FCA Guidance Consultation GC17/1:

Changes to the way firms calculate redress for unsuitable defined benefit pension transfers
Summary

Due to fundamental changes in the pensions sector over recent years, the FCA has proposed changes to the current methodology for calculating redress for unsuitable DB transfers, including the underlying assumptions. Key points include that the FCA proposes:

- to review the new methodology at least every four years;
- that the methodology will only apply to complaints received by firms on or after 3 August 2016; and
- the deadline for responding to the proposals is 10 June 2017.

Significant proposed changes to the redress methodology include:

- changing the method of assessing the future level of RPI to use. The FCA proposes that spot rates based on the term to retirement are used;
- assuming a cautious investment mix for pre-retirement discount rates, which will result in a material increase in redress for those further from retirement;
- applying a fixed rate allowance of 0.75% to the consumer’s personal pension to take account of future personal pension charges;
- using the conduct of business sourcebook figures for mortality rates; and
- making a deduction of 0.6% from the post-retirement discount rate for annuity provider pricing and reserving.

Other proposals include gender-neutral annuity rates and an assumption that consumers are the same age as their spouse.

Introduction

The primary intention of the guidance is to update the methodology used to calculate levels of redress due to consumers where they have received unsuitable advice from a firm/advisor, or a firm/advisor has committed some breach of the relevant requirements in relation to transfers from defined benefit (“DB”) pensions to personal pensions.

The primary purpose remains to put the consumer back into the position they would have been had they not suffered actionable loss as a result of moving pension funds in reliance on bad advice.

The FCA has obtained advice from PWC and has produced Guidance Consultation 17/1 (the “Consultation”) which sets out the FCA’s proposed updates to the current redress methodology and seeks the views of interested parties on these proposals. The deadline to respond is 10 June 2017.

The Consultation is relevant to consumers who were given unsuitable advice to transfer out of a DB pension scheme but have not yet accepted compensation. The proposals update the redress methodology that firms are required to use to reflect the current pension environment, including changes to the level of risk of DB pension schemes and gender-neutral annuity rates.

There is often a concern amongst firms when the FCA amends guidance which impacts historic issues that it will amount to retrospective regulation by applying a more demanding standard or interpretation of the rules after the event. The FCA has made it clear in the Consultation that it is mindful of this and has tried to avoid using the benefit of hindsight when updating the methodology. Additionally, as below, the new methodology will not have a retrospective effect so firms can be assured that previous redress will not have to be revisited as a result of the Consultation.

The FCA recognises in the Consultation that in cases where there is actual loss (i.e. where the consumer has already retired) calculating redress is a relatively straightforward exercise. However, where the loss is prospective (i.e. the consumer has not yet retired) the loss must be calculated using assumptions. These assumptions are reviewed in the Consultation.

Over recent years (and certainly since the Pensions Review) there have been fundamental changes in the pensions sector (e.g. pension freedoms). The FCA has sought as part of the Consultation to take into account such changes to the pensions environment.

The FCA proposes that the revised methodology will apply only to complaints received by firms on or after 3 August 2016 or complaints which had been received but not settled on a full and final basis by that date.

The FCA has confirmed that the methodology will now be regularly updated. Whilst this is undoubtedly a provision designed to ensure a customer-focused process to calculations over time, if the goalposts are moved too frequently, this may affect the ability of firms to effectively and promptly resolve complaints.

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1 Full report available on the FCA website
2 The revised methodology would also not apply to cases falling within the scope of the Pensions Review or the free standing additional voluntary contributions (FSAVC) review
Summary of the proposals

The FCA will update the current redress methodology, including the underlying assumptions. The proposals include:

– updating the inflation rate used to better reflect likely inflation;
– acknowledging the pensions protection fund (PPF) in updating the pre-retirement discount rate;
– updating the post-retirement discount rate, and acknowledging the likelihood that consumers will take a pension commencement lump sum;
– making allowance for gender-neutral annuity rates;
– assuming that male and female consumers are the same age as their spouse;
– simplifying the assumption about the proportion of people who are married or in a civil partnership at retirement;
– making allowance for enhanced transfer values (“ETVs”); and
– updating these assumptions on a regular basis to reflect the fact that markets are often volatile.

Thankfully, the FCA recognises that redress calculations need to be relatively simple, using factors which are transparent and readily available. This naturally means the FCA’s assumptions are approximate for all consumers rather than specific to individual circumstances. This is the only sensible and reasonable approach in our view, requiring only limited individual-specific information as part of the calculation methodology, such as the number of years until retirement.

The proposals – in detail

The FCA states that it has considered various options regarding the methodology. The preferred option is to compare the present value of the DB pension scheme benefits and the consumer’s personal pension, as was the approach taken in the Pensions Review. This is the preferred methodology because it results in:

– an immediate settlement of the complaint for the consumer; and
– potentially the least delay in settling complaints because it follows the existing approach.

However, the FCA recognises the need to reconsider the methodology previously used.

Valuation of DB pension scheme benefits

The FCA has considered two approaches of calculating the value of the DB pension scheme that the consumer was advised to transfer out of.

The FCA is proposing to follow the same approach as the Pensions Review, such that the process is to:

– calculate the amount of pension that the consumer would have been entitled to receive in retirement by applying the actual increases applied up to the date of calculation, and making an assumption for the future level of increases between the calculation date and the consumer’s retirement date;
– convert the value of the pension income in retirement into the capitalised lump sum using assumed annuity factors that would apply at the retirement date; and
– calculate the current value of the lump sum by discounting from the retirement date to the date of calculation using an assumed growth rate.
The FCA considers that this approach has an advantage because it is familiar to firms that have previously calculated redress in similar cases. It should also produce a broadly appropriate valuation of the benefits. However, this approach is complicated and often leads to firms outsourcing the calculations to third parties with the proper expertise to complete them. This can itself lead to delays for consumers and, importantly, significantly increases the cost for firms. This approach is particularly disproportionate for smaller firms or instances where the redress value is low.

The FCA did consider taking a more simplistic approach such as requesting a notional transfer value from the DB pension scheme as at the calculation date to reflect the current value of the benefits the consumer accrued in the scheme before the transfer. However, this approach would have its own difficulties such as if the DB scheme no longer exists (where a separate methodology would need to be used). There are also difficulties because there is no obligation on the scheme to provide the valuation and it may be unwilling to absorb the costs where they do provide such information. The FCA recognises this issue and also says its reluctance to adopt this approach is influenced by the fact that this valuation method would not accurately reflect the actual cost of purchasing an annuity for the scheme member.

The views of pension providers will vary depending on the make-up of their portfolio of customers. The simpler above option dismissed by the FCA may be the preferred approach for many, but the FCA is strongly of the view that accuracy of calculations outweighs the potential benefit to firms of having a more simplistic and more cost-efficient approach. Given the FCA’s statutory objectives it is not surprising that it has taken this approach but nevertheless we expect firms will want the FCA to seriously consider the impact this may have on them.

Redress methodology

The FCA has considered how to update the redress methodology and assumptions used as part of the methodology. Its thinking has been informed by the significant changes in both pensions and the wider economy since the Pensions Review. For each area of change (dealt with below) the FCA has given an indication of the likely impact of the changes on the valuation of scheme benefits by way of two hypothetical example consumers:

1. **Consumer A** is two years from retirement with a DB pension scheme benefit that would have been £2,100 per annum at retirement.

2. **Consumer B** is 20 years from retirement with a DB pension scheme benefit that would have been £3,100 per annum at retirement.

**Inflation**

The FCA considers that the Bank of England’s implied inflation curve remains a reasonable basis for deciding the future level of RPI to use. However, the FCA proposes a different approach to deciding the precise rate because the Pensions Review did not take account of the time between the calculation date and retirement date when taking the future inflation rate assumption from the BOE curve.

The FCA proposes the rate to use is derived from the BOE’s inflation curve to 25 years, extrapolated to longer terms to maintain consistency with the post-retirement gilt yields. Pre-retirement, the FCA proposes that spot rates are used based on the term to retirement.

Using the FCA’s examples of Consumer A and Consumer B, the impact of this would result in redress reducing slightly under the new methodology of -2.5% and -8.6% respectively.
Pre-retirement discount rate

This is the rate used to discount the value of the DB pension scheme benefits at retirement back to the calculation date. It is the rate at which the investments in the consumer’s personal pension are expected to grow between the calculation date and their retirement date.

The existing approach assumes that the consumer holds a portfolio of 50% equities and 50% gilts until they reach 10 years from their retirement date. From the 10 year point, it is then assumed that the portfolio moves on a linear basis towards 100% gilts on the consumer’s retirement date.

The above approach assumes a very risk-averse consumer when the reality is that many people approaching retirement have a greater appetite to risk, particularly since the pension freedoms were introduced and consumers have greater risk options.

Attitude to risk

Whilst the FCA recognises there is now less need to eliminate risk as retirement approaches because consumers’ choices show they are willing to continue accepting investment risk into their retirement, it still proposes in its pre-retirement discount rates to assume a very cautious investment mix. The FCA suggests the following:

1. Half of the expected return on equities (defined in terms of the FTSE all share index) until the consumer is five years from the normal retirement age of the DB pension scheme. This is approximately equivalent to a 67% gilt/33% equity holding.

2. A linear decrease in the expected return over the final five years so the portfolio is aiming to achieve one third of the expected return on equities at the point of retirement.

Extrapolating these changes across Consumer A and Consumer B means there is a minimal change of +0.6% for Consumer A but a much larger change of +20.1% for Consumer B.

Although the FCA considered specifying different discount rates depending on the consumer’s attitude to risk, it decided to maintain one assumed risk profile. We agree this is sensible to keep the methodology more straightforward. Otherwise, more time would be spent by firms ensuring the correct risk profiles were used and it could be difficult to ensure the correct rates were applied to every consumer (as this would involve an assessment of their attitude to risk).

Pension Protection Fund (PPF)

The FCA considers that an individual’s attitude to risk remains the same regardless of whether or not their DB scheme has become insolvent and entered the PPF (although there is some possibility of validly treating PPF benefits differently). The FCA proposes for the purposes of the methodology that the same pre-retirement discount rate should be used regardless of whether a DB scheme has entered the PPF or not. We agree this is a sensible approach.

Personal pension charges

The value of the consumer’s personal pension must be reduced to make allowance for future charges. Presently the reduction applied is dependent on the charges applied to the customer’s personal pension at the date of review. The FCA now proposes that a fixed rate allowance of 0.75% per annum should be used for simplicity.

In this example, the FCA creates two types of Consumer A and Consumer B; one that was paying 0.5% per annum in charges and one that was paying 1% per annum in charges. For the consumers paying 0.5% per annum in charges, the new methodology provides increased redress of +1% for Consumer A and +26% for Consumer B. For consumers paying 1% per annum in charges the changes to redress methodology would result in Consumer A being paid the same redress but Consumer B receiving +14.5% more redress than currently.

Post-retirement discount rate

This is the rate used to calculate the capitalised value of the DB pension scheme benefits through retirement that the consumer would have received if they had not transferred (i.e. the amount required to buy an annuity that is equivalent to the pension that would have been provided by the DB pension scheme).

The FCA considered the current approaches taken by the Statutory Money Purchase Illustration (“SMPI”) and FCA projections for the Transfer Value Analysis (“TVA”) calculations.

The SMPI/FCA projections and TVA aim to model a risk-free post-retirement income stream and so have very similar approaches. Many firms do not consider such an approach is appropriate given the pension freedoms and the increased risk appetite of many consumers and the FCA rightfully recognises that in the Consultation.
The FCA considers that the nominal gilt liability curve published by the Bank of England to derive future post-retirement discount rates based on average weighted payment terms should be used. This is because it can be used to derive expected future gilt yields at each member’s expected retirement rate, rather than the rate that applied at the time of the redress calculation.

Annuity pricing

Currently there is a loading of 4% of the annuity for the implicit costs of converting the fund into an income stream at retirement. The FCA proposes making a deduction of only 0.6% from the post-retirement discount rate to allow for annuity provider pricing and reserving. This is a significant reduction.

The impact for Consumer A would be an increase in redress of about +15% and for Consumer B an increase of +26%.

Pension commencement lump sum

The majority of DB pension scheme members do take advantage of the option of a tax-free cash sum and most take close to the maximum entitlement. The FCA rightly therefore considers it is reasonable to make an allowance for this in the redress methodology.

The FCA proposes an adjustment of 1.6% to the post-retirement discount rate per year, calculating that 25% of the benefits are likely to be taken as a tax-free cash lump sum.

The impact on example Consumers A and B would be that both would receive redress of approximately -5.5% than under the old methodology.

Mortality

This assumption estimates for how long the DB pension scheme would have been paid. The FCA considers that the mortality rates that should be used are those in the conduct of business sourcebook (“COBS”). The FCA has also considered whether it should make allowance for the likelihood of the consumer being in ill health when they retire and so qualify for an impaired life annuity. The impact here could be very significant. However, the FCA is proposing (and sensibly in our view) that it would be difficult to assess the likely future health of individual consumers and is taking into account the potential impact this could have on the level of redress. The FCA therefore has taken what it considers to be a pragmatic solution and proposes using the COBS tables which is a better result for firms than a more complex analysis, which would also lead to overall higher redress.

Gender-neutral annuity rates

The FCA proposes to use gender-neutral annuity rates to reflect the market approach. The annuity rate will therefore be calculated by taking the average of the male and female mortality rates.

Spouses’ age difference

The FCA wants to take a standardised approach and treat all consumers equally irrespective of gender or sexual orientation. This simplifies the calculation and avoids the need for consumers to give sensitive data to firms. The FCA proposes to assume that male and female consumers are the same age as their spouse.

The changes in respect of Consumer A and Consumer B, depending upon the sex of their spouse, are between +0.6% and +2%.

Proportion married or in a civil partnership at retirement

The FCA proposes a single assumption of 85% for the percentage of people married or in a civil partnership at retirement. This takes into account the Office for National Statistics’ figures from the latest UK census that shows around 70% to 75% of the population aged 60 to 69 were either married or in a civil partnership.

The impact upon Consumer A and B depending upon the gender of partner and marital status shows percentage changes under the new methodology of between -1.3% and +9.9%.

Enhanced transfer values

The FCA recognises that where the enhancement was paid as part of the transfer value then this will be allowed for as part of the standard calculation approach and therefore no further adjustments are required. If the enhancement was paid as a cash lump sum outside the transfer process, the FCA proposes applying a consistent approach to valuing this sum, whether or not the consumer has invested or spent it. The proposal is that the actual increases to the consumer’s personal pension are applied from the date of payment to the redress calculation date. This figure would then be added to the value of the personal pension policy.
Frequency of updates

The FCA proposes that the economic assumptions which are based on public information are updated every quarter in order to reflect changing market conditions. Specifically, firms should review and update the inflation and gilt yield curves together with the dividend yield based on their values on the last working day of every quarter, for calculations commencing on the first working day of each quarter. The mortality assumption mirrors the assumption COBS projections and TVA which changes automatically every year on 6 April. For ease, the FCA proposes that for redress calculations, it should be updated at the end of March along with the update of the publicly available economic assumptions.

The FCA also proposes to review the overall methodology at least every four years (or sooner, if feedback suggests this is required). We consider regular, clear and informative updates/reviews of the success of methodologies and assumptions is imperative to ensure both consumer protection and that firms are provided with a clear, fair and proportionate basis on which to calculate redress.

Proposed updated guidance

Annex 1 to the Consultation includes draft proposed guidance covering the above issues.

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Applicability of the methodology

The current methodology is also used to calculate redress in complaints for non-joiner opt-out and FSAVC redress cases.

The FCA explains that PWC has not specifically considered whether the proposed methodology should apply to these complaints. However, some stakeholders have argued that doing so would simplify complaint handling and ensure that consumers receive more appropriate redress. The FCA does not give its view on this issue but does invite comments so it can assess whether there is a case for applying the methodology more broadly to include redress for advice to transfer safeguarded benefits.

Tax considerations

The FCA has not provided specific guidance on how tax should be factored into redress payments. It says, typically, that this is a matter for Her Majesty’s Revenue & Customs to consider. The FCA proposes to continue the usual approach that redress payments should be paid directly into the consumer’s personal pension where possible and to pay a lump sum otherwise. The FCA reminds firms that in either scenario, they must take account of the consumer’s tax position and ensure that any tax restrictions or liabilities have been allowed for appropriately.