine the location of where property is situated. The following table gives some indication of how they might be treated but it is important to remember that these are general indications only and will vary from country to country.

Location of Assets

Kind of Property	Location
Real estate	• Place where the property is located
Personal property	• Place where the property is located
Deposits with a bank	• Location of the office where it is deposited
Insurance proceeds	• Location of the head office or the principal office of the insurance company that issued the policy
Retirement pensions	• Location of the head office or the principal office of the payer company
Government bonds	• Country of issuance
Shares and bonds	• Place where the issuing company has its head office or the location of the share register
Mutual funds	• Location of the trustee or fund administrator's office or the location of the share register
Copyright or royalties	• Location of the publisher's office
Patents and trademarks	• Place where they are registered
Mining or quarry rights	• Location of the mine or quarry
Ships or aircraft	• Place where they are registered

For some clients who have limited assets overseas, this may not be an issue as the value may be below a minimum threshold at which estate taxes are payable; for others, however, an unexpected liability may arise. It is important, therefore, to recognise the need for caution when dealing with overseas assets to avoid complications.

7. Trusts

A trust is the legal means by which one person gives property to another person to look after on behalf of yet another individual or a set of individuals. The formal definitions of a trust contained in legal textbooks can be quite difficult to follow, but the Hague Convention on the Law Applicable to trusts and on their Recognition has the following straightforward definition:

> *'For the purposes of this Convention, the term trust refers to the legal relationships created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose'.*

So, a trust is an obligation in which certain individuals (trustees) are bound to deal with property over which they have control (the trust property) for the benefit of other individuals (beneficiaries). In simpler terms, a trust is essentially a way of gifting property. This could be any kind of property: for example, land and buildings, shares or other securities, or cash.

Trusts are based on common law and developed from the early Middle Ages onwards, as a way of preserving wealth and passing on assets on death in a controlled way. In more recent times their use expanded internationally and they now tend to be a feature of countries that have common law systems. Trusts are not exclusively found, however, in common law jurisdictions. Their inherent flexibility has led civil law countries such as Japan, South Africa and Switzerland to introduce trusts into their legal systems.

An alternative to a trust is a foundation. Foundations are similar to trusts and originated in civil law jurisdictions but are also now available in some common law jurisdictions as an alternative to a trust.

7.1 Basic Characteristics of Trusts

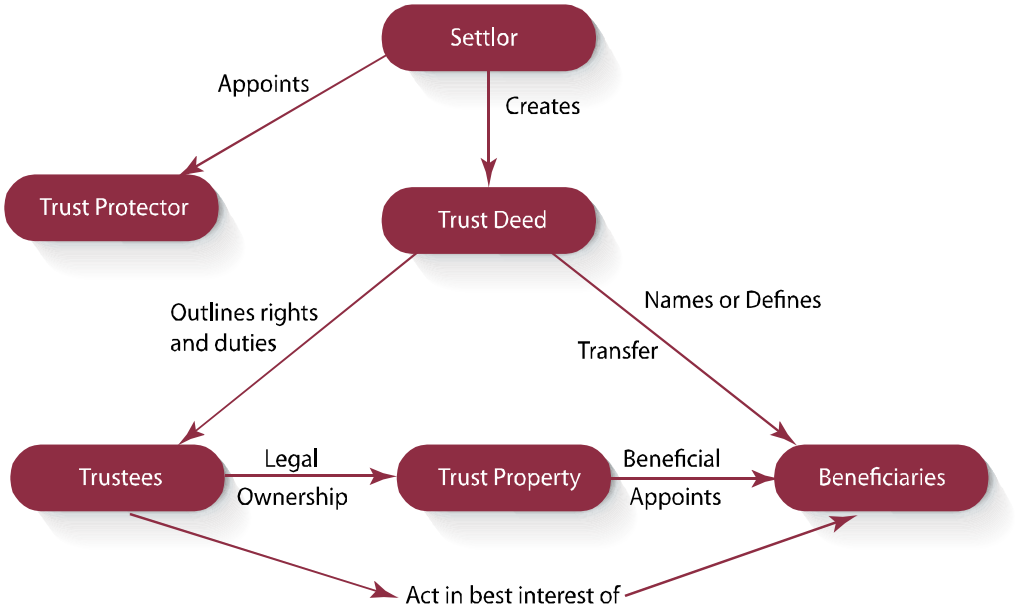
A trust arises when one person is the legal owner of property but owes a duty to exercise the rights of ownership for someone else's benefit. Any individual who receives property on trust for someone else is legally obliged to exercise the rights of ownership for that other person, who can in law enforce that obligation.

Trusts will often be express trusts, in that they are expressly and explicitly set up by a settlor, identifying the trustee and the beneficiary (these terms are explained in what follows). A trust which is set up only by accident or implication is referred to as a resulting or constructive trust.

7.1.1 Parties to a Trust

The participants and elements in a trust arrangement are described in the following diagram.

Parties to a Trust



Settlor	• The individual who decides to set up the trust and arranges for a portion of their assets (the initial settled funds) to be transferred to the trustees.

Trustees	• The individuals appointed by the settlor to act as trustees. • These could be members of the family or close friends, but it is advisable to appoint professional trustees or a corporation that is authorised to act as a trustee. A corporation allows for continuity as it avoids the necessity of appointing a new trustee if any one individual dies.
Beneficiaries	• The trust deed will identify who the initial beneficiaries are or specify a class from which the beneficiaries may be drawn. • Beneficiaries may include the settlor, the spouse/civil partner, children, grandchildren, any future children not yet born, or any other parties the settlor may propose.
Trust Protector	• A protector is an individual whose role is to ensure the trustees act in accordance with the settlor's wishes. They will typically have the power to appoint or remove trustees and to nominate further beneficiaries. • The use of a protector is optional, widely used in offshore trusts and is now increasingly used for more complex trusts.

These are covered further below.

7.1.2 Settlor

The settlor is the original owner of certain designated property and the person who creates a trust by transferring legal ownership of that property to one or more trustees. For the arrangement to be a legal trust, the settlor will have to state expressly that the property is to be held in trust for one or more beneficiaries.

The act of transferring the property in this formal way is known as constituting the trust.

Almost anyone can be a settlor, as long as they have legal title to the property in question. The exception is where an individual is deemed to be incapable of making decisions, perhaps due to a mental disorder; that individual will not be able to settle property.

7.1.3 Beneficiaries

The beneficiary is the individual for whose benefit the property is being held. There may be more than one beneficiary, such as a life tenant or remainderman, and it is also possible for both the settlor and a trustee to be a beneficiary (note that if the settlor is also a beneficiary this can have tax consequences due to the reservation in benefit rules).

It is of the essence of the trust arrangement that beneficiaries do not have control over the property held in the trust. Notwithstanding the lack of control of the property, a beneficiary can ensure through the courts that the trust is administered correctly and can obtain information on the trust and inspect trust documents. Where all of the beneficiaries are aged 18 or over and absolutely entitled under the trust, they can, by unanimous agreement, bring a trust to an end or vary its provisions.

7.1.4 Trustees

The actual legal owner of the property in question is known as the trustee and has control over the property settled in the trust. The trustee is obliged to manage the settled property for the beneficiaries, in accordance with the terms of the trust deed.

It is possible for there to be more than one trustee and for a trustee also to be the settlor, a beneficiary or both. (Note that a settlor can be a beneficiary, but it is classed by HMRC as a 'settlor-interested trust' and has special tax rules).

In the case of trusts over land, there must be a minimum of two and a maximum of four trustees. The maximum of four trustees is prescribed by law. The minimum of two trustees is a practical point, since there must be two trustees to give a valid receipt on the sale of land owned by the trust. If there were only one trustee, it would be difficult to sell any settled land.

In the case of trusts set up under a will, there must be a maximum of four trustees. In any other case, there are no restrictions on the number of trustees. These restrictions are not based on trust law but on other legal principles relating to ownership.

Virtually anyone can be a trustee, so long as they are capable of holding legal title. Trustees will often be solicitors, banks or trust corporations specifically set up for the purpose. Children under the age of 18, however, are not allowed to be trustees.

7.1.5 Trust Deed

A trust deed sets out the terms of the trust and the rights and duties of each of the participants in the trust. It is not essential for there to be a written trust deed, except in the case of a trust for land (it is a legal requirement that transfers of land are evidenced in writing). However, it is recommended to execute a written trust deed to avoid subsequent legal problems in interpreting the objects and beneficiaries of the trust.

Proper formalities should be observed in the creation of a trust in order to rebut any attack on their validity at a later date. A trust is usually created by the execution of a formal trust deed by the settlor and the trustees. The trust deed will set out the terms of the trust, the duties and powers of the trustees and the beneficiaries who are to benefit.

A trust document by itself will not, however, constitute an effective trust unless the trust property is transferred to the trustees in a proper manner. The trust deed may be used to formally transfer assets to the trustees, but depending on the type of asset involved, different formalities may apply.

To be valid a trust usually needs to meet the test of the three certainties in order to ensure the trust is properly constituted.

Three Certainties	
Certainty of words or intention	• The key test is whether the requisite intention is present to show whether the creator of the trust wanted someone to be under a duty to hold property for the benefit of another person. • If there is an absence of certainty of intent to create a trust, there will be no valid declaration of a trust.
Certainty of subject matter	• Trusts can be declared over all kinds of property, including intangible property, but the subject matter must be clearly defined in the trust instrument. • As well as the property being defined, the property must be able to be identified; if it cannot be identified the trust will be void for uncertainty.
Certainty of objects	• The objects of a trust refer to the intended beneficiaries. • For fixed trusts, it must be possible to identify exactly who all of the beneficiaries are in order for the trustees to distribute the property correctly. It is not necessary to draw up a complete list when the trust is created but property is to be distributed or a specified condition met. • For discretionary trusts, it is important to have certainty of objects so the trustees know who to consider when deciding how to distribute the trust property. This means that the trustees must be able to show whether a potential beneficiary will fit within the description of the objects.

7.1.6 Separate Ownership of Property

A trust, therefore, is essentially a legal vehicle into which assets are transferred and which is then managed by the trustees, who have a responsibility to hold and apply the assets for the benefit of the named beneficiaries.

The central idea behind trust law hinges on separate ownership of property.

- Legal title to assets is vested in the name of the trustee or in the name of another person acting on their behalf. The beneficiaries are described as having beneficial ownership.
- The assets of a trust constitute a separate fund and are not part of the trustee's own estate.
- The trustee has the duty to manage the assets on behalf of the intended beneficiaries in accordance with the terms of the trust and any special duties imposed by law.

In the next section, we will look at the powers that trustees can exercise in their management of a trust.

7.2 Powers of Trustees

In order to carry out their obligations under the trusts, trustees have a range of powers and duties that are conferred by either the trust deed or statute. In the next sections, we will look at the general powers and duties of trustees, the changes brought in by the Trustee Act 2000 and then in more detail at the trustee's duty to invest.

7.2.1 Powers and Duties of Trustees

The table below summarises the main powers of trustees.

Powers of Trustees	
Powers of maintenance	• To be able to pay income to minor beneficiaries for their upkeep.
Powers of advancement	• To be able to advance funds from the trust prior to the date specified in the trust deed. This could be used, for example, to pay school fees.
Powers to make dispositions from discretionary trusts	• Under a discretionary trust, the trustees have the discretion to appoint funds within the named class of beneficiaries.
Powers of appropriation	• Permits trustees to transfer assets to a beneficiary in settlement of their entitlement, rather than having to sell the asset and transfer the cash raised.
Power to appoint nominees and custodians	• This allows trustees to take advantage of the safe custody services offered by brokers and custodians, and therefore be able to settle stock market transactions using CREST.
Power to appoint investment managers	• Trustees have the power to appoint investment managers to manage the investment portfolio on their behalf.

With these powers come a series of duties that the trustee must undertake. These include the duty to:

- keep the trust accounts, ie, proper records of their dealings with the trust
- deal with and distribute the assets according to the terms of the trust, and
- invest the trust funds.

A trustee's liability is joint and several; this means that the beneficiaries can claim and execute judgments against one or all of the trustees.

If the trustee breaches any of these duties, they are personally liable for breach of trust. Beneficiaries can sue for such a breach of trust so long as the trustee lives – or against their estate if they have died.

7.2.2 Trustee Act 2000

The Trustee Act 2000 came into force on 1 February 2001. The main aim of the Trustee Act 2000 is to widen the investment powers and powers of delegation for trusts that do not specifically have wide investment powers. Trustees and their advisers will need to follow the Act unless the trust deed specifically overrules the provisions of the 2000 Act.

The Trustee Act of 2000 brought about major changes in five important areas:

- Investment powers.
- The power to delegate.
- A new statutory duty of care.
- Trustee remuneration.
- The power to insure trust property.

Investment Powers

Prior to the Trustee Act 2000, many trusts could only invest in accordance with the Trustee Investment Act 1961. This Act authorised trustees to invest in certain permitted investments and obliged them to split trust funds between different types of investments with a view to protecting the trust from undue risk.

The approach is now acknowledged to be overcautious and unduly restrictive. It placed unnecessary administrative burdens on trustees but did not enable them to manage trust funds to best effect. It led to lawyers drafting varying provisions for inclusion in a trust deed to give them additional authority to manage investments more flexibly.

Under the Trustee Act 2000, trustees can make any investment of any kind as if the funds were their own, except for investment in overseas land.

As a counterbalance to exercising this power, trustees are subject to a fundamental duty to act in the best interests of all the beneficiaries and are also subject to a statutory duty of care in exercising new investment powers.

The Trustee Act 2000 imposes three special duties on trustees, are as follows:

- To be aware of the need for diversification and suitability of the investments of the trust.
- To obtain and consider proper advice when making or reviewing investments.
- To keep all investments under review.

Power to Delegate

The 2000 Act allows trustees to delegate to specialists/agents any of their functions, including their powers of investment. This means that they can employ discretionary fund managers and delegate many other decision-making functions. In such circumstances where delegation occurs to asset management services, the 2000 Act introduces the need for a policy statement.

There are, however, exceptions to this power of delegation in respect of certain defined responsibilities, such as the distribution of trust assets, appointment of trustees and whether fees should be allocated out of income or capital.

Duty of Care

The 2000 Act imposes a statutory duty of skill and care, which applies when trustees carry out certain functions such as exercising their powers of investment, employing agents, using nominees and custodians and insuring trust properties. This somewhat nebulous concept of duty of care relies on the knowledge, experience and professional status of the trustee. Generally, higher standards will be expected of investment professionals than of lay persons.

Professional Charging

The 2000 Act reversed a rule that previously prevented professional trustees from benefiting from their office. Whenever there is more than one trustee, powers were granted by the Act enabling one or more of the trustees to charge for services to the trust if they are acting in a professional capacity.

Power to Insure

The 2000 Act gives to trustees the power to insure the full value of the property that is subject to the trust against risk of loss or damage due to any event as if the property were their own, where in the past they could only insure up to 75% of the value. The premiums can be paid out of income or capital funds arising from the property or instruments involved in the trust. Purchasing of investment products with capital guarantees will normally fall within these powers.

7.2.3 Trustee's Duty to Invest

Within a trust there will always be assets or investments of various kinds and so the trustees need powers to invest; otherwise they would be liable for any loss. A body of case law has built up around the duty of trustees to invest the trust assets. Some of their main duties under the common law are to:

- Exercise due diligence and prudence in exercising a power of investment.
- Demonstrate professional expertise, as professional trustees are held to higher standards.
- Act impartially or fairly between different beneficiaries and between different classes of beneficiaries.
- Administer the trust property in the best interests of the present and future beneficiaries.
- Make the trust productive, ie, to invest to earn income and/or produce growth.
- Obtain advice on any matters in which the trustees are not competent to decide for themselves.

A trustee's power to invest emanates from either the trust deed or a statute. A properly drafted trust deed will specify the investment powers of the trustees but there is also a statutory power that needs to be considered.

A statutory power to invest was introduced as part of the Trustee Act 1925 and extended by the Trustee Investments Act 1961. The latter was described by some as one of the most poorly drafted pieces of legislation ever to reach the statute books. Although it extended the investment powers of trustees, it gave limited flexibility to invest and was very difficult to use from a practical point of view. As a result, after the 1960s, most trust deeds gave trustees absolute powers of investment.

The Trustee Act 2000 reformed the investment powers available to trustees and introduced a statutory duty of care. It gave trustees a new and wide statutory power of investment, and permitted trustees to invest in investments of any kind as if they were absolute owners. The general investment power is in

addition to any limited express power in the trust deed of older trusts. It is not completely unfettered, however, and is subject to any restrictions in the trust deed. The implication is that investment managers need to check whether any proposed investment is permitted.

Standard Investment Criteria

The Trustee Act 2000 imposes a duty on trustees to have regard to the need for diversification and suitability of investments to the trust. These are referred to as the standard investment criteria.

Standard Investment Criteria	
Diversification	• The duty to have regard to the need for diversification and the suitability of the trust investments. • The requirement to diversify the trust fund means that, where appropriate, the trustees should use a spread of investments. • The degree of diversification that is desirable depends on the size of trust assets.
Suitability	• Suitability relates to considerations such as the size and risk of the investments, and the need to produce an appropriate balance between income and capital growth to meet the needs of the beneficiaries. It also includes any relevant ethical and religious considerations as to the kind of investment which is appropriate for the trust. • Suitability depends on a range of factors, including: ◦ nature and terms of the trust ◦ the investment requirements of the trustees and beneficiaries ◦ amount available to invest ◦ investment term ◦ investment skills and knowledge of the trustees ◦ underlying taxation of the investment ◦ tax position and risk profile of the trustees and beneficiaries, and ◦ administration costs involved.

Obtaining Advice

Section 5 of the Trustee Act 2000 imposes a statutory duty to obtain advice. Its requirements include the following:

- Before exercising any power of investment, the trustees must obtain and consider proper advice about the way in which that power should be exercised, having regard to the need for diversification of investments of the trust and the suitability to the trust of the proposed investments.
- When reviewing the investments of the trust, the trustees must obtain and consider proper advice about whether, having regard to the standard investment criteria, the investments should be varied.

For these purposes, proper advice is advice from a person whom the trustees reasonably believe to be qualified to give it, as evidenced by their ability in and practical experience of financial and other matters relating to the proposed investment.

The requirement to obtain and consider proper advice applies to all trusts, not just those into which the general power of investment is imported.

Statutory Duty of Care

Trustees have a statutory duty of care when exercising their powers of investment and are expected to satisfy themselves that the intended adviser is properly qualified. Their duty is to obtain and consider proper advice, but it does not mean that the trustees must actually follow the advice.

The advice must be about the way in which the trustees' investment powers should be exercised having regard to the need for diversification and the suitability of the proposed investment for the trust. The trustees require advice about investments in the context of the specific trust and therefore the adviser should have specialist experience and knowledge of trust investment management.

For an adviser it is, therefore, essential to establish:

- the investment powers available to the trustees,
- the nature and purpose of a trust and how this links into investment objectives,
- the range of permissible investments and whether there are any constraints contained in the trust deed,
- the tax treatment of the trust, and
- an investment policy statement that sets out the investment objectives, investment strategy and any constraints under which the investment management firm needs to operate.

7.3 Uses of Trusts

A properly structured trust is a flexible vehicle for financial planning for wealthy private clients.

They are particularly useful in directing the succession to family wealth, and to protect assets from a wide variety of contingent risks such as divorce and bankruptcy. For residents of some countries, trusts may provide a structure through which IHT and income taxes can be minimised. Some of their main uses are considered below.

7.3.1 Preservation of Wealth

A trust involves vesting the legal title of assets such as a family business in the name of the trustees, while allowing individuals to continue to benefit from the assets. As the legal title to the assets remains with the trustee, this prevents the dilution of ownership that would occur if the assets were distributed from the original owner to second and third generations.

7.3.2 Asset Protection

An asset protection trust can be used to protect the assets of an individual from claims by potential future creditors.

If an individual transfers part of their assets to a trust, these assets cease to be part of their estate and as such any future claims by creditors will not normally be enforceable against the trustees. However, it is

important to note that if the settlor creates the trust with the intent to avoid creditors, it is likely that the trust can be set aside.

7.3.3 Forced Heirship

Certain countries have laws which determine how an individual's estate should be distributed on their death known as forced heirship laws.

By divesting assets during the lifetime of the settlor, the trust will not form part of their estate upon their death. Where some of the assets of an individual are held outside that country, it may be possible to use a trust to distribute those assets in a manner which would not be possible under the forced heirship laws.

7.3.4 Private Trust Companies

Private trust companies can be created and used by wealthy clients as a way of managing large family businesses that professional trustees might find difficult. A private trust foundation can also be used to achieve the same purpose.

As a trust involves the transfer of ownership to the trustees, this can present issues for both the settlor and the trustees. The settlor may be reluctant to hand over control as they are concerned that the trustees will not necessarily understand the nature of the business owned by the trust. The trustees, for their part, may be concerned that should something go wrong with the business that they could be sued by the beneficiaries for failing to diversify the trust's assets and so reduce risk.

In this arrangement, instead of the family business being owned by a trust, additional layers are created in the structure.

- A trust will hold the family business as its asset.
- A private trust company is created to act as trustee of the family trust.
- The private trust company is a limited company and the board of the company can be selected to ensure that there are suitably qualified advisers appointed who understand the nature of the business along with the settlor.
- Whilst the settlor could own the shares in the private trust company directly it would probably be undesirable to have any direct link with its ownership, whether for tax, disclosure or for a variety of other reasons. Instead, a non-charitable purpose trust is often created which holds the shares in a private trust company as its sole asset.

Private trust companies and private trust foundations are used for owning and administering the assets of wealthy families and are favoured because they enable the board of directors to be suitably qualified and address the concerns of the trustees over their potential liability.

To avoid the possibility that the structure being attacked as a sham, there must be evidence that the settlor and the trustee (the private trust company) intended to set up and operate a proper trust structure. The appointment of a licensed administrator to carry out the general administration of the private trust company and the underlying trusts is used to help avoid such sham attack.

7.3.5 Other Uses

Trusts can play a key role in estate and financial planning for individuals. Other uses include:

- **Tax** – the major tax benefit in using a trust is that the assets held by a trust belong to the trustees and not to the settlor and are not liable to IHT on the settlor's death if they survive for seven years after the creation of the trust. By taking the assets out of the settlor's estate, they would normally cease to be taxable on the settlor. This can be very useful for inheritance tax and for deferring capital gains. The tax benefits will depend on the tax position of the settlor and beneficiaries, and where they reside.
- **Anonymity** – trusts in many jurisdictions, are not required to file information with the authorities, either on creation or on an annual basis. It is also possible to create a trust through a declaration of trust without identifying the settlor in the document itself.
- **Commercial trusts** – in many international centres there has been a growth in the use of trusts for commercial purposes. Uses include: employee incentive schemes, unit trusts and the issue of a number of debt instruments.

7.3.6 Sham Trusts

It is becoming increasingly common for trusts to come under attack and for the validity of a trust to be questioned on the basis that the instrument creating it is a sham document or fails to fulfil the requirements for the creation of a valid trust. From a wealth management perspective, this refers to where trusts are challenged because they are aggressive tax avoidance devices, where creditors seek to overturn the validity of the trust in order to get at the underlying assets or in divorce actions.

If the validity of a trust can be challenged, a court may set aside the trust and open the assets to the claims of creditors. In some countries, where the validity cannot be challenged rules have been introduced to allow a 'look through' of the transaction where it is deemed to have been undertaken to avoid, for example, payment of fees so that the effect of the creation of trust is ignored.

To reduce the chances of attack on the validity of a trust, trustees should understand the importance of acting independently.

- Evidence of a sham can be demonstrated where control of the trust property is vested in the settlor and the trustees exercise no independent discretion or take any actions consistent with the terms of the trust.
- Trustees should keep detailed minutes showing their proper independent consideration of trust matters, the exercise of any discretion and that they were not subject to any improper influences of the settlor.
- Where trustees are asked by a settlor to be involved in a transaction which is being led by the settlor and perhaps principally for their benefit, it is essential that the trustees demonstrate their independent evaluation of the transaction and their consideration of the interests of other beneficiaries who might be affected.

If the court finds a trust to be a sham, then the trust will be regarded as void and it is likely that the trust property will be found to be held on a resulting bare trust for the settlor, which will leave the settlor with an absolute beneficial interest in the trust property capable of being taxed, inherited or claimed.

The trustees might then find themselves subject to tax penalties and subject to an investigation by regulators into their conduct as trustees.

7.4 Types of Trust

One of the great advantages of a trust is its flexibility and it is possible to create a wide range of trusts with different characteristics.

There are a variety of types of trust, but generally they can be distinguished by two important characteristics, namely whether they are fixed trusts or discretionary trusts.

- **Fixed trusts** – the main distinguishing characteristic of a fixed trust is that the trust deed will set out precisely who will benefit from the trust and at what stage in the future.
- **Discretionary trusts** – these differ in that a class of beneficiaries is specified in the trust deed but the trustees are given the power to determine which beneficiaries of that class will benefit and when.

To describe the different tax treatment of trusts, the following terms are used:

- **Interest in possession trusts** – an interest in possession trust is one where the beneficiary of a trust has an immediate and automatic right to the income from the trust as it arises. An example of such a trust is a life interest trust.
- **Non-interest in possession trusts** – these are a type of discretionary trust and may be specially structured to achieve certain objectives such as accumulation trusts or age 18–25 trusts or to assist disabled persons.

7.4.1 Main Types of Trust

The characteristics of some of the common types of trust that are encountered are shown below.

Main Types of Trust	
Bare Trusts	• A bare trust is one where the beneficiaries have an immediate and absolute right to both the capital and income held in the trust. They are sometimes known as 'simple trusts'. • The assets are held by the trustees, but the trustees have no discretion over what income or capital to pass on to the beneficiary or beneficiaries. • Bare trusts are commonly used to transfer assets to minors. Trustees hold the assets on trust until the beneficiary becomes of legal age, at this point, beneficiaries can demand that the trustees transfer the trust fund to them.
Interest in Possession (IIP) Trusts	• These are trusts where the trustee must pass on all trust income to the beneficiary as it arises (less any expenses). • An IIP trust can provide a person with a right to enjoyment of assets during their lifetime with no absolute right to the capital or the assets. • Instead, the trust can provide that this capital passes on to someone else after that person's death.

Main Types of Trust	
Discretionary Trusts	• This is the most flexible form of trust and will normally allow the trustees to appoint additional beneficiaries or to remove existing beneficiaries, and will usually also allow the trustees to distribute the income and capital of the trust between the beneficiaries as they see fit. • The settlor will often write a letter of wishes which sets out what they would like to happen to the trust fund in the future. This letter is not legally binding, but in practice the trustee always follows it.
Accumulation Trusts	• This is where the trustees can accumulate income within the trust and add it to the trust's capital. They may also be able to pay income out, as with discretionary trusts.

Further details of certain types of trust are noted below.

7.4.2 Bare Trusts

A bare trust is one where the beneficiary has an immediate and absolute right to both the trust capital and the income received by the trust from that capital.

Under a bare trust arrangement, assets are transferred into trust by the settlor. At this point, the settlor gives up the legal title to the assets; they cease to be their property and instead become the property of the trust. Trustees then take on the responsibility for the management of these assets, which must be dealt with in such a way as to produce the maximum benefit for the intended beneficiaries. The terms of the trust will determine how much discretion is given to the trustees in terms of how they invest and their powers of maintenance and advancement.

The trust assets are held in the name of a trustee (the person administering the trust), but the trustee has no discretion over what income or capital to pass on to the beneficiary or beneficiaries.

Someone who sets up a bare trust can be certain that the assets they set aside will go directly to the beneficiaries they intend because, once the trust has been set up, the beneficiaries cannot be changed. 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 demand that the trustees transfer the trust fund to them.

The assets of a bare trust are treated for tax purposes as if the beneficiary holds the trust property in their own name and the beneficiary is liable to income tax on income received but, at the same time, each individual, even children, has a personal allowance. The beneficiaries of a bare trust need to report any income on their self-assessment tax return and account for any income tax due. In a bare trust, CGT is charged on the beneficiary, as if the trust did not exist. The beneficiary must declare any chargeable gains on their personal self-assessment tax return.

For IHT purposes, assets placed in a bare trust are treated as PETs. This means that they are usually only subject to IHT if the settlor who put the assets into the trust dies within seven years of doing so. In this case, since the capital and income of a bare trust belong absolutely to the beneficiary, the beneficiary is responsible for any IHT that may be due.

7.4.3 Interest in Possession Trusts

An interest in possession (IIP) trust is an arrangement which gives a person a right to the present enjoyment of something. At least one of the beneficiaries of this type of trust will have the right to receive the income generated by the trust (if trust funds are invested) or the right to enjoy the trust assets for the present time in another way, for example by living in a property owned by the trustees.

The main characteristics are summarised below:

- These are also known as life interest trusts (or liferent trusts in Scotland) and are characterised by a specified individual, being entitled to either some or all of the income produced by the assets in the trust and/or to the use of trust assets such as being entitled to live in a property owned by the trust for their lifetime.
- This individual is known as the life tenant or referred to as having a life interest. In Scotland they are known as a liferenter or as having a liferent interest.
- A trust can give the interest in possession to a beneficiary for a fixed period, for an indefinite period or, more usually, for the rest of the beneficiary's life.
- The life tenant often has no rights over the capital of such a trust but the trustees may have the power to pay capital to a beneficiary even though that beneficiary only has a right to receive income.
- On the death of the life interest/income beneficiary, the assets of the trust will be held for the benefit of the second class of beneficiary, known as the remainderman or fiar in Scotland or more simply, the ultimate beneficiaries. Alternatively, the assets could be held on another life interest trust until they finally pass to the ultimate beneficiaries.
- In England and Wales the interest of a remainderman in a trust is described as a reversionary interest as the possession or enjoyment of it is postponed to the prior interest of another person in the same capital.

A life interest trust is the most common example of an interest in possession trust. Historically, a surviving spouse would be granted a right to the income of the trust by the settlor. When the surviving spouse dies, the rest of the fund (the remainder) may pass to the couple's children or other named persons.

From an income tax perspective, an interest in possession trust is one where the beneficiary of a trust has an immediate and automatic right to the income from the trust as it arises. The trustee must pass all of the income received, less any trustees' expenses, to the beneficiary.

Following the Finance Act 2006, two other types of interest in possession trusts can be created that are not treated as discretionary trusts for tax purposes.

- **Immediate post-death interest (IPDI)** – an IPDI can only be created by will and is treated as an IIP trust under the old rules for tax purposes. This means that you can make a will leaving your estate upon trust for a named individual, such as your spouse or child, for that individual's lifetime, and that trust will not be taxed like a discretionary trust, but like an IIP trust.

- **Bereaved minor's trust** – this can only be set up by will. To qualify it must be created for the benefit of the children of the deceased. Income generated within a bereaved minor's trust can be retained within the trust or paid out for the benefit of the child. All of the capital within a bereaved minor's trust must be paid to the child or children when they reach the age of 18.

Interest in possession trusts can also enable individuals to benefit from the property while protecting them from their own improvident actions, since they are unable to spend the capital value of the trust. This is a protective trust which can be created under the Trustee Act 1925 which will keep the trust property protected from the life interest's creditors, should the life interest become bankrupt as the trust deed will specify that the life interest ceases if the life interest becomes bankrupt.

The trustee of an interest in possession trust has the duty to safeguard the interests of both classes of beneficiary. Any investments made should not favour one beneficiary at the expense of the other. The trustee should not, for example, invest solely in the capital shares of an investment trust. These will benefit the remainderman but will not generate any income for the income beneficiary.

Usually, the will or trust deed establishing the trust will set out how tax and trustees' expenses will be divided between the income beneficiary and the capital of the trust. Trustee investment policies will also allow emphasis on either present income (which may reduce the real value of the capital) or capital growth (increasing income in the long term and the capital remaining when the interest in possession is terminated) or a balance.

7.4.4 Non-Interest in Possession Trusts

An alternative to an interest in possession trust is those which are set up where the beneficiary does not have an absolute entitlement to benefit from the trust but relies on the exercise of the discretion granted to the trustees. The characteristics of various types of these trusts are shown below.

Types of Non-Interest in Possession Trusts	
Discretionary Trusts	• Discretionary trusts are where the trustees exercise their discretion as to which beneficiaries will be entitled to receive income or capital from the trust. The exact rights of each beneficiary are not determined in advance. • This can be of use in family situations. The settlor may be able to control the conduct of the beneficiaries by the trustees' use of discretionary powers. • Discretionary trusts can be a more flexible type of trust. For example, the settlor can constitute a discretionary trust for the benefit of a class of people, such as their grandchildren. If a new grandchild is born after the trust is set up, that grandchild will automatically rank as a beneficiary.

Types of Non-Interest in Possession Trusts	
Accumulation and Maintenance Trusts (A&M trusts)	• A&M trusts are a type of discretionary trust that was usually used created by will and received favourable tax treatment. • The beneficiaries will normally be children or grandchildren and the trust deed will usually state the age at which they can benefit from the trust income, which has to be no later than by the time they attain the age of 25. The right to capital can be delayed until they are aged 40 or even later or left subject to a power of appointment being exercised by the trustees. • Following the Finance Act 2006, it is no longer possible to establish a trust which enjoys the IHT advantages previously afforded to A&M trusts. Instead an 'age 18–25' trust is now used.
Age 18–25 trust	• This is a trust for the benefit of a person under the age of 25 which is established under the will of a deceased parent. • It is one of a number of tax favoured trusts that does not fall to be treated as a discretionary trust. • It is similar to a bereaved minor's trust but the trustees are not obliged to pay the capital to the children until they are 25. However, there may be an IHT charge on any capital transferred out to the children at any time between the ages of 18–25 and when it is paid out at 25.
Accumulation Trusts	• In an accumulation trust, the trustees can accumulate income within the trust, ie, add it to the trust capital. They will often do so until the beneficiary becomes legally entitled to the trust assets (such as money, land or buildings) or to the income produced from the assets. • Income that has been accumulated becomes part of the capital of the trust. The trustees may also pay income at their discretion, which is useful given all individuals have an income allowance. • Accumulation trusts should not be confused with accumulation and maintenance trusts.

7.4.5 Charitable Trusts

A charitable trust is a type of trust set up for a cause or purpose that will benefit a large group of people or society in general, not specific individuals. Such a trust is considered to be for the benefit of the public and so qualifies for tax reliefs that private trusts do not get.

Charitable trusts are set up for the purpose of charitable deeds, defined by part of the HMRC tax code as the relief of poverty, the advancement of religion, the advancement of education or purposes beneficial to the community. These four purposes were expanded into 13 by the Charities Act 2006. They are essentially defined as being beneficial to the community. A charitable trust enables the settlor to give some degree of individuality to a gift, specifying how it may be used and also knowing that the benefits will flow through to the designated charitable cause without attracting taxation.

To be regarded as charitable, all the purposes of a trust must be within the legal meaning of charitable and must promote public benefit.

7.4.6 Personal Injury Trusts

A personal injury trust holds compensation awarded to an individual following injury, such as from an accident, medical negligence or criminal injury, to protect eligibility for means-tested state benefits and local authority support, which might otherwise be lost if the compensation is held directly by the individual. Although not statutory, these trusts are widely used and should ideally be established before compensation is received to avoid benefits being compromised. The first payment of compensation is typically disregarded for up to 52 weeks, after which a properly set-up trust is crucial.

Personal injury trusts can take various forms but are often created as bare trusts for simplicity. The funds held in the trust, along with any income they generate, are disregarded for the purposes of means-tested benefits, provided the compensation arises from a valid personal injury claim. This helps ensure that the individual's eligibility for benefits is preserved. Trustees must manage the trust carefully, avoiding income payments directly into the injured person's bank account to protect benefits.

7.5 Taxation of Trusts

From a tax perspective, HMRC consider the main types of trust as bare trusts, interest in possession trusts or accumulation or discretionary trusts. Each type of trust is taxed differently. HMRC also refer to a mixed trust which is a combination of more than one type of trust. The different parts of the trust are treated according to the tax rules that apply to each part.

There are also special rules for settlor-interested trusts, parental trusts for children, trusts for vulnerable people and non-resident trusts which are covered below.

Charitable trusts are not covered below as they are exempt from tax with the exception of any trading profits that arise from commercial activities.

7.5.1 Bare Trusts

The beneficiary of a bare trust is treated as if they hold the trust property in their own name, therefore income tax and CGT are charged on the beneficiary as if the trust did not exist.

Income Tax

Although trustees can pay income tax on behalf of a beneficiary, it is still the beneficiary who is liable for the tax. Income from bare trusts should be reported on the beneficiaries' self-assessment tax return. The exception to this principle is income arising from assets placed in trust by parents for their own minor children – see below.

Capital Gains Tax (CGT)

In a bare trust, as with income tax, CGT is charged on the beneficiary as if the trust did not exist. The beneficiary must declare any chargeable gains on their personal self-assessment tax return.

Inheritance Tax (IHT)

For IHT purposes, assets placed in a bare trust are treated as PETs. This means that they are usually only subject to IHT if the settlor who put the assets into the trust dies within seven years of doing so. In this case, since the capital and income of a bare trust belong absolutely to the beneficiary, the beneficiary is responsible for any IHT that may be due.

If the beneficiary dies before becoming absolutely entitled to the trust assets, then the trust will form part of their estate.

7.5.2 Interest in Possession Trusts

Income Tax

The trustees are responsible for paying income tax at the rates below.

Income Tax Rates for Interest in Possession Trusts	
Type of Income	**Income Tax Rate**
Dividend-type income	8.75
All other income	20%

The trust is not entitled to a personal allowance. There is no higher-rate tax within the trust but the beneficiary may be liable for additional tax if it takes them into the higher-rate band. Expenses incurred by the trustees in running the trust are not permitted as allowable deductions for tax purposes, in the same way as an individual earning investment income is not allowed to charge personal expenses against their own taxable income.

IIP trusts are not normally taxed at the special trust rates of tax that apply to non-IIP trusts. However, some items that are capital in trust law are treated as income for tax purposes when received by trusts. This is a complicated area of trust taxation. You can find specialist information about capital items that are treated as income in HMRC's Trusts, Settlements and Estates Manual.

Income from the trust forms part of the beneficiary's taxable income. The beneficiary is deemed to receive the income net of the appropriate rate of income tax. The trustees are responsible for declaring and paying tax on income received by the trust. They do this on a Trust and Estate Tax Return.

Sometimes the trustees mandate income to the beneficiary. This means it goes to the beneficiary directly instead of being passed through the trustees. If this happens, the beneficiary needs to complete a self-assessment tax return.

CGT

CGT on an IIP trust may arise when assets are put into the trust, on gains made by the trustees and when assets are taken out of the trust.

The settlor gives assets to the trust when they constitute the trust. They will therefore have made a chargeable disposal for CGT purposes and hence be liable to CGT based on the market value of the assets at the date of the gift.

For most trusts other than bare trusts, the settlor is able to claim holdover relief, meaning that the CGT is held over until the trust disposes of the asset. The settlor is disposing of assets to a connected person, meaning that any loss on the disposal will only be allowed to be set off against gains on disposals made to the same connected person: the trust.

Trustees are liable to CGT on any chargeable gains above an amount set each year called the annual exempt amount and gains are taxed at the tax rates applicable for trusts.

Annual Exempt Amount and Rates of CGT for Trusts effective from 30 October 2024 (following the Autumn Budget 2024)	
Annual exempt amount	• £1,500 ie, half the annual exemption of £3,000 available to individuals
CGT rates	• 24% for gains on residential property not eligible for Private Residence Relief. • 24% for all other chargeable gains realised by higher rate taxpayers, including trustees. • 18% for chargeable gains realised by lower rate taxpayers.

An exception to this is a trust set up for a beneficiary who is vulnerable or disabled. In these circumstances the annual allowance is £3,000[3].

Trustees can deduct costs to reduce chargeable gains including the following:

- The cost of the property (including any administration fees).
- Professional fees, for example, for a solicitor or stockbroker.
- The cost of improving property or land to increase its value, for example building a conservatory (but not repairs or regular maintenance).

Trustees might also be able to reduce or delay the amount of tax the trust pays if gains are eligible for tax relief.

CGT Reliefs	
Private Residence Relief	• Trustees pay no CGT when they sell a property the trust owns provided that it is the main residence for someone allowed to live there under the rules of the trust.
Entrepreneur's Relief	• Trustees pay 10% CGT on qualifying gains if they sell assets used in a beneficiary's business, which has now ended. • They may also get relief when they sell shares in a company where the beneficiary had at least 5% of shares and voting rights.
Hold-over Relief	• Trustees can claim hold-over relief and so pay no tax if they transfer assets to beneficiaries (or other trustees in some cases). The recipient pays tax when they sell or dispose of the assets, unless they also claim relief.

Trustees are responsible for paying any CGT due. Beneficiaries are not taxed on any trust gains and do not get credit for any tax paid by the trustees.

CGT may also arise when assets are taken out of a trust. When the beneficiary of a trust becomes absolutely entitled on reaching a certain age, CGT is based on the market value of the assets at the time when the beneficiary becomes entitled but can claim hold-over relief. When an interest in possession ends such as on the death of a life tenant, no CGT is payable as the trust will be liable to IHT.

IHT

Where an IIP trust was set up before 22 March 2006, the value of the trust is included in the estate of the beneficiary when they die. It is the trustees duty to complete an IHT100 Inheritance Tax Account form with the value of the IIP trust. The same approach is taken for trusts set up after 22 March 2006 where the trust was either an 'immediate post death interest', a 'disabled person's interest' or a 'transitional serial interest' trust.

Trusts for bereaved minors are also treated differently. This is one in which property is held on trust under the rules of intestacy or held on trust under the will of a deceased parent for the benefit of a bereaved minor. The terms of the trust must be that at the age of 18 the bereaved minor will become absolutely entitled to the trust property, any income arising from it and any accumulated income.

3 https://www.gov.uk/guidance/capital-gains-tax-rates-and-allowances

Whilst the trust is in existence, there will be no charge to IHT and there will be no IHT exit charge when property ceases to be held in the trust.

7.5.3 Discretionary and Accumulation Trusts

Income Tax

Trustees are responsible for declaring and paying tax on income received by discretionary and accumulation trusts.

Income is taxed at the special trust rates, apart from the first £500 known as the standard rate band.

The first £500 is taxed at the standard rate and if the settlor has more than one trust, this amount is divided by the number of trusts they have. However, if the settlor has set up five or more trusts, the standard rate band for each trust is £100.

Trust Income Tax Rates		
Trust Income up to £500	• Dividend-type income • All other income	• 8.75% • 20%
Trust income over £500	• Dividend-type income • All other income	• 39.35% • 45%

Trustees do not qualify for a dividend allowance, meaning that they pay tax on all dividends; the amount depends on the tax band they fall within.

Some items that are capital in trust law are treated as income for tax purposes when received by trusts. They are taxed at the trust rate (45%) or the dividend trust rate (39.35%), depending on the type of item.

A beneficiary is taxable only on income paid to them by the trustees or applied by the trustees for their maintenance, education or benefit. Amounts received by the beneficiary are deemed to be net of the special trust rate and a corresponding credit is available. If a beneficiary receives £55, they will be taxable on £100 but a credit of £45 is available. Thus, if the beneficiary is a non- or basic-rate taxpayer, some or all of the tax can be reclaimed.

If the settlor of a trust is also a beneficiary or potential beneficiary, the trust income is regarded as theirs for income tax purposes. The trustees remain liable, but if the settlor is not a higher-rate taxpayer they may reclaim the balance of tax.

CGT

CGT is chargeable in the same way on all trusts, apart from bare trusts, so non-interest in possession trusts are liable to CGT as covered earlier.

IHT

There is now little difference between the CGT treatment of discretionary/accumulation trusts and IIP trusts; therefore the approach covered in the previous section applies with some exceptions.

Since March 2006, some tax benefits have been withdrawn from interest in possession trusts and accumulation and maintenance trusts. This means that, for the purposes of IHT, the three types of trust are normally taxed in the same way.

For all three types, there may be an IHT charge when:

- Assets (money or property) are put into a trust.
- A trust reaches a ten-year anniversary – the ten-yearly IHT charge.
- Assets are distributed from a trust – exit charges.

The act of putting money into a trust or settling property gives rise to a potential IHT liability where the value exceeds the NRB (£325,000).

Assets Transferred into a Trust	
Chargeable lifetime transfer	• When assets are transferred into these trusts during the settlor's lifetime, a chargeable lifetime transfer is made for the purposes of IHT. • This is a charge of 20% of the value of the assets being put into the trust, for amounts in excess of the IHT threshold.
Deaths within seven years of transfer	• If the settlor dies within seven years of making a transfer into a trust their estate will have to pay IHT at the full amount of 40%. • This is instead of the reduced amount of 20% which is payable when the payment is made during lifetime. The personal representative of the settlor will have to pay a further 20% out of the estate based on the value of the original transfer. • If no IHT was due when the transfer into the trust was made, the value of the transfer is added to the settlor's estate when working out whether any IHT is due.

Trustees have to pay a charge on every tenth anniversary of the date the trust was set up if the trust contains relevant property with a value above the IHT threshold at that time. It is charged on the net value of any relevant property in the trust on the day before that anniversary. It is payable by the trust.

Ten-Year IHT Charge

- The calculation of the ten-yearly charge is complicated. It is based on the value of the trust assets at the ten-year anniversary but takes into account the values of chargeable transfers made by the settlor in the seven years leading up to the trust being set up, and also distributions made by the trust in the ten years before the charge.
- The rate of tax is usually 30% of the normal rate for lifetime transfers, ie, 30% × 20% = 6%.

In addition, tax is charged whenever assets are distributed from the trust. Essentially, this is a scaled down version of the ten-year charge, designed to prevent trustees avoiding the ten-year charge by distributing assets prior to the end of the ten-year period.

Exit Charge	
Exit charges in the first ten years	• If lifetime inheritance tax was payable at outset, exit charges will apply in the first ten years. • If there was no inheritance tax payable at outset, there will be no inheritance tax exit charges on any distributions of capital to the beneficiaries in the first ten years.
Exit charges after the first ten years	• Once the trust has passed its first ten-year anniversary, IHT exit charges are always based on the effective rate of tax used for the previous ten-year anniversary charge. • If this was zero, there will be no inheritance tax exit charges on any distributions of capital to the beneficiaries in the following ten years.

For the calculation, you must establish the effective rate of tax applying to the trust at outset or at the ten-year anniversary. This tax rate is then applied to the amount of the capital distribution. However, there is a proportionate reduction based on the number of complete calendar quarters since the last ten-year anniversary, or since outset if within the first ten years. The calculation is therefore:

Exit charge = amount of capital distribution x (tax suffered by trust / value of the trust at inception or the 10th anniversary) x X/40

The 'X factor' represents the number of complete calendar quarters, with 40 representing the number of quarters in a ten-year period.

The rules are different for an 18–25 trust. Whilst the trust is in existence and the beneficiary is under the age of 18 years, there will be no ten-yearly charge or exit charge. If the trust continues beyond the beneficiary attaining the age of 18, there will be an exit charge on certain events including:

- Where the beneficiary becomes absolutely entitled to the trust property after age 18.
- The death of the beneficiary after age 18.
- Trust assets being paid or applied for the benefit of the beneficiary after age 18 – ie, a capital distribution.

In an 18–25 trust, when a child over 18 receives a payment from the trust there may be an IHT charge if the trust fund exceeds the nil-rate band. It is calculated using the same method as for exit charges. As the maximum rate of a ten-year charge is 6% and it is for a maximum period of seven years (ie, or age 18–25), the maximum rate will be 4.2% on the excess over the nil-rate band.

7.5.4 Settlor-Interested Trusts

These are where the settlor, their spouse or civil partner benefits from the trust. The trust could be either an IIP trust, an accumulation trust or a discretionary trust. The settlor is responsible for income tax on these trusts, even if some of the income is not paid out of them. However, the income tax is paid by the trustees as they receive income. The trustees pay income tax on the trust income by filling out a trust and estate tax return.

They give the settlor a statement of all the income and the rates of tax charged on it. The settlor tells HMRC about the tax the trustees have paid on their behalf on a self-assessment tax return. The rate of income tax depends on what type of trust the settlor-interested trust is.

7.5.5 Parental Trusts for Children

These are trusts set up by parents for children under 18 who have never been married or in a civil partnership. They are not a type of trust in their own right but will be structured as a bare trust, an IIP trust, a discretionary or an accumulation trust.

Income tax on income from the trust is paid to the trustees, but the settlor is responsible for it. The trustees pay income tax on the trust income by filling out a Trust and Estate Tax Return and provide the settlor with details of the income and the rates of tax charged on it. The settlor then tells HMRC about the tax the trustees have paid on their behalf when filling out their Self Assessment tax return.

7.5.6 Trusts for Vulnerable People

Certain trusts are designed for disabled people or children and are called 'trusts for vulnerable beneficiaries'. They receive special tax treatment.

Vulnerable beneficiaries include people under 18 whose parent died or disabled individuals who are eligible for any of the following benefits:

- Adult disability payment.
- Armed forces independence payment.
- Attendance allowance.
- Child disability payment.
- Constant attendance allowance.
- Disability living allowance (adults and children).
- Industrial injuries disablement benefit.
- Personal Independent Payment (PIP).
- Pension Age Disability Payment.
- Scottish Adult Disability Living Allowance.

Furthermore, a vulnerable beneficiary can also be someone who is unable to manage their own affairs due to a mental health condition.

For income tax purposes, the trustees are entitled to a deduction from their own income tax liability based on the difference between what tax would be payable if no claim was made and what would be payable if the vulnerable person had received it directly. There is a similar approach for CGT where they can claim reduction in CGT payable. The trustees work out what they would normally pay and what the beneficiary would pay if the gains had been made by them and then claim the difference between the two amounts as a reduction of the CGT payable.

There are also situations where trusts for vulnerable people receive special IHT treatment. There is no IHT charge if the person setting up the trust survives for seven years from the date they set it up and on transfers made out of the trust to a vulnerable beneficiary. There is no ten-yearly IHT charge and when the beneficiary dies, any assets held in the trust on their behalf are treated as part of their estate and IHT may be charged.

7.5.7 Personal Injury Trusts

From a tax standpoint, personal injury trusts are generally considered settlor interested trusts, with the injured party acting as settlor and usually a named beneficiary. As such, there are no automatic tax advantages purely on account of the trust's personal injury status.

Tax treatment depends on the trust structure:

- **Income tax and CGT** – for trusts structured as bare, income and capital gains are typically taxed on the settlor (injured person) at their personal rates, allowing access to personal allowances and annual CGT exemptions. By comparison, discretionary and interest-in-possession trusts are subject to higher trust tax rates and may incur periodic and exit charges.
- **IHT** – if established as bare, they are exempt from this immediate charge. Otherwise, if the compensation sum held exceeds the inheritance tax NRB, an immediate lifetime IHT charge of 20% applies on the excess.
- **Benefit protection** – provided the trust is correctly established and holds only compensation funds, personal injury trusts are disregarded for means-tested benefits. Mixing funds or failing to meet administrative conditions may jeopardise this.

Timely setup and ongoing compliance are essential to preserve both benefits protection and tax efficiency.

Some clients who receive personal injury compensation and also meet the legal criteria for vulnerability (such as having long-term mental or physical disability) may have a choice between establishing a personal injury trust or a vulnerable person trust. The former are specifically designed to protect compensation awards to preserve eligibility for means-tested benefits and offer a simpler, more straightforward structure without requiring proof of disability. However, they generally provide no special tax advantages and may trigger inheritance tax charges. In contrast, vulnerable person trusts require the beneficiary to meet strict vulnerability criteria, and the trustees need to apply for the vulnerable person election (VPE1 form), but offer enhanced tax reliefs on income, capital gains and IHT.

7.5.8 Non-Resident Trusts

This is a trust where:

- none of the trustees are resident in the UK for tax purposes, and
- only some of the trustees are resident in the UK and the settlor of the trust was not resident, ordinarily resident or domiciled in the UK when the trust was set up or funds added.

The tax rules for non-resident trusts are very complicated and reference should be made to HMRC guidance when needed.

7.6 Trust Tax Registration Rules

Part 5 of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 requires trustees of taxable 'relevant trusts' to maintain accurate and up-to-date written records of all beneficial owners. The information needs to be recorded on the Trust Register maintained by HMRC, and must be provided on or before 31 January after the tax year in which the trustees were first liable to pay tax.

A taxable relevant trust is any trust which is liable to pay any UK tax in a tax year. This means that, once the trustees are required to submit a tax return to HMRC, they are also obliged to provide information to the trust register on the beneficial owners. Beneficial owners include not just named beneficiaries but any potential beneficiary named in a letter of wishes or other relevant document. Under a discretionary trust if a class of beneficiaries has been included, the trustees need to record a description of the class of persons who are beneficiaries or potential beneficiaries under the trust. However, if the settlor has indicated that certain beneficiaries should only benefit if other named beneficiaries die, then the trustees do not need to include them in their records.

It is worth noting that, where the only asset held by the trust is an investment bond, then the trustees are only obliged to provide information to the trust register when a chargeable gain occurs and the trustees are liable or when a periodic or exit charge is payable.

7.7 Trust Registration Extension

New rules were introduced on 6 October 2020 to extend the scope of the Trust Register to UK and some non-UK trusts, with some specific exclusions, regardless of whether the trust is liable to pay any tax.

These new rules were introduced as part of the UK's implementation of the Fifth Money Laundering Directive (5MLD) to ensure that the UK has:

- an anti-money laundering (AML) and counter terrorist financing regime that is up to date, effective and proportionate, and
- improved more transparency about on the ownership of assets held in trusts.

Trustees or their agents must register a trust using HMRC's Trust Registration Service (TRS).

7.7.1 Trusts to be Registered

Trusts that need to be registered are broadly all UK express trusts, unless they are specifically excluded (see 'Trusts that do not have to be registered'[4] on the UK government website), and non-UK express trusts that:

- acquire land or property in the UK, and
- have at least one trustee resident in the UK and enter into a 'business relationship' within the UK.

4 https://www.gov.uk/trusts-taxes/registering-a-trust

Though estates are not themselves subject to registration on TRS under the Money Laundering Regulations, some estates also must register if the personal representatives need to complete a Self-Assessment Trust & Estate tax return. This is because TRS is the mechanism for estates to acquire a unique taxpayer reference (UTR).

7.7.2 Trustees and Agents

The trustees or agents will have to give some basic information to HMRC about the persons involved in the trust (the settlors and beneficiaries). This will apply to both taxable and non-taxable trusts.

7.7.3 Register Information Requests

Organisations and persons involved in preventative work in the field of anti-money laundering, counter terrorist financing and associated offences, can request access to details on the register about the people associated with a trust. The information will only be released on request in certain limited circumstances.

7.8 Family Offices

While early family offices can be traced to Europe as early as the 6th century, it was in the 19th century that the modern concept was developed. In 1838, the family of J.P. Morgan founded the House of Morgan to manage the family's assets, and in 1882, the Rockefellers founded their family office. Today a family office is increasingly becoming the organisation of choice for high-net-worth families because it can be tailored to meet their unique needs. There are thousands of family offices around the world – most of them were set up since the 2000s and their number is growing fast.

Family offices are closely held and lightly regulated yet manage an estimated $6 trillion globally. London is one of the leading family office hubs, alongside New York and Singapore.

7.8.1 What is a Family Office?

There is not one clear definition, because every family office is different. Family offices vary depending on the needs and wants of the families that established them. Generally, the term is used to describe an organisation dedicated to holding and managing the wealth of a family.

The basic version consists of an assistant who manages the bills and financial needs of a wealthy family. An advanced version could be a private trust company which manages all aspects of wealth, including investments, retirement, and taxes, and enables the members of a wealthy family to become involved in the governance of the family assets.

A family office may also look for the best jurisdictions in which to establish wealth preservation vehicles.

7.8.2 Benefits

A family office can manage a family's wealth more efficiently and effectively than other financial services firms as it makes decisions quickly and flexibly, while supporting the family's vision and legacy as well as transitions (eg, leadership or ownership) in a more structured way.

There are several ways to set up a family office. These include:

- Transferring the management of disparate wealth preservation vehicles and other affairs to one central trusted adviser (an individual or organisation) to ensure no overlaps and gaps.
- Starting a private trust company to centrally manage the wealth with expert advisors sitting alongside family members on the board overseeing the management of all assets.
- Agreeing a wealth allocation plan with the family office, including the creation of companies to ensure optimal distribution of income and dividends and protection of assets.

7.8.3 Single-Family versus Multi-Family

There are two main categories of family offices:

- **Single-family office (SFO)** – SFOs serve just one family and therefore are fully customised and offer the highest level of confidentiality.
- **Multi-family office (MFO)** – MFOs are independent wealth management firms that manage the wealth of a group of families. Generally, MFOs are either start-ups or units of established financial institutions. However, there are also cases where groups of families pool their resources to scale and be able to access investment and cost-saving opportunities that would otherwise not be available.

MFOs have traditionally had a large number of diverse experts in-house and only a handful of them outside of the organisation that provided non-core expertise. This has evolved with more and more experts working outside. Many MFOs have now just a small core team of experts and a diverse network of specialists on call. This arrangement is generally referred to as a virtual family office. This allows more families to access family office services. All family office types have more and more FinTech solutions to better manage wealth.

Limitations

A family office is expensive compared to advice from a wealth management firm. The average costs for a single-family office are about 0.6% of assets under management. It could cost more than $1 million a year since all support activities such as IT and legal need to be procured and run from scratch. SFOs cannot leverage efficiencies of scale and require incremental investments in IT systems. MFOs can spread the costs over a larger asset base and add new families to the existing IT platform. An SFO is viable only when it manages assets worth at least $500 million.

7.8.4 Sustainable Investing

Most family offices continue to increasingly integrate ESG principles into their investment strategies, reflecting a clear shift from risk mitigation towards seeking opportunities.

The UBS Global Family Office Report 2024[5] found:

- **Growing opportunity focus** – nearly half (46%) of family offices that incorporate sustainability and impact factors now regard it primarily as an attractive investment opportunity, up from 42% in 2024. By contrast, only a third (33%) see it mainly as a means to manage financial and non-financial risks, a decrease from 47% last year.

5 UBS, 2024. Global Family Office Report 2024. Retrieved from https://www.ubs.com/global/en/wealthmanagement/family-office-uhnw/reports/global-family-office-report.html (Accessed: August 2025)

- **Popular investment themes** – family offices prioritise key sustainability areas such as electrification, energy transition, agriculture and sustainable living, and water scarcity solutions, while many continue exploring these evolving opportunities.
- **Challenges** – more than a third (33%) of family offices cite the need for better, more accurate sustainability and impact data to fulfil their objectives.

Overall, family offices are evolving their approach to sustainable investing – increasingly recognising it as a source of value and innovation, while striving for greater sophistication through enhanced data quality, active ownership and strategic alignment with family values.

7.8.5 Crypto Investing

Family offices are also turning their attention to crypto space, but they are focusing on the applications that blockchain technologies provide rather than cryptocurrencies like Bitcoin.

One third of family offices surveyed by UBS are either investing in, or considering, blockchain technologies and only a quarter are either investing in cryptocurrencies or considering them. US and Middle Eastern family offices are participating the most actively. About half of US and Middle Eastern respondents are turning to blockchain with only a quarter doing so in Asia-Pacific and Latin America.

8. Later Life Planning

More of us are living to 'a ripe old age' and with it comes the need to plan for some of the consequences of living longer and the health issues it brings.

8.1 Equity Release

Equity release refers to a range of products that enable clients to borrow money against the value of their home.

These products allow customers to release equity from their home and use the funds for a variety of reasons such as:

- Repay their existing mortgage.
- Carry out home improvements, essential household repairs and adaptations.
- Consolidate burdensome debts.
- Reduce their working hours or fund earlier retirement.
- Paying for help around the home, including domiciliary social care.
- Making gifts to children or grandchildren.

There is an increasing demand for later life lending and the market has seen significant growth in recent years meaning that wealth managers need to be aware of the range of products available. There are two main types of equity release – lifetime mortgages and home reversion plans.

8.1.1 Lifetime Mortgages

Most people who take out equity release use a lifetime mortgage. These involve taking out a mortgage that does not require monthly repayments and instead, the interest is rolled up until the loan is repaid when the person dies or moves into long-term care.

The amount that can be borrowed depends on the value of the property, the person's age and their health. Usually, the amount that can be borrowed is linked to age; the older you are the greater the cash sum that can be released; for example a 60-year-old could release 20%, a 65-year–old could release 25%, and so on. The amount available varies between providers. Some people may be able to release larger lump sums due to impaired health. Lifetime mortgage applications are assessed based on whether the person can afford to repay the loan so the person must meet the provider's affordability criteria.

There are four main costs associated with equity release:

1. advice fees
2. a valuation fee
3. legal fees for the conveyancing, and
4. some lenders charge an application fee.

Benefits of Lifetime Mortgages

- The mortgage and accrued interest are only repaid when the home is sold.
- Interest rates are fixed or if they are variable they will have a cap which is fixed for the life of the loan.
- There is a 'no negative equity' feature so that the liability cannot exceed the value of the home.
- A drawdown option allows a release of an initial cash lump sum while establishing access to a pre-approved further borrowing facility.
- Some providers offer an inheritance protection facility which allows clients to protect a specific percentage of the property's future value.
- It is still possible to move to another property subject to the new property being acceptable to your product provider as continuing security for your equity release loan.

Risks of Lifetime Mortgages

- Allowing the interest to roll up could be more expensive than a traditional mortgage.
- Consolidating debts over a longer period may mean paying more overall.
- Releasing equity may affect that person's tax position and entitlement to means tested benefits.
- The overall value of the person's estate will decrease and this will affect the amount of inheritance they may leave.

There are variations on these basic features including the options to make monthly capital repayments and interest payments in part or in full with an option to roll up at a later date if the monthly repayments became unaffordable.

An interest only lifetime mortgage allows someone to manage the interest charges on the loan by making monthly repayments. As long as the interest payments are made, the amount owed never increases. This avoids the compounding of interest associated with lifetime mortgages, where interest is charged on the interest already added to the mortgage.

8.1.2 Home Reversion Plans

A home reversion plan involves releasing equity from the value of the house and still having the right to remain in the property rent-free for the rest of that person's life, but the provider purchases all or part of the house.

The amount received for the sale of the house or part of it depends on the property's value, which is determined by a number of factors including age and condition. Some home reversion providers have a minimum age of at least 60 or 65 and the amount released is usually between 20–60% of the market value of the home. The amount received is discounted in exchange for rent-free lifetime tenure or until the person goes into long-term care.

8.1.3 Regulatory Position

Equity release is a regulated activity and requires specific permissions to undertake advice.

The FCA undertook exploratory work into the later life lending focusing on lifetime mortgages and issued its key findings in June 2020. The results of the review warrant study as they revolve around the suitability of advice process.

It found that where customers were suitably advised, the FCA saw some good outcomes where consumers ended up with an equity release product that met their long-term needs. In these cases, consumers benefited from the stability of a long-term fixed interest rate, unlocked wealth from their main or only asset, and did not have to make monthly interest payments. However, when consumers are given unsuitable advice, they can suffer major harm which affects them for the rest of their lives; in some cases, ending these contracts or repaying the amount owed early can be unaffordable.

The FCA findings were mixed. They saw cases where lifetime mortgages were working well, unlocking equity for consumers who would not have been able to afford traditional mortgages or other sources of borrowing. However, they also saw cases where it was not clear that the advice was in the best interests of the consumer.

They found the following three significant areas of concern about the suitability of advice provided.

	FCA Findings
Personalisation of advice	• A form-filling approach to fact finds that indicated a failure to focus on the needs and circumstances of the individual in coming to a view that a particular lifetime mortgage is suitable.
Insufficient challenging of customer assumptions	• There was insufficient challenge when customers believed that a lifetime mortgage was the right solution for them leading to 'order taking' rather than considered advice.
Evidence of the suitability of advice	• Reviews showed inadequate evidence to demonstrate the suitability of advice. Suitability letters were generic and failed to record how conclusions about suitable options were reached or alternatives discounted.

8.2 Care Home Funding

The cost of care in older age is a major concern for many clients which is unsurprising given the high costs of both residential care and nursing care, as we saw in the Long-Term Care Protection section of chapter 5.

8.3 Discussing Illness and Death

Discussing illness and death with close family can be a difficult and emotional challenge for clients who may turn to their advisers for help with what they should discuss. There is never an easy time for someone to talk with loved ones about what will happen if they become very ill and after their death. It does make a difference, though, if their loved ones know their wishes for end-of-life care, their funeral and the arrangements they have made for passing on their estate.

Areas that may be discussed include:

- Medical issues and their wishes surrounding certain treatments and whether a Lasting Power of Attorney for Health and Welfare and a living will is needed.
- Practical arrangements for their property, possessions and pets.
- Whether any smaller possessions should be given to someone who might appreciate them as a memento.
- What style of funeral they would prefer and what music, readings or setting they would like.
- The location of their will and details of their executors and legal and other advisers.

Recording their wishes in writing will also help those left behind when arrangements have to be made.

8.4 Lasting Power of Attorney (LPA) for Health and Welfare

As we saw in section 5.1, a Lasting Power of Attorney (LPA) for Health and Welfare is one of the two types of LPA.

The attorney under such an LPA can make decisions about anything to do with the donor's health and personal welfare when they are unable to make their own decisions and provided that the decisions are in their best interests. This includes decisions about:

- medical treatment
- where the person is cared for
- the type of care put in place, and
- day-to-day things such as diet, dress and daily routine.

The other type of LPA is a property and financial affairs lasting power of attorney. Under this, the LPA gives the attorney the power to make decisions about money and other assets and can make decisions about areas such as:

- buying or selling property
- paying the mortgage or arranging repairs
- managing bank, building society and other financial assets
- claiming and collecting welfare benefits or tax credits

- tax affairs
- paying care home fees and other bills, and
- making gifts on behalf of the donor.

An LPA is only valid when it is registered with the Office of the Public Guardian which can take eight to ten weeks. A certificate provider needs to confirm that no one is forcing the donor to make an LPA and this is usually a professional such as doctor or lawyer and notice of the LPA may need to be given. As a result, the earlier the arrangements are made the better.

When making such a LPA, the donor should consider whether or not they want the attorney to be able to make decisions about life-sustaining treatment. If not, then they should make a living will.

8.5 Living Will

A living will, or an advance decision to refuse treatment (an ADRT) as it now called, allows someone to state their wishes about any treatments they do not want to have in the future in case they become unable to make or communicate decisions for themselves.

An advanced decision can be used to refuse any medical treatment, including life-sustaining treatment, but cannot be used for something illegal such as assistance to end your life.

An advance decision should be made in writing and signed and dated in the presence of a witness who must also sign and date the document. Close family should be made aware that the document has been executed and a copy should be given to the GP and anyone else involved in that person's care.

Advance decisions are legally binding in England and Wales, as long as they meet certain requirements. This means that if a healthcare professional knows you have made an advance decision, they have to follow it. An advance decision is legally binding as long as it complies with the Mental Health Act, is valid and applies to the situation. To be considered valid, an advance decision must:

- Be made by someone aged 18 and over who has mental capacity.
- Specify clearly the treatments they wish to refuse and the circumstances in which they wish to refuse them.
- Have been made of that person's own accord without any harassment or undue influence.
- Include a statement where life-sustaining treatment is to be refused and applies even if your life is at risk or shortened as a result of refusing treatment.
- Not have been contradicted by something said or done by that person such as saying they have changed their mind.
- Signed and witnessed.

If your advance decision is binding, it takes precedence over decisions made in your best interest by other people.

Advance decisions need to be regularly reviewed.

- They will only apply if you are in a situation that you have included within it. If you are in a different situation then it will not apply. For example, if you refuse life-sustaining treatment in the situation you develop dementia but not in any other situation, then you have a stroke, the advance decision would not apply.

- The advanced decision only applies to the treatments refused within it.
- If something later happens that might have affected your decision, such as new treatments being developed, it may not be applicable.

8.5.1 Advance Decision and a Lasting Power of Attorney

As long as the advance decision is valid and applicable then it is legally binding and cannot be overruled with one exception. If the person made a Lasting Power of Attorney for Health and Welfare after their advance decision was completed, then the later document will take priority when a decision needs to be taken about a person's treatment and care. If the advance decision was made after the LPA, the attorney will not be able to override the decision.

8.5.2 Disagreements about an Advanced Decision

An advanced decision is legally binding but if their doctor believes that it is not valid or applicable, such as when the patient may have acted in a way that suggests they changed their mind or the advance decision was made a long time ago, then the doctor may decide not to follow the advance decision. The doctor in charge of the patient's treatment is responsible for making the final decision but if there is disagreement about this then a formal complaint would need to be made or if all other attempts to come to an agreement fail, then an application to the Court of Protection can be made.

8.5.3 Advance Statement

An advance statement is often made in conjunction with an advance decision. It allows someone to record how they would like to be cared for and can give family, carers and healthcare professionals an indication of your wishes in the event that treatment is needed that is not covered by the advance decision.

There are no formal guidelines for making an advance statement as it is not legally binding but preparing a document and sharing it as an advance decision can mean that it is less likely that your wishes will be called into question. Whilst it is not legally binding and doctors do not have to follow it, it must be taken into account when considering that person's best interests.

8.5.4 Do Not Attempt Resuscitation (DNAR) Form

A **Do Not Attempt Resuscitation (DNAR) form** is a document issued and signed by a doctor, which tells the medical team not to attempt cardiopulmonary resuscitation (CPR). It is not legally binding, but tells healthcare professionals not to attempt CPR, as otherwise they will always attempt it. We regularly see CPR being performed successfully in TV programmes but the reality is that in hospital only two out of ten people survive and leave hospital after having CPR and even when successful, a patient can develop serious complications.

Everyone has the right to refuse CPR if they wish. This is known as a do not attempt cardiopulmonary resuscitation (DNACPR) decision, or DNACPR order. Once a DNACPR decision is made, it is put in the person's medical records, usually on a special form that health professionals will recognise. An advance decision can be used to refuse any treatment whereas a DNACPR only applies to CPR.

9. Vulnerable Clients

The issue of vulnerable clients is becoming ever more prominent and is an increasing focus of regulators and other interested groups with a particular focus on whether they are receiving fair treatment.

9.1 Vulnerability Drivers and Impact

Understanding what constitutes a vulnerable client, however, is not that obvious. The FCA defines a vulnerable customer as:

> *'A vulnerable consumer is someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care'.*

Vulnerability can, however, come in a variety of guises. The Competition and Markets Authority distinguishes between two broad categories of vulnerability – one that arises from certain market contexts in which all of us can experience a degree of vulnerability and one that arises as a result of some personal characteristics.

Examples of when they may arise include:

- **Market context** – making purchases or financial decisions during stressful points in time, such as bereavement or choosing care arrangements for someone near to us.
- **Personal characteristics** – physical disability, poor mental health, compulsive or impulsive behaviour or impaired cognitive skills due to illness or ageing.

Research by the FCA highlighted some of the consequences of such vulnerability as:

- heightened stress levels due to difficult, or different, personal circumstances
- increasing time pressures due to additional responsibilities
- increasing pre-occupation ('brain is elsewhere') limiting ability to manage
- processing power and ability decreases due to competing pressures, for example, due to the side effects, or emotional toll, of receiving medical treatment
- lack of perspective, especially when experiencing something for the first time, not fully understanding the broader implications; unable to make comparisons, or see the 'bigger picture', and
- changing attitudes towards taking risks; people often become more 'reckless' and/or careless at moments of stress.

These consequences may affect the way vulnerable consumers engage with financial services firms and other providers. The impact of these characteristics includes:

- Businesses are able to exploit these vulnerabilities to charge consumers higher 'prices' such as the clear examples that have been seen in recent years in the prices charged by energy companies or the interest rates offered to loyal customers by savings institutions.
- Individuals may not be able due to physical, cognitive or mental problems to fully engage with firms or struggle to comprehend what is involved with what might otherwise seem straightforward transactions or decisions. Equally, behavioural biases may prevent someone from choosing the right option so that inertia applies.
- Business practices can also exacerbate existing vulnerabilities and create new forms of vulnerability.

These types of challenges can mean that consumers falling into these groups are at an increased risk of experiencing poor outcomes in markets. FCA research found that:

- Financial services, products and systems often 'streamline' consumers and are not designed to meet non-standard needs of those who do not fit into a set mould.
- Frontline staff may not have the skills to recognise vulnerability and so access to a good outcome is missed.
- Frontline staff need specialised training to identify when a vulnerability may be present and know how to deal with it or when to refer on.
- Systems tend to be inflexible and can exacerbate existing vulnerabilities making the situation more difficult.
- Some consumers are overwhelmed by complex information and can find it hard to identify important points they should deal with.
- Inaccurate interpretation or overzealous implementation of rules, such as those around data protection or affordability, is preventing firms from meeting the needs of vulnerable customers.
- Many vulnerable consumers may be valuable customers if firms respond to their needs and treat them flexibly. Where they do not, consumers may withdraw from the mainstream market and their problems may spiral if their needs are not met.

Vulnerability can affect consumers across all financial products and services and may be a long-term characteristic or one that is transient in its nature. Recognising when a client may be vulnerable is, therefore, important.

9.2 FCA Guidance

The FCA expects regulated firms to treat customers, including vulnerable customers, fairly. Securing an appropriate degree of protection for consumers is one of the FCA's three operational objectives. FSMA (as amended) in the consumer protection objective sets a general principle that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate having regard, among other things, to the capabilities of the consumers in question.

The level of care that is appropriate for vulnerable consumers may therefore be different from what is required for other consumers.

In 2021, the FCA published an updated guidance[6] for firms on the fair treatment of vulnerable customers. The guidance clarifies what the FCA considers is required under the FCA Principles and is grouped into four key areas:

1. Understand the target market/customer base's needs.
2. Ensure staff have the right skills and capability to recognise and respond to the vulnerable customers' needs.
3. Respond to customers' needs throughout product design, flexible customer service provision and communications.
4. Monitor and assess if they are meeting and responding to the vulnerable customers' needs and make improvements where this is not the case.

6 Financial Conduct Authority, March 2025 (update). Guidance for firms on the fair treatment of vulnerable customers (FG21/1). Retrieved from https://www.fca.org.uk/publications/finalised-guidance/guidance-firms-fair-treatment-vulnerable-customers (Accessed: June 2025)

This guidance sets out the actions firms should take in each of the four areas to treat customers with characteristics of vulnerability fairly.

9.2.1 Understanding Vulnerability

Understanding vulnerability is the first critical step to being able to treat vulnerable customers fairly. The FCA expect firms to take a proactive approach to understanding the nature and extent of vulnerability in their target markets and customer base as well as making it easy for customers to disclose information.

FCA Guidance

Firms should understand the needs arising from different vulnerabilities:

- Firms should understand the nature and scale of drivers of vulnerability present in their target market and customer base.
- Firms should understand the impact of vulnerabilities on the needs of consumers in their target market and customer base.
- Firms should consider how vulnerabilities could affect the customer's experience outcomes.

The FCA identify four key factors that act as drivers to actual or potential vulnerability with examples as shown in the following table.

Health (health conditions or illnesses that affect the ability to carry out day-to-day tasks)
Physical disability
Severe or long-term illness
Hearing or visual impairments
Poor mental health
Low mental capacity or cognitive disabilities
Life Events (major life events such as bereavement or relationship breakdown)
Caring responsibilities
Bereavement
Income shock
Relationship breakdown
Having non-standard requirements such as ex-offenders, care leavers, refugees
Resilience (low ability to withstand financial or emotional shocks)
Low or erratic income
Over indebtedness
Low savings
Low emotional resilience
Lack of support structure

Capability (low knowledge of financial matters or low confidence in managing money)
Low knowledge or confidence in managing financial matters
Poor literacy or numeracy skills
Low English language skills
Poor or non-existent digital skills
Learning impairments

The FCA requirements include:

- Firms should be aware of the many situations and circumstances that may lead to a consumer in their target market or customer base becoming vulnerable.
- Firms should understand that vulnerability can arise in a range of ways and that the drivers of vulnerability are likely to be complex, overlapping and transient. For example, a life event such as a separation or divorce may lead to further vulnerability such as mental ill-health.
- They should also understand how it can be perpetuated, including by the actions, or inaction, of the firm itself.
- This high-level approach should then be used to understand the needs of their target market, make it easy for such customers to tell the firm about their needs and take action to ensure behavioural biases are not exploited.

9.2.2 Skills and Capabilities of Staff

The staff of a firm are able to influence outcomes for vulnerable consumers in many ways, whether through direct interaction, designing products, or setting up systems.

If staff are not able to recognise vulnerability when customers disclose their circumstance or where there are clear signs that a customer may be vulnerable, they will be unlikely to meet their needs and less likely to treat the customer fairly. This goes beyond front line staff to any staff involved in ensuring that customer's needs are met.

Firms should make sure that all staff, in particular those who operate at the frontline, have the appropriate skills and capability to treat vulnerable customers fairly in order to comply with the principles.

FCA Guidance

Understanding the needs of individual vulnerable customers:

- Staff should be able to understand a range of indicators of actual and potential vulnerability, and the needs that can arise from these vulnerabilities.
- Frontline staff should have the skills to engage with customers to seek relevant information to understand their vulnerability.
- Staff should recognise when the information the firm holds or obtains from customers indicates that the customer is vulnerable and warrants additional support.
- Staff should be able to record relevant information on vulnerability in an appropriate way that is accessible by other staff who may need it.

- Responding appropriately to the needs of vulnerable customers.
- Staff who interact with vulnerable customers should be sensitive to their needs, and consider how to adapt to meet them.
- Staff should understand what additional support is available to help vulnerable customers, and when it is appropriate to offer this support.
- Firms should offer practical and emotional support to staff dealing with vulnerable customers.

Staff should recognise when it is appropriate to seek additional support, for example escalating to senior management, or seeking additional help from specialist teams. Staff should also know when it is appropriate to refer a customer to third-party support, for example if the customer is in a difficult situation which is out of scope of the firm's remit.

9.2.3 Taking Practical Action

The FCA guidance groups the practical action that firms should take into three broad areas:

Product and Service Design

The way products and services are designed can have a positive or negative impact on vulnerable customers; the latter can happen if, for example, products are complex or poorly designed. Firms should be considering the needs of vulnerable customers in their target market at each stage of the design process and identifying the positive and negative impacts of a product or service on vulnerable customers.

Customer Service

Vulnerable customers are more likely to have particular service needs, for example they may need more time to understand information and make decisions. The FCA therefore expect firms to consider the impact of their service on vulnerable customers. 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 vulnerable consumers. Firms should also make vulnerable customers aware of the options available to them for help.

Communications

Communications can also be a significant barrier for vulnerable consumers where they have additional or different needs and failure to communicate appropriately may result in an increased risk of harm. The FCA wants firms to consider how good and appropriate communications can help vulnerable consumers and consider what communication channels and what tailored communications they may be able to provide. Communications should be clear and easy to understand for vulnerable customers.

9.2.4 Monitoring and Evaluation

The FCA expects firms to embed vulnerability into every aspect of their work, including monitoring and evaluating the impacts of any action they take – through testing and feedback. By having appropriate processes in place to assess where things have gone well and where they have not, firms may be able to identify key gaps in their own service for vulnerable customers, and make improvements.

Glossary

Accrued Interest

Interest that has been earned but not yet paid.

Active Risk

The risk that arises from holding securities in an actively managed portfolio in different proportions to their weighting in a benchmark index. Also known as tracking error.

Adviser Charging

Either a flat fee, on an hourly rate or a percentage based on the total value of assets that the wealth manager is managing on behalf of the client.

Annuity

An investment that provides a series of prespecified periodic payments over a specific term or until the occurrence of a prespecified event, eg, death.

Arbitrage

The process of deriving a risk-free profit by simultaneously buying and selling the same asset in two related markets where a pricing anomaly exists.

Article 3 firms

Financial advisers who do not hold or manage client assets and solely operate within the UK. They are exempt from Markets in Financial Instruments Directive (MiFID) regulations and are referred to as 'MiFID optional exemption firms'.

Articles of Association

The legal document which sets out the internal constitution of a company. Included within the articles will be details of shareholder voting rights and company borrowing powers.

Asset Allocation

An investment term that relates to the percentages of assets held in a portfolio. Construction of a portfolio generally centres around this concept of holding a mix of assets.

Assets Under Management (AUM)

The total market value of all the financial assets which a financial institution or fund manages on behalf of its clients.

Base Currency

The currency against which the value of the quoted currency is expressed. The base currency would be currency X for the X/Y exchange rate.

Behavioural Finance

A concept that seeks to explain how decision makers take financial decisions in real life, and why their decisions may not appear rational, with unpredictable consequences.

Beneficiaries

The beneficial owners of trust property.

Best Execution

A term that refers to the duty of an investment services firm (such as a stock broker) executing orders on behalf of customers to ensure the best execution possible for their customers' orders. This can relate to speed of an execution and best possible price.

Beta

The covariance between the returns from a security and those of the market relative to the variance of returns from the market.

Bonds

Debt securities issued by an organisation such as a government or corporation. Bonds pay regular interest and repay their principal or face value at maturity. One of the most common underlying assets for derivative contracts.

Call Option

An option that confers a right on the holder to buy a specified amount of an asset at a prespecified price on or sometimes before a prespecified date.

Cash Equivalent Transfer Value (CETV)

The capitalised value of a defined benefit (DB) pension scheme member's benefit which they can transfer to an alternative pension scheme. This could be to another DB scheme, a UK defined contribution (DC) scheme, or an overseas pension scheme, in certain circumstances.

Cash-Flow Modelling

A tool that provides a visual image of a client's financial situation and allows them to understand their financial situation in different 'what if' scenarios, the limits of their current financial resources and how much cover they need.

Central Bank

A public institution that operates at the heart of a nation's financial system. Central banks typically have responsibility for setting a nation's or a region's short-term interest rate, controlling the money supply, acting as banker and lender of last resort to the banking system and managing the national debt. They increasingly implement policies independently of government control. The Bank of England is the UK's central bank.

Chargeable Lifetime Transfer (CLT)

Will arise where an individual makes a gift into a relevant property trust. If the donor survives for seven years from the date of the gift, there will be no further inheritance tax (IHT) payable, but there is no refund of any IHT paid at outset.

Close Company

Defined in tax legislation as a company which is under the control of five or fewer participators or where the directors control the company.

Closing Out

The process of terminating an open position in a derivatives contract by entering into an equal and opposite transaction to that originally undertaken.

Combination

A strategy requiring the simultaneous purchase or sale of both a call and a put option on the same underlying asset, sometimes with different exercise prices, but always with the same expiry dates. Combinations include straddles and strangles.

Commutation Factor

Used to determine the amount of pension given up to provide the tax-free lump sum that a member can take at retirement. The commutation factor is usually decided by the scheme's actuary to ensure the pension fund can pay out what it has promised. The higher the commutation factor, the higher the lump sum.

Consumer Duty

A new Consumer Principle that requires firms to act to deliver good outcomes for retail customers. It features cross-cutting rules requiring firms to ensure consumers receive communications they can understand, products and services meet their needs and offer fair value, and the support they need.

Consumer Price Index (CPI)

Geometrically-weighted inflation index targeted by the Monetary Policy Committee (MPC).

Convertible Bonds

Bonds issued with a right to convert into either another of the issuer's bonds or, if issued by a company, the company's equity, both on prespecified and specified terms.

Correlation

A statistic that measures the degree to which two securities move in relation to each other. Correlation does not prove that a cause-and-effect or, indeed, a steady relationship exists between two variables, as correlations can arise from pure chance.

Defined Benefit (DB) Schemes

An occupational pension whereby the final retirement benefits are linked to final salary or career averaged salary.

Defined Contribution (DC) Schemes

A pension that accepts personal and company contributions; retirement benefits are paid based on the value of contributions and investment growth over the term.

Derivative

An instrument whose value is based on the price of an underlying asset. Derivatives can be based on both financial and commodity assets.

Designated Investment Business

Any activity that is specified in Part II of the Financial Services and Markets Act (FSMA) 2000 (Regulated Activities) Order 2001. Examples include arranging deals in investments, operating a multilateral trading facility (MTF), and managing a UK UCITS.

Director's Loan Account

A record of transactions where an amount of money (which is not a salary, dividend or expense repayment), is either owed by the company to a director or owed by a director to the company, at that point in time.

Discretionary Investment Management

A discretionary investment manager will create a discretionary portfolio for a client that is bespoke and actively managed for their circumstances. Typically comes at a higher cost.

Diversification

The strategy of investing in a variety of assets to reduce the overall risk of a portfolio.

Dividend

The distribution of a proportion of a company's distributable profit to its shareholders. Dividends are usually paid twice a year and are expressed in pence per share.

Do Not Attempt Resuscitation (DNAR) Form

A document issued, and signed by, a doctor, which tells the medical team not to attempt cardiopulmonary resuscitation (CPR). It is not legally binding, but tells healthcare professionals not to attempt CPR, as otherwise they will always attempt it.

Duration

The weighted average time, expressed in years, for the present value of a bond's cash flows to be received. Also known as Macaulay Duration.

Economic Cycle

The course an economy conventionally takes as economic growth fluctuates over time. Also known as the Business Cycle.

Effective Rate

The annualised compound rate of interest applied to a cash deposit. Also known as the Annual Equivalent Rate (AER).

Enduring Power of Attorney (EPA)

Until October 2007, it was possible to make an EPA to appoint someone to act when the donor could no longer manage their financial affairs. These are still valid and can be used while someone still has mental capacity provided that the donor consents to its use.

Enterprise Investment Schemes (EISs)

A UK government's venture capital scheme that offers tax relief to individual investors who buy new shares in an early stage company. It has yearly and lifetime maximums.

Environmental, Social and Governance (ESG)

A set of factors to assess a business' impact on the environment and society as well as how the business is run.

Estate

The total of an individual's assets and liabilities at death, including property, possessions, investments, and financial holdings. For inheritance tax purposes, it includes all assets the

deceased was entitled to, with some exceptions. The estate is distributed according to the will or intestacy laws.

Eurobond

International bond issues denominated in a currency different from that of the financial centre(s) in which they are issued. Most eurobonds are issued in bearer form through bank syndicates.

European Economic Area (EEA)

An economic union that includes the states that are members of the EU plus Norway, Iceland and Liechtenstein.

Exchange Rate

The price of one currency in terms of another.

Exercise Price

The price at which the right conferred by an option can be exercised by the holder against the writer.

Fiduciary Duty

The legal obligation of a financial adviser to act in the best interests of their clients and put the clients' interests before their own.

Financial Conduct Authority (FCA)

The UK regulator responsible for conduct issues across the entire spectrum of financial services; it is also responsible for market supervision as well as prudential supervision of firms not supervised by the Prudential Regulation Authority (PRA).

Financial Ombudsman Service (FOS)

An official body established by Parliament. It settles disputes between UK-based regulated financial companies and their customers and has legal power to adjudicate on individuals' complaints.

Financial Policy Committee (FPC)

Responsible for identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

FinTech

A series of responses to the failings of the 'traditional' financial system, which apply technology to improve financial activities.

Fund of Funds (FOFs)

A type of multi-manager fund. It has one overall manager that invests in a portfolio of other existing investment funds and seeks to harness the best investment manager talent available within a diversified portfolio.

Fundamental Analysis

The calculation and interpretation of yields, ratios and discounted cash flows (DCFs) that seek to establish the intrinsic value of a security or the correct valuation of the broader market. The use of fundamental analysis is nullified by the semi-strong form of the efficient markets hypothesis (EMH).

Future

A derivatives contract that creates a legally binding obligation between two parties for one to buy and the other to sell a prespecified amount of an asset at a prespecified price on a prespecified future date. Futures contracts differ from forward contracts in that their contract specification is standardised so that they may be traded on a derivatives exchange.

General Data Protection Regulation (GDPR)

The regulations that cover the principles of the protection of an individual's data that firms have to adhere to.

Gilts

UK government securities issued primarily to finance government borrowing.

Governance (corporate)

The mechanism that seeks to ensure that companies are run in the best long-term interests of their stakeholders.

Hedging

A technique employed to reduce the impact of adverse price movements in financial assets held.

HM Treasury

Has overall responsibility for the UK's financial system, the institutional structure of financial regulation and the legislation that governs it, both domestic and international.

Inflation

The rate of change in the general price level or the erosion in the purchasing power of money.

Insider Dealing

A criminal offence created when a director or employee of a listed company buys or sells shares in that company for financial gain knowing information that is not available in the public domain.

Insurable Interest

In insurance law, you can only buy insurance for something or someone in which you have an insurable interest. This is the interest that a person has in some asset or person where they would suffer a financial loss should the property or individual be harmed.

InsurTech

A broad category of innovations that utilise emerging technologies to renew the insurance sector.

Integration

The third stage of money laundering, where the money from proceeds of crime is fully integrated into the financial system.

Intestate

The term where an individual has died without leaving a will.

Key Person Cover

Life insurance written on the life of the person who is crucial to the business.

Lasting Power of Attorney (LPA)

A legal document that lets a donor appoint one or more people (known as attorneys) to help make decisions on their behalf. The two types of LPA are 'health and welfare', dealing with medical and personal care, and 'property and finances', which covers assets. An individual can choose to have one or both.

Layering

The second stage of money laundering where multiple transactions are carried out to conceal the original origin of the money.

Lifestyling

An investment concept that aims to increase the liquidity and reduce the level of risk a client has as they approach retirement.

Liquidity

The ease with which a security can be converted into cash. Liquidity is determined by the amount of two-way trade conducted in a security. Liquidity also describes that amount of an investor's financial resources held in cash.

Loan Stock

A corporate bond issued in the domestic bond market without any underlying collateral or security.

London Stock Exchange (LSE)

The UK market for listing and trading domestic and international securities.

Long-Term Asset Funds (LTAFs)

FCA-authorised open-ended investment funds designed to facilitate investment in long-term, less liquid assets, targeting a broad range of investors.

Macroeconomics

The branch of economics that studies the behaviour of the economy as a whole, dealing with the issues of growth, trade, investment, inflation, and unemployment as well as with the fiscal policies of governments and monetary policies of central banks.

Macroeconomic Analysis

The detailed examination of a macroeconomic framework that provides context to the markets in which the financial and real assets move, such as growth, inflation, and unemployment. It offers investors critical insights that support their investment processes.

Manager of Managers (MOMs) Fund

A type of multi-manager fund. The lead manager arranges segregated mandates with individually chosen fund managers, constructs the asset allocation, and appoints different fund managers to run the different asset classes or regions that make up the overall fund.

Market Abuse

An activity where an individual or firm behaves unlawfully by disadvantaging financial investors directly or indirectly.

Market Capitalisation

The total market value of a company's shares or other securities in issue. It is calculated by multiplying the number of shares or other securities a company has in issue by the market price of those shares or securities.

Markets in Financial Instruments Directive (MiFID)

A piece of EU legislation that came into effect on 1 November 2007. It replaces the Investment Services Directive (ISD) and covers the regulation of certain financial services for the 30 member states of the European Economic Area (EEA). After Brexit, parts of MiFID have been onshored in the UK.

Markets in Financial Instruments Directive (MiFID) II

An EU directive that came into effect on the 3 January 2018. This directive adds to, and enhances, the original MiFID directive.

Markets in Financial Instruments Regulation (MiFIR)

MiFIR is an EU suite of regulation relating to MiFID.

Market Value Adjustments (MVAs)

Reductions applied to with-profit endowment policies in times of poor performance to ensure that both members keep their policies and members that surrender their policies are treated fairly**.** Also called Market Value Reducers (MVRs).

Model Portfolio

A portfolio service normally offered by an investment house that provides consumers a generic portfolio classified by its risk scale, eg, cautious, balanced, higher. It is typically cheaper than a bespoke portfolio service.

Money Laundering (ML)

The placing of money into the financial system that hides its true origins of how it was generated, such as drug trafficking.

New Issue

A new issue of ordinary shares whether made by an offer for sale, an offer for subscription or a placing. Also known as an initial public offering (IPO).

Nominal Value (NV)

The face or par value of a security. The nominal value is the price at which a bond is issued and usually redeemed and the price below which a company's ordinary shares cannot be issued.

Normal Market Size (NMS)

A trading classification system for securities. It defines the minimum size of share packages for normal-sized market transactions in a company.

This system comprises 12 categories and has two primary objectives: first, to establish the transaction size that market makers must adhere to, and second, to set the basis for the disclosure of these transactions.

Office of the Public Guardian (OPG)

A government body that registers powers of attorney and also can appoint deputies for individuals who have lost capacity without an Lasting Power of Attorney (LPA) in place.

Opportunity Cost

The value of the most favourable alternative to be sacrificed. Needed to make a choice among alternatives when resources are limited.

Option

A derivatives contract that confers the right, but not obligation, from one party (the writer) to another (the holder) to either buy (call option) or sell (put option) an asset at a prespecified price on, and sometimes before, a prespecified future date, in exchange for the payment of a premium.

Over-the-Counter (OTC)

Transactions between banks and their counterparties which are not executed on a recognised exchange. Of major importance in the commodities industry.

Packaged Retail and Insurance-Based Investment Products (PRIIPs)

A market-based EU regulation that required key information documents, called key information documents (KIDs) to be provided on certain products to clients. After Brexit, the PRIIP regulation has been onshored in the UK.

Passive Management

An investment approach employed in those securities markets that are believed to be price-efficient.

Pension Fund

A fund set up by a company or government to invest the pension contributions of members and employees to be paid out at retirement age.

Placement

The first stage of money laundering whereby proceeds from criminal activity is placed into the financial system.

Power of Attorney

A document that gives an attorney power to look after the financial affairs of the donor or undertake a specific task on their behalf.

Premium

The amount of cash paid by the holder of an option to the writer in exchange for conferring a right. Also the difference in the spot and forward exchange rate that arises when interest rates in the base currency are higher than those in the quoted currency.

Pre-Owned Asset Tax (POAT)

A yearly charge to income tax that aims to tax the benefit if someone continues to derive use from an asset that has been given away for IHT purposes.

Probate

The process after death where an individual or professional deals with the property, money and possessions of the deceased in order to obtain a grant of probate. If an individual died intestate, these are called letters of administration.

Property Income Distribution (PID)

Dividends of a UK property business that after deduction of withholding tax paid to HMRC are distributed to the shareholders.

Prudential Regulation Authority (PRA)

A subsidiary of the Bank of England (BoE), which is responsible for the prudential regulation of financial firms, including banks, investment banks, building societies and insurance companies.

Put Option

An option that confers a right on the holder to sell a specified amount of an asset at a prespecified price on or sometimes before a prespecified date.

Qualifying Corporate Bonds (QCBs)

UK corporate bonds issued in sterling without conversion rights. QCBs are free of capital gains tax (CGT).

Redemption

The repayment of principal to the holder of a redeemable security.

RegTech

A subset of FinTech which helps firms follow regulations through automation, leveraging APIs and artificial intelligence (AI).

Reserved Investor Funds (RIFs)

Unregulated collective investment schemes primarily aimed at professional and institutional investors, specialising in long-term investments in less liquid assets.

Rights Issue

The issue of new ordinary shares to a company's shareholders in proportion to each shareholder's existing shareholding, usually at a price deeply discounted to that prevailing in the market.

Risk

Potential for an investment to generate an outcome different from that expected. In financial terms market risk is often interpreted as the volatility, or standard deviation of returns.

Risk Capacity (Capacity for Loss)

Assesses the capacity the client has as to how much money they can afford to lose through a market downturn.

Risk Tolerance

A term to describe the level of risk that an investor is willing to take with their money.

Robo-Advice

A subgroup of WealthTech which provides automated and semi-automated wealth management services.

Secondary Market

The market for trading securities already in issue.

Section 32 (S.32)

Otherwise known as a buy out contract, accepts the transfer of funds from an occupational scheme.

Section 179 liabilities

A specific valuation method prescribed by the Pension Protection Fund (PPF) used to assess defined benefit pension scheme liabilities. This method reflects the level of compensation the PPF would provide and is primarily used for calculating the PPF levy and producing aggregate funding statistics like the PPF 7800 Index.

Security Bond

Insurance to protect the assets of a mentally incapable person whose financial affairs are managed by a Deputy. It is also called a 'surety bond'.

Seed Enterprise Investment Schemes (SEISs)

A UK government's venture capital scheme that offers tax relief to individual investors who buy new shares in a company when it is starting to trade. It has a lifetime maximum.

Self-Invested Personal Pension (SIPP)

A personal pension that allows a wider investment remit than a standard personal pension.

Senior Managers & Certification Regime (SMCR)

A regime to improve and enhance the accountability of individual senior managers within a firm.

Settlor

The creator of a trust.

Shareholder Capitalism

The traditional form of capitalism in which the interests of one stakeholder – the shareholder, – dominate over all others. Businesses operate with the purpose of maximising shareholder value, often at the expense of other stakeholders and the environment.

Sharia

An Arabic term meaning 'the way' or 'the path to water', which refers to Islamic or sacred law. Muslim scholars provide a comprehensive interpretation of Sharia, encompassing many perspectives through which Muslims seek to understand and practise their faith.

Small Self-Administered Scheme (SSAS)

An occupational pension scheme for company directors, can only have a maximum of 12 members.

Spreads

A strategy requiring the simultaneous purchase of one or more options and the sale of another or several others on the same underlying asset, with either different exercise prices and the same expiry date, or the same exercise prices and different expiry dates. Spreads include bull spreads, bear spreads and butterfly spreads.

Stakeholder Capitalism

An alternative form of capitalism in which corporations serve the interests of all their stakeholders, such as shareholders, customers, suppliers, employees and local communities. Its supporters believe that serving the interests of all stakeholders, as opposed to only shareholders, is critical to the long-term success of a business.

Standard Deviation

A measure of dispersion. In relation to the values within a distribution, the standard deviation is the square root of the distribution's variance.

Statutory Residence Test (SRT)

An individual's tax position in the UK is determined using the statutory residence test. The SRT considers the amount of time an individual spends in the UK and any other connections they have with the UK, in order to determine whether they are UK resident for tax purposes.

Suitability

The requirement that a financial product or service must be appropriate for a client's investment objectives, risk tolerance, and financial situation.

Sukuk

Financial instruments adhering to Sharia principles, designed to generate returns comparable to conventional fixed-income securities, such as bonds.

Swap

An over-the-counter (OTC) derivative whereby two parties exchange a series of periodic payments based on a notional principal amount over an agreed term. Swaps can take the form of interest rate swaps, currency swaps and equity swaps.

Technical Analysis

The analysis of charts depicting past price and volume movements to determine the future course of a particular market or the price of an individual security.

Term Assurance

Life cover that has a fixed term, the sum assured can be level, increasing or decreasing.

Treating Customers Fairly (TCF)

Initiative launched in 2006, there are six consumer outcomes that the FCA expects firms to strive to achieve to ensure fair treatment of customers.

Triage Processes

Initial assessment and prioritisation procedures used by the FCA to evaluate information received from firms, consumers, or other sources – including applications, notifications, intelligence, complaints, or reports of potential misconduct.

Trustees

The legal owners of trust property who owe a duty of skill and care to the trust's beneficiaries.

Value Stocks

Stocks deemed to have strong intrinsic value characteristics (generally as opposed to growth characteristics), for example with low PE ratios.

Variance

A measure of dispersion. In relation to the values within a distribution, the variance is the mean of the sum of the squared deviations from the distribution's arithmetic mean.

Venture Capital Trust (VCT)

Companies listed on the LSE and are similar to investment trusts. They are designed to enable individuals to invest indirectly in a range of small higher-risk trading companies, whose shares and securities are not listed on a recognised stock exchange, by investing through VCTs.

Volatility

A measure of the extent to which investment returns, asset prices and economic variables fluctuate. Volatility is measured by the standard deviation of these returns, prices and values.

Vulnerability

Forms part of the initial fact finding process, vulnerability can relate to age, health, key life events, that may make a person financially vulnerable and susceptible to exploitation.

Wealth Management

Management of a client's wealth. Including investment, financial advisory and planning disciplines, client relationships, and understanding the client's investment requirements for the benefit of the client.

WealthTech

A broad category of services that embrace emerging technologies to reinvent the wealth management sector.

Whole of Life Cover

Life insurance contract that can be set up on a fixed or reviewable basis to provide life cover for the life of the insurable interest.

Syllabus Learning Map

Learning Outcome 01 **Be able to explain the UK financial services regulatory system and its implications for firms and their advisers**	
1.1 Describe the UK regulatory system: • Financial Services and Markets Act 2000 (FSMA), principles-based regulation, and the role of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) • HM Treasury and the Bank of England • relevant European Union Directives and Regulations • main types and impact of financial crime – market abuse; money laundering; terrorist financing • prevention, detection, and reporting of financial crime • Data Protection legislation • roles of other regulating bodies, including: Competition and Markets Authority (CMA); the Pensions Regulator; the Information Commissioner's Office (ICO); Payment Systems Regulator (PSR) • additional oversight – senior management; trustees; auditors; external compliance support services	Chapter 1, sections 1–5
1.2 Explain FCA and PRA regulation of firms and individuals: • principles, authorisation, approval, and the role of the investment manager • senior management systems, controls, business standards and ethics • permitted business and scope of advice • complaints and compensation	Chapter 1, section 2
1.3 Identify and apply the FCA Conduct of Business Rules pertaining to the investment management process: • the fiduciary relationship between adviser and client • analysis of client circumstances and objectives, risk profile and existing arrangements • suitability and 'Know Your Customer' rules • comparison of discretionary and non-discretionary portfolio management	Chapter 1, section 4 and Chapter 2, sections 2 and 5
1.4 Explain and evaluate the application and outcomes of Consumer Duty	Chapter 1, section 6
1.5 Consider and explain the integrity, standards, and professional values required of practitioners and the Code of Ethics	Chapter 1, section 6
1.6 Distinguish between ethical behaviour and rule based compliance, plus critically evaluate the outcomes for consumers, advisors, firms and the industry	Chapter 1, section 6
1.7 Explain what RegTech is and how it can help wealth managers	Chapter 1, section 7

Learning Outcome 02 **Be able to develop, construct, and implement an appropriate investment plan for a client by applying the principles of investment planning, and communicate the plan to the client**	
2.1 Apply the financial planning process in the design and construction of a client's financial and investment portfolio	Chapter 2, section 1
2.2 Elicit and evaluate client information, and appraise the client's financial and personal situation: • elicit current and future client circumstances: personal and family employment and other sources of wealth, financial details, protection, attitudes to risk and investment • elicit the purpose of investment, the client's financial objectives, future needs and aspirations • utilise client information in the selection of suitable investments, considering relevant solutions, products and, where applicable, providers • identify and explain the main drivers underpinning the client's financial needs and objectives, and determine their priority in collaboration with the client • identify the impact of life events	Chapter 2, section 3 and Chapter 7, section 9
2.3 Identify differing client needs, wants, financial objectives and associated timescales, appraise objectives and establish their order: • client objectives • associated risk tolerances • ethical and religious preferences	Chapter 2, section 3 and Chapter 3, sections 5 and 6
2.4 Evaluate and appraise financial and investment objectives in light of client attitude and behaviour towards: • debt • health and morbidity • longevity and mortality • employment • access to advice and/or insurance cover • house versus home • budgeting and money management	Chapter 2, sections 3 and 4

2.5	Develop and implement a plan to meet client objectives by: • formulating recommendations to meet client objectives • prioritise needs, establishing investment for growth or income • identifying time horizons • assessing impact of taxation • comparing costs and charges, including transaction costs • spreading risk • managing the use of debt and credit • protecting against inflation • hedging market volatility • cash management • selecting financial products and stocks • identifying an appropriate course of action where no suitable product is available	Chapter 2, sections 3-5 and Chapter 3, section 3
2.6	Explain the consequences of changes in clients' attitude to risk, as a result of changes in the market, experience, personal and family circumstances, and possible changes this creates to the financial objectives identified for the client and their economic circumstances	Chapter 2, section 3 and Chapter 3, section 7
2.7	Explain and implement intergenerational financial and investment planning where appropriate to the client: • definition and usage • main vehicles • risks • effectiveness	Chapter 7, sections 6 and 7
2.8	Explain the safeguards and heuristics a wealth manager can employ to help clients stay on track with long-term objectives	Chapter 2, section 3
2.9	Explain and justify how the plan or recommendations meet the client's specific circumstances, explaining in a manner the client can understand	Chapter 2, section 5

Learning Outcome 03 **Be able to revisit and review appropriately the investment plan within the ongoing client relationship and management of a private client portfolio**		
3.1	Apply the financial planning process in the review and maintenance of a client's financial and investment portfolio, and review investment objectives and investment strategy	Chapter 2, section 1 and Chapter 3, section 7

3.2 Identify changing needs over time, giving specific consideration to: • debt management • income/growth requirements • asset allocation • risks/rewards of various investments • flexibility • ethical and religious values • charging structures • affordability and sustainability • taxation/benefit implications of advice • cognitive ability • risk attitude	Chapter 3, sections 1-8
3.3 Explain and evaluate the ongoing monitoring of the investment portfolio relative to the financial plan to meet the client's requirements: • funds • managers • markets and economies • costs and charges • benchmarks and indexes	Chapter 3, sections 4 and 7
3.4 Regularly review and revise the portfolio with the client, evaluating changes in: • investor circumstances • the environment: economic, regulatory, market • investment products and investment vehicles	Chapter 3, sections 4 and 7
3.5 Evaluate the communication skills needed for effective ongoing communication and client relationships	Chapter 2, sections 1-7
3.6 Explain the approach for dealing with insistent clients, and appraise the potential consequences of the client declining to provide relevant personal and financial information	Chapter 2, section 5
3.7 Evaluate reasons for not proceeding with a recommendation and explain how agreement is best reached with the client about how to proceed	Chapter 2, section 5
3.8 Critically review the suitability of recommendations: Know Your Customer (KYC), customer understanding; affordability and accessibility, and manage the inter-relationship between protection, retirement provision, saving and investment, and other objectives such as liquidity	Chapter 2, section 5
3.9 Explain what WealthTech is and how it can help both investors and wealth managers	Chapter 3, section 8
3.10 Analyse the new opportunities and risks crypto assets bring to investors and their wealth managers	Chapter 3, section 8
3.11 Explain what crowdfunding is and its different types	Chapter 3, section 8

Learning Outcome 04 **Be able to apply and evaluate the management of liquidity to meet short and long-term funding requirements**	
4.1 Cash flow projections, establishing the objectives and principles for establishing a long-term cash management programme	Chapter 7, section 1
4.2 Assess short and long-term funding requirements: • everyday and emergency liquidity • special use accounts • use of credit and loan facilities	Chapter 7, sections 1 and 2
4.3 Determine the size of an appropriate investment reservoir and manage the efficient movement of cash from income to investments and vice versa	Chapter 7, section 1
4.4 Discuss the structuring of a portfolio to meet ongoing liquidity and liability needs such as regular payments or need for income	Chapter 7, section 1

Learning Outcome 05 **Be able to evaluate financial protection needs and apply suitable protection products where appropriate**	
5.1 Evaluate the financial protection requirements of clients, including: • individuals and families • foundations, charities, and trusts	Chapter 5, section 3
5.2 Evaluate the financial protection requirements for small and medium-sized enterprises (SME) businesses	Chapter 5, section 2
5.3 Evaluate the key features, functions, contexts & tax treatment of the following products: • term and whole of life assurance • investment-based policies • income protection insurance • critical illness cover • private medical insurance • long-term care plans • annuities • general insurance • mortgage payment protection insurance (MPPI) and accident, sickness & unemployment (ASU) insurance	Chapter 5, sections 1 and 2
5.4 Explain the role and limitations of State Benefits and state/local authority funded solutions for financial protection while considering the range and limitations of these benefits and their impact on financial planning	Chapter 5, section 3
5.5 Appraise and evaluate the consequences of inadequate protection for both individuals and SME business including outcomes such as insolvency and bankruptcy	Chapter 5, section 3

5.6 Discuss and appraise the application of insurance to facilitate investment aims: • risk management • securing a lump sum • securing income • high net worth clients as underwriters	Chapter 5, sections 1, 2 and 3

Learning Outcome 06 **Be able to evaluate how political, economic, legal, social, tax, and regulatory factors provide the context for, and impact on retirement planning**	
6.1 Explain the political, economic, social, and environmental factors that provide the context for pensions planning: • role of government, policy direction, and challenges • demographic trends, longevity, health, cognitive ability and ageing population • incentives, disincentives, attitudes to saving • financial and economic factors • blurring of distinctions between retirement and non-retirement and between retirement and non-retirement products	Chapter 4, section 1
6.2 Explain the fundamental principles of auto enrolment as they apply to occupational schemes: • the Pensions Commission recommendation for auto enrolment • employers' duties • assessing and enrolling staff, and opt out issues • contributions and payroll issues • default and deferment issues • importance of the employer contribution • the pensions commission recommendation to create the National Employment Savings Trust (NEST), and the role of NEST	Chapter 4, section 3
6.3 Explain the application of the HMRC tax regime to pensions planning: • concept of registered pension scheme • tax benefits of contributions to registered pension schemes, tax relief • tax treatment of pension scheme investment • tax treatment of death benefits • choices about drawing retirement benefits • amounts and recent changes to the annual allowance, lifetime allowance, transitional protection, money purchase annual allowance and other limitations on tax relief • tax treatment of non-registered pensions in outline • calculation of pension contributions	Chapter 4, sections 4 and 5

6.4	Explain the structure of pension laws and regulation relevant to pensions planning and disclosure requirements: • main types of pensions provision, differences between occupational and personal pensions, legal differences between contract-based and trust-based pensions, differences between trust-based defined contribution (DC)/defined benefit (DB) pensions • The Pensions Regulator's compliance requirements • the FCA • the Pension Protection Fund • the role of the Financial Services Compensation Scheme (FSCS) • role and duties of trustees, administrators, investment governance committees, and other professional advisers of DC / DB pensions • divorce and breakdown of family relationships • employment law relevant to pensions, the rights of older workers • bankruptcy law and pension assets • scams and misselling issues • pension flexibilities introduced in Budget 2014	Chapter 4, sections 4 and 5
6.5	Explain the key features of DC and DB pension schemes from the perspectives of financial planning, investment selection and drawing benefits at retirement	Chapter 4, section 3
6.6	Explain the main state pension benefits to which an individual and/or their dependant(s) may be entitled to in retirement and the impact this may have on retirement planning: • current system of Basic State Pension, including means tested benefits, pensions credit, and contributory benefits • single tier pension, including means tested benefits, contributory benefit, and link to national insurance contribution records • state retirement benefits and state retirement ages (SRA) and levels of benefit • other relevant State benefit entitlements	Chapter 4, section 3
6.7	Explain the structure, characteristics and application of DB schemes to private client pension planning: • key attributes and benefits of DB pension provision • types, variations and hybrid arrangements • rules and operation of DB schemes • funding methods and issues • impact of employer covenants • benefits upon ill health and death • membership eligibility criteria and top-up options • private and public sector (transfer club) schemes	Chapter 4, sections 3–5
6.8	Explain the structure, characteristics, attributes and application of DC schemes to private client pension planning: • personal vs group personal • types of DC pensions, features, costs and benefits • employer, employee and other individual pension contributions – methods and issues	Chapter 4, section 3

Learning Outcome 07 Be able to evaluate and apply suitable accumulation, derisking, decumulation, and retirement income strategies appropriate to a client's retirement planning and provision	
7.1 Evaluate accumulation, de-risking, and decumulation phases and the different types and styles of investment management and funds that may be appropriate	Chapter 4, section 5
7.2 Evaluate and critically appraise the structure of default funds, appropriate types of investment choice, design of investment glide paths, and target date versus lifestyle funds	Chapter 4, sections 2–3
7.3 Discuss and explain default fund guidance for offering a default option in automatic enrolment DC pension schemes	Chapter 4, section 3
7.4 Discuss and appraise the value of, and interaction of: • switching between DC pension arrangements • safeguarded benefits • pension consolidation • death, sickness, and survivor benefits	Chapter 4, section 5
7.5 Analyse and appraise the main accumulation factors and features relevant to a client when using DC pensions: • clients' aims and objectives for accumulation • quantifying future retirement need and wants in relation to other priorities • affordability, prioritisation, and contribution levels • limits on tax relieved contributions and impact on accumulation methods • investments available for accumulation for retirement • suitability and risk issues • levels of funds and rates of return assumed and needed • impact of costs on long term returns • relationship between pension and non-pension investments • investment strategies for different life stages and time horizons	Chapter 4, sections 2 and 3
7.6 Explain and evaluate the different options a client has and may choose to secure a retirement income, and appraise the benefits for clients, dependents, and beneficiaries: • rules for drawing income and lump sums: • crystallisation events • annuity purchase • flexi-access drawdown • uncrystallised funds pension lump sum (UFPLS) • drawing the pension fund as cash • small pots/trivial commutation rules • deferral of drawing pension benefits	Chapter 4, sections 3–5

7.7	Analyse and appraise the main factors and features relevant to a client when planning and taking retirement income from pensions: • clients' aims and objectives • consideration of pension options, investments available, and desire for flexibility • patterns of phasing or stopping work • longevity, health, and cognitive assumptions during retirement • spending patterns at different stages of retirement and the use of long-term cash flow analysis • health and long-term care issues • estate planning issues • immediate and long-term income needs for the client, family and dependents • investment strategies and issues in relation to clients' goals and risk profiles • appropriateness of both pension and non-pension investments to fund retirement and later life planning • suitability and risk issues: sequencing risk and reverse pound cost averaging • rates of investment return and costs	Chapter 4, section 2 and Chapter 7, section 8
7.8	Examine and appraise managing investments in retirement	Chapter 4, sections 2 and 3

Learning Outcome 08 **Be able to explain and evaluate the use of social investment and philanthropy for clients and wealth management**		
8.1	Evaluate social investment: • definition and usage • differences between social investment and philanthropy compared to investment stewardship, environmental, social and governance (ESG) portfolio factors and ethical and religious investment • types of investment • risk and returns	Chapter 3, sections 5 and 6
8.2	Outline and explain the FCA's Sustainability Disclosure Requirements and framework, and how it applies to clients	Chapter 3, section 6
8.3	Evaluate philanthropic objectives and strategy: • define the scope of philanthropic investment • sources of information on philanthropic investment • extent of client involvement in scheme	Chapter 3, section 6
8.4	Consider means to channel philanthropic money efficiently and measure performance	Chapter 3, section 6
8.5	Evaluate tax issues concerning philanthropy	Chapter 3, section 6
8.6	Discuss main points of Charities Act and Trust law	Chapter 7, section 7

Learning Outcome 09 Be able to assess the impact of personal taxation on the investment planning and investment decision-making process	
9.1 Determine the impact of income tax on private clients: • scope • liability • sources of income • reliefs • allowances • planning • assessment methods • calculation	Chapter 6, section 2
9.2 Explain and illustrate by narrative and numerical example the liability of National Insurance contributions for the employer, employee and self-employed worker	Chapter 6, section 5
9.3 Identify and explain the nature of special reliefs available to private clients: • Individual Saving Accounts (ISAs) • Enterprise Investment Scheme (EIS) • Venture Capital Trusts (VCTs) • share option schemes	Chapter 6, section 2 and Chapter 7 section 2
9.4 Explain the nature of overseas income: • UK paying agents • types of income • withholding taxes • double taxation agreements • basic calculations	Chapter 6, section 1 and Chapter 3, section 4
9.5 Establish the scope of family tax planning: • allowances • reliefs • planning	Chapter 6, sections 1 to 4, 6 and 7
9.6 Establish the scope of inheritance tax (IHT): • its calculation • exemptions and reliefs • allowances • administration of estates • planning	Chapter 6, section 4
9.7 Contrast tax avoidance with tax evasion	Chapter 6, section 7
9.8 Explain the nature of corporation tax and its relevance to financial and investment portfolios	Chapter 6, section 6

9.9 Explain and appraise the scope of international taxation and tax planning strategies: • domiciled status • the influence of residence on taxation and tax planning, including the foreign income and gains regime • overseas aspects of income tax, capital gains tax (CGT), IHT, allowances and reliefs (basic calculations)	Chapter 6, section 1 and Chapter 3, section 4

Learning Outcome 10 **Be able to identify, explain, and examine the types and uses of trusts, the rights of beneficiaries, and the taxation of trusts**	
10.1 Explain the characteristics of trusts: • concepts of settlor, beneficiary and trustee • express, resulting and constructive trusts • investment powers of trustees • Trustee Act 2000 and duties of trustees	Chapter 7, section 7
10.2 Identify and explain the uses of trusts including: tax and estate planning	Chapter 7, sections 6 and 7
10.3 Explain and describe legal persons and powers of attorney, the basic law of contract and agency, wills and intestacy, Court of Protection	Chapter 7, sections 3 to 7
10.4 Distinguish between, and explain, the following types of trust: • bare trusts • interest-in-possession trusts (life interest and revisionary interest) • non-interest-in-possession trust (accumulation and maintenance trusts/ discretionary trusts) • charitable trusts • personal injury trusts	Chapter 7, section 7
10.5 Specify and appraise the income tax implications of trusts: • interest in possession trusts • non-interest in possession trusts • bare trusts • tax rates • exemptions and reliefs • personal injury trusts	Chapter 7, section 7
10.6 Specify and appraise the CGT implications of trusts: • liability of the settlor and trustees • tax rates • exemptions and reliefs	Chapter 7, section 7

10.7	Specify and appraise the inheritance tax implications of trusts: • chargeable lifetime transfers • periodic charges • exit charges • tax rates • exemptions and reliefs	Chapter 7, section 7
10.8	Explain what Family Offices are, the two main categories, and the benefits & limitations compared to advice from a wealth management firm	Chapter 7, section 10

Unit Summary

The objective of the examination is to enable candidates to think critically, apply, and communicate clearly in the context of:

- the structure and conduct of UK financial services regulation.
- the integrity, standards, and professional values required of practitioners.
- the prevention, detection, and reporting of financial crime.
- developing a picture of circumstances and preferences of clients from the information obtained, and the determination of appropriate financial and investment solutions.
- communicating effectively the recommendations, advice, and action for the client.
- managing liquidity to meet short and long-term funding requirements.
- matching clients to appropriate financial protection and retirement strategies, and communicating the recommendations and approaches.
- the structuring and managing of social investment and of philanthropic activity.
- the scope of taxation applicable to private clients.
- the appropriate application of trusts and intergenerational financial and investment planning.

NB: The learning in this syllabus builds on the content of the two previous units in the qualification, Financial Markets and Portfolio Construction Theory. Candidates can be assessed on aspects of all three units in the Applied Wealth Management exam.

Assessment Structure

This is a three-hour examination of 100 marks comprising three sections:

- **Section A worth 20 marks:**
  - candidates answer FOUR questions from SIX, worth five marks each.
- **Section B worth 40 marks:**
  - candidates answer BOTH questions in this section worth 20 marks each.
- **Section C worth 40 marks:**
  - candidates answer ALL parts of the case study-based questions in this section.

Syllabus Structure

The syllabus is divided into learning outcomes. These are broken down into a series of assessment criteria.

Candidate Update

Candidates are reminded to check the Candidate Update area of the Institute's website on a regular basis for updates that could affect their examination as a result of industry change.

Reading List

Periodicals/Newspapers/Journals

- Financial Times.
- FT Weekend.
- The Economist.
- Financial sections of The Times, The Daily Telegraph, Independent and Evening Standard.
- Bank of England Quarterly Bulletin.
- Bank of England Inflation Report (Quarterly).
- Annual Debt and Reserves Management Report – The UK Treasury (Quarterly).
- DMO Annual Review (The Debt Management Office).
- Risk Magazine.
- Journal of Derivatives.
- Journal of the Futures Market.
- Investors' Chronicle.
- The Review (CISI).
- Investment Week.
- Professional Investor (the quarterly journal of the CFA).
- Money Management.
- What Investment?
- Investment Adviser.
- Professional Adviser.
- Bloomberg Markets.
- Bloomberg Green.
- The Fintech Times.
- FinTech Futures.

Books

Chishti, Susanne, 2016. The FINTECH Book: The Financial Technology Handbook for Investors, Entrepreneurs and Visionaries; John Wiley & Sons Inc, Hoboken, New Jersey.

Cooper, George, 2008. *The Origin Of Financial Crises*; Harriman House ltd, Petersfield.

Derman, Emanuel, 2011. *Models. Behaving. Badly: Why Confusing Illusion With Reality Can Lead To Disaster On Wall Street And In Life*; John Wiley & Sons, Chichester, UK.

Dimson, Elroy, Marsh, Paul & Staunton, Mike, 2002. *Triumph Of The Optimists*; Princeton University Press, Chichester, West Sussex.

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Montier, James, 2007. *Behavioural Investing: A Practitioners Guide To Applying Behavioural Finance*; John Wiley & Sons, Chichester.

Montier, James, 2009. *Value Investing: Tools And Techniques For Intelligent Investment*; John Wiley & Sons, Chichester.

Raworth, Kate, 2022. Doughnut Economics: The must-read book that redefines economics for a world in crisis; Random House Business, New York.

Savage, Sam L, 2009. *The Flaw Of Averages: Why We Underestimate Risk In The Face Of Uncertainty*; John Wiley & Sons Inc, Hoboken, New Jersey.

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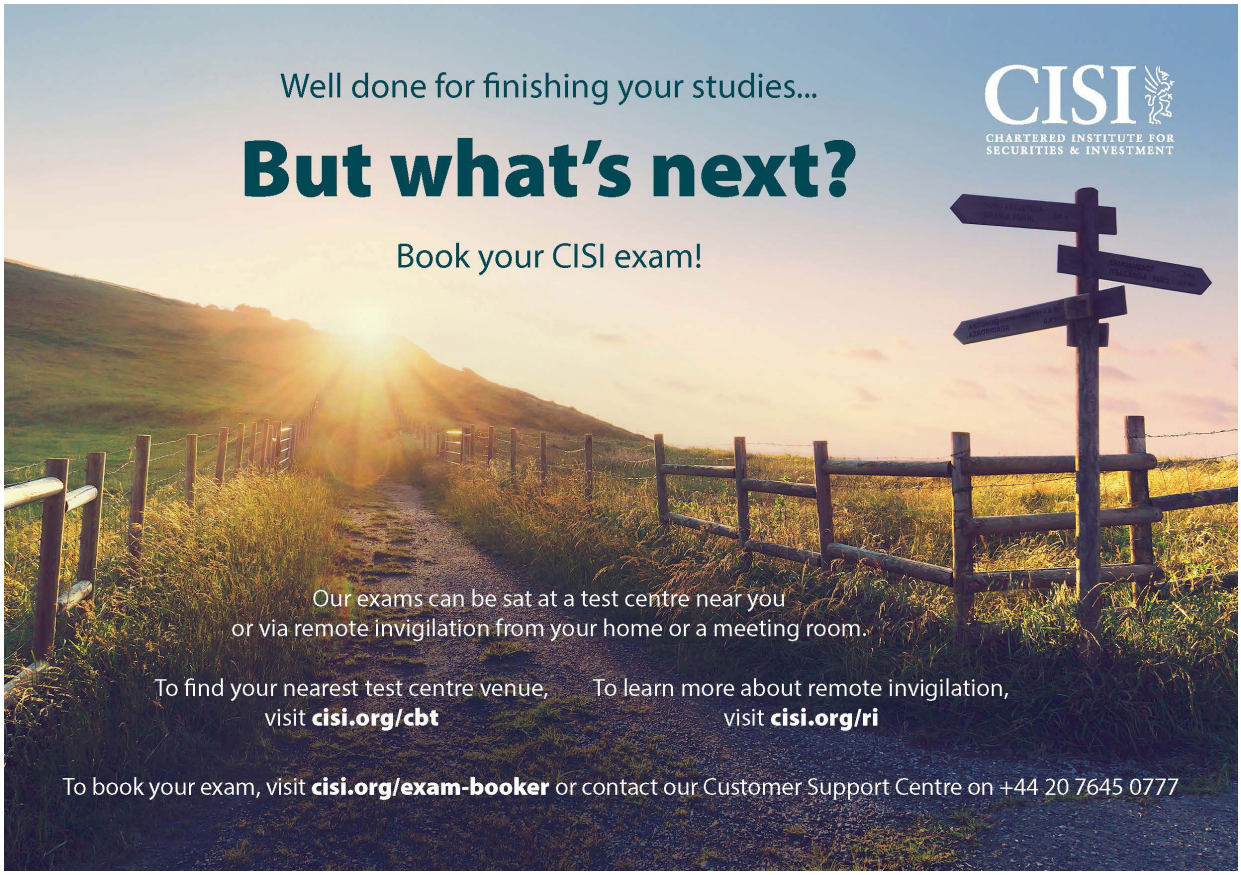
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UK Branches and 9 National Advisory Councils who represent local members and guide our offering



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Our Professional Refresher series offers cutting edge analysis and insight for financial services professionals in bite-sized elearning modules.

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Our award-winning members magazine incorporates the latest news, insight and thought leadership affecting your profession, available both online and in print.

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Understand AML legislation and regulation, the role of the MLRO, and the sanctions and penalties.



Client Assets and Client Money Essentials
Gain an overview of the principles and high-level rules associated with holding and protecting client assets.



Conflicts of Interest
Consider examples of conflicts of interest, tools, policies and procedures, enforcement action, and good practice.



Data Science
Digitisation of business operations has accelerated the speed of data capture. Harness the value of your data.



Diversity and Inclusion
Targeted at those responsible for diversity, equality and anti-discrimination, and those recruiting and managing.



Financial Crime
Gain an overview of insider dealing, market abuse, money laundering, terrorist finance and financial sanctions.



Financial Planning
Gain an overview of the financial planning process, key terms and the regulatory framework that governs it.



Greenwashing
This module explores the key concepts surrounding greenwashing, the wider implications, and the measures being taken to fight it.



Impact Investing
Aim to take ethical and sustainable investment principles a step further through intentional investment.



Integrity and Ethics
Understand ethics in finance, the importance of trust and trustworthiness, and compliance versus ethics.



Market Abuse
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