Pension redress methodology and unsuitable advice—changes on the horizon

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Pensions analysis: The Financial Conduct Authority (FCA) is consulting on updates to pension redress methodology. Roger Score, consultant actuary at OAC, says it's good news for consumers and their champions that the FCA is proposing a methodology that is expected to increase the amounts paid in redress and that will put them, as best as can be ascertained, in the financial position they would have been in had they not been advised to transfer their defined benefit (DB) pension.

Original news

FCA proposes update to pension redress methodology, LNB News 10/03/2017 19

Proposals for updating the methodology used to calculate the redress owed to consumers who were given unsuitable advice to transfer out of a DB pension scheme to a personal pension have been published by the FCA. Comments on the proposals should be submitted by 10 June 2017.

What is the background to the FCA's consultation on the methodology used to calculate the redress owed to DB consumers given unsuitable transfer advice?

Calculation methodology for the redress of unsuitable advice to transfer pensions away from DB into investment-based personal pension plans was established by the Securities and Investments Board and Personal Investment Authority in the mid-1990s. The methodology was used for the review of pension transfers that had been advised in the period April 1988 to June 1994. The redress methodology was maintained with a quarterly review of financial and demographic assumptions until the Financial Services Authority ceased maintaining the methodology in 2004.

The redress methodology was adopted for the calculation of redress of unsuitable pension transfers advised after June 1994, in particular as directed by the Financial Ombudsman Service (FOS) which commissioned from PwC annual reviews of the financial and demographic assumptions.

On 3 August 2016, the FCA announced that it would consult on redress methodology for unsuitable transfers from DB schemes as the FCA was concerned that the existing methodology may no longer have been achieving the objective of putting consumers back in the position they were in if they had retained their DB pensions. The FCA ordered advice firms to cease making offers in full and final settlement until the outcome of the consultation is made known.

What are the changes being proposed, and why are these changes being proposed now?

The most significant changes that the FCA is proposing are to the price inflation and discount rates used in the valuation of lost DB pensions. Certain simplifications and other changes are also proposed. The methodology for the discount rate used until retirement will reflect the risk appetite of cautious investors willing to take modest investment risk and that used for life after retirement is expected to approximate to the discount rate applicable in the pricing of annuities. The existing methodology was based on the assumption of a balanced risk appetite before retirement and made the assumption that the consumer would hold a basket of gilts in retirement. Other changes include:

- the assumption that consumers would have commuted pension at retirement for the maximum pension commencement lump sum—previously it was assumed there would be no commutation of pension
- the assumption of gender neutral mortality
- simplification of the assumptions regarding spouse's and dependant's pensions, and
- the assumption of uniform future charges under personal pension plans

The net effect of the changes is expected to increase redress amounts. The FCA does not have the data to make a reliable estimate of the likely increase in average redress. Examples in the consultative document based on financial conditions on 30 June 2016, consistent with the timing of the latest review by PwC for FOS, show increases in the valuation of the DB pensions ranging from 5% to 30%. These percentage increases would be leveraged up by the deduction of the value of the personal pension.

The FCA has decided to review the position because of the changes since 2004 including:

- establishment of the Pension Protection Fund that has reduced the level of risk associated with DB pensions
- enhanced transfer values (incentivised by companies keen to reduce their DB liabilities), and
- the change to gender neutral annuity rates and pension freedoms

The FCA also points to PwC's advice to FOS indicating that the existing redress methodology does not provide sufficient capital in order that consumers can purchase an annuity in replacement of lost DB pension.

Does the preferred redress methodology outlined in PwC's report accompanying the consultation deal with the issues? Are there any outstanding points of contention?

The PwC report explains the thinking that underlies the preferred redress methodology. The methodology is intended to put the consumers who have received unsuitable advice back in the position they would have been had they not acted on that advice. The PwC report declines to define what unsuitable advice is but makes the assumption that the consumers who have been badly advised are on the cautious side of a balanced attitude to risk.

What are the implications of the proposals for consumers, advice firms and professional indemnity insurers? Are there any other issues that need to be considered?

It is good news for consumers and their champions that the FCA is proposing a methodology that is expected in general to increase the amounts paid in redress and that subject to the assumption that consumers will take modest investment risk will put them, as best as can be ascertained, in the financial position they would have been had they not been advised to transfer their DB pension—though seeking to avoid overcompensating them. By the same token, advice firms and professional indemnity insurers can be expected to have to shoulder a heavier burden of redress payments for complaints that are upheld. The technicalities of the new redress methodology are similar in principle to the existing and the need for calculation software to be amended should be limited so that advice firms should not see any major hike in calculation fees. The FCA states that it has little data on which to judge whether the new methodology will have any impact on the numbers of upheld complaints.

Will the proposals have any implication on the amount of the levies for the FOS and the Financial Services Compensation Scheme (FSCS)?

There is no reason to expect any change in the level of charges made by the FOS for its work. On the other hand, the FSCS, being a body that is required to pay redress, may need to increase its levy—unless it has already factored into its estimated life and pensions advice levy for 2017/18 a suitable amount for the expected increase in the level of redress payments.

OAC*, the independent actuarial and financial services consultancy, are experts in carrying out a wide range of redress calculations and complaint investigations. Roger Score is a recognised leading specialist in loss and redress calculations. He is regularly involved in resolving complex matters surrounding all aspects and types of pension arrangements and disputes.*

Interviewed by Kate Beaumont.

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