HINDSIGHT
Collegiate Underwriting
Winter 2011

Welcome to the latest edition of our Hindsight publication.

Welcome to the latest edition of our Hindsight publication.

Pension transfers from occupational pension schemes are again in the news. The decline in defined benefit schemes has continued and many Trustees are looking to de-risk their pension liabilities. This has led to a number of enhanced transfer value schemes being offered to members. The Pensions Regulator has issued guidance to Trustees and given his thoughts on when pension transfers are in member's interests.

The Pension Protection Scheme was established in 2005. We look at the levels of compensation that are payable when pensions schemes enter the fund. Many schemes are not fully funded and this can have an impact on any decision to accept a transfer.

Finally we have enclosed a copy of our response to the FSA on the proposed changes to the limit for Ombudsman awards and the implications of the proposals that firms need to consider and learn from their experiences with the Ombudsman.

My thanks go to Mark Gibbon, our Managing Director and Martin Archer, our Legal Director for producing this newsletter.

We hope that you will find these articles informative and useful.

If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk

Richard Turnbull
Underwriting Director
Collegiate Underwriting

Pension Transfers

What does the Pension Regulator have to say about pension transfers?

The Pensions Regulator issued guidance on pension transfer incentive exercises in December 2010 (www.thepensionsregulator.gov.uk/guidance/incentive-exercises.aspx). The Pensions Regulator states that Trustees should start from the presumption that such exercises and transfers are not in most members' interests. They should therefore approach any exercise cautiously and actively.

In December 2010 David Norgrove, chair of the Pensions Regulator, gave a speech at the NAPF annual conference in which he discussed enhanced transfer values. He reiterated his belief that in the overwhelming majority of situations enhanced transfers were not in the member's interests. He accepts that there will be specific and individual circumstances in which a transfer may be in the member's interests. These were:-

- Limited life expectancy
- No dependents
- Sophisticated investor balancing risks in portfolio of retirement benefits
- Level of benefits significantly higher than the PPF cap and as such would be cut if schemes entered the PPF

His expectation is that there will be a minority of members who fit this bill. The Pensions Regulator pays out approximately 150,000 pensions from the Pension Protection Fund with an average value of £3,800 per annum.

Mr. Norgrove acknowledges that it is a simple fact that it is very difficult for members to gauge whether giving up a defined benefit pension promise in exchange for a cash transfer into a defined contribution scheme, will be in the best interests over the long term. But given the gravity of the decision, the difficult financial equation, and potential for detriment if they get the decision wrong he believes the Regulator's stance is reasonable and proportionate.

Cash equivalent transfer values

From 1 October 2008 new transfer regulations were introduced making Trustees of Occupational Pension Schemes responsible for the method of calculating the cash equivalent transfer value ('CETV'). Previously this was certified by the scheme's actuary. The Pension Regulator issued guidance to assist Trustees in fulfilling these duties. This can be found at www.thepensionregulator.gov.uk/guidance-transfer-values.aspx. The key points raised were:-

- There is scope for Trustee judgement in producing transfer values appropriate for their scheme.
- Where a member has an option that can be exercised under the scheme and it will increase the value of benefits this has to be taken account of by the Trustees in calculating the 'CETV'. The Trustees can allow for the chance that the member will not take up the option, which can be based on past experience.
- Where discretionary benefits can be awarded but are not automatic the Trustees have to decide to what extent these discretionary benefits are to be included. They must have regard to any established custom for awarding them and any consent requirements.
- Trustees are allowed to reduce the 'CETV' to allow for underfunding although where the employers covenant is judged to be strong and any funding shortfall is being remedied over a reasonably short period trustees should not normally reduce the 'CETV'

An example of an option may be early retirement without consent. Similarly a discretionary benefit might be early retirement with consent of the employer.

Transfer value Analysis System

The transfer value analysis system ('TVAS') was introduced from 1 July 1994. The 'TVAS' should be applied to all transfers from a final salary occupational scheme. The critical yield, calculated by the 'TVAS', is the return required from a receiving personal pension or section 32 policies to match at retirement age the benefits provided by a final salary occupational pension scheme. This can be calculated at normal retirement age and at early retirement age. The reports will also compare tax free cash amounts, death benefits payable and pension income levels at varying rates of return as compared to the existing scheme.

The critical yield is then reviewed together with the risk assessment of the client to determine if the defined contribution scheme that the pension is being transferred to has a fair chance of matching or exceeding the benefits that were payable under the defined benefit scheme and whether this is a risk that the client is prepared to take in the circumstances.

What the transfer is doing is removing risk from the employer scheme onto the shoulders of the employee. The employee has no certainty over what will eventually be paid out as pension in retirement. This will depend on a number of factors namely investment performance, charges, interest rates and life expectancy. If these move against the employee in the time to retirement then they may well face a reduced income. As an example we have seen a number of transfers that were done in 2006 where investment performance has been poor. Annuity rates have fallen. It is likely that anyone doing a loss calculation now on that transfer would be facing a loss somewhere around 30% of the transferred amount.

Capacity for loss

If a complaint is made in the future, FOS when considering their decision will look at a number of factors, including whether the employee understood that risk and also whether they had the capacity to bear the level of loss. The FOS is very sympathetic to individuals who, in their opinion, did not have the capacity to bear the loss, but were advised to transfer benefits and have then suffered detriment. In January 2011 the FSA produced a Guidance consultation on 'Assessing suitability'. This can be found at www.fsa.gov.uk/pubs/guidance/gc11_01.pdf. They define capacity for loss as 'the ability to absorb falls in the value of investment. If any loss of capital would have a material detrimental effect on a customer's standard of living, this should be taken into account in assessing the risk they are able to take.' Although this guidance is aimed at investment decisions this must equally apply to an investment decision on pension assets where investment performance is required to match benefits and may not be achieved. This loss can be measured against the alternative option of leaving the benefits with the existing pension scheme.

There are benefits to the deferred member of making a pension transfer, access to greater tax free cash, the opportunity to do better, flexibility and control but it is important that any advice also concentrates on what is being given up. This is not just a question of whether the critical yield is reasonable in light of the overall risk assessment of the client and what might be expected from investment performance but should also cover what will happen if those yields are not achieved. This is particularly important where the deferred member is close to retirement age or the value of the pension benefits forms the majority of the customer's pension provision. It would be very sensible to include an analysis of the downside in any advice to the customer.

What does the Pension Protection Fund provide?

This was established in April 2005 to pay compensation to members of eligible defined benefit pension schemes where there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. There are currently 195 schemes transferred.

Compensation is paid to individuals who have reached schemes normal retirement date or are in receipt of survivors or ill health pensions. This is paid at 100%. Where part of the compensation is derived from service on or after 6 April 1997 the payment will be increased by RPI capped at 2.5%.

For people below normal retirement date compensation is generally 90% of accrued pension at date of assessment revalued at RPI, capped at 5% for service prior April 2009 and 2.5% compound for service post April 2009. This compensation is subject to an overall cap of £29,748 as at April 2010. Once in payment that part that derives from service post April 1997 is increased by RPI capped at 2.5%.

When a scheme is in an assessment period, the trustees may only pay a transfer value where, before the assessment date, the member has requested and accepted the transfer value in writing and has designated a scheme willing to accept that transfer value.

Further, the trustees may only pay that transfer value if:

- they are satisfied that to do so is consistent with the objective of ensuring protected liabilities do not exceed assets (or that where they do, the excess is kept to a minimum); and
- they reduce the transfer payment to the extent necessary to ensure that it does not exceed the cost of securing the benefits which correspond to the compensation that would be payable if the Pension Protection Fund were to assume responsibility.

Where the assessment period has come to an end and the Pension Protection Fund has assumed responsibility for a scheme, the member will become entitled to compensation at normal pension age. Once the Pension Protection Fund has assumed responsibility for the scheme, a member would not be entitled to a transfer payment unless pensionable service was ended by the start of the assessment period and at that time the member had less than 3 months' pensionable service in the scheme.

There will be a small number of members who have concerns that they face reduced benefits payable in retirement if the pension scheme entered the Pension Protection Fund. The solvency of an employer scheme is not something we would expect an IFA to advise on. It would be reasonable to point out the critical yield required to match benefits payable under the Pension Protection Fund and the level of those benefits. If we refer back to the guidance to Trustees on 'CETV' they are allowed to reduce transfer values for funding issues. Ultimately any decision based on a scheme's solvency must be for the member to make.

Consultation Paper 10/21 – Consumer Complaints:

The ombudsman award limit and changes to complaints-handling rules

Below is an extract from Collegiate's response to the FSA in respect of this Paper;

Award Limit

We do not agree with your proposal to increase the award limit for the compulsory jurisdiction.

If the award limit is set too high there could be increased pressure on the Ombudsman to become more like the courts – with consequent implications for formality, speed and cost. As your own research has indicated the vast majority of cases comfortably fall within the existing £100,000 limit. The organisation in terms of its procedures, the calibre of people it employs, and the length of time it is prepared to devote to any particular case has been tailored to deliver a lot of decisions quickly and relatively economically and this does come at the expense of the quality of the decisions that are made.

It seems to us that you can make a cost benefit analysis argument for this approach for lower value claims where the cost, in terms of wrong decisions, is less significant to any individual and more proportionate to the benefit of not having to spend significant legal costs to get the decision. That cost benefit analysis breaks down when dealing with significant sums.

All parties who are subject to the FOS should be entitled to a fair hearing proportionate to the sums at stake. Within the proposal there is no suggestion that FOS's own internal regime will be modified to ensure higher value claims are subjected to a more rigorous procedure to ensure justice is being delivered fairly. We do not think it is acceptable to consider a substantial increase in the award limit without considerable improvement to the safeguards for those who will be subjected to its jurisdiction.

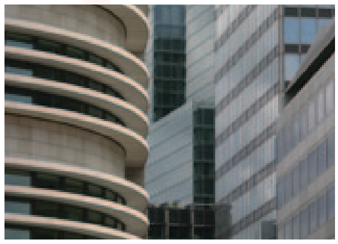
Introducing appropriate safeguards would increase the costs of the Ombudsman regime. That cost has been ignored in the cost benefit analysis, as clearly there are no plans to improve the decision making procedures within the Ombudsman. That is not an argument against introducing appropriate safeguards, it simply follows that the limitations of the Ombudsman need to be recognised and the limit not increased.

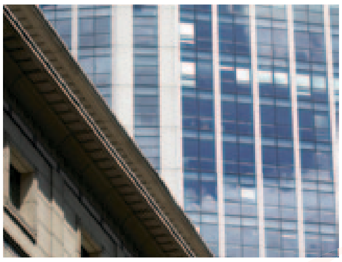
In 2.23 of the paper it states that an increase in the Ombudsman limit is expected to benefit all consumers that have a "valid" dispute. Our concern centres on how a "valid" dispute is determined and ensuring that the Ombudsman only upholds "valid" complaints. Given the lack of the standard safeguards available in a court regime, which is acknowledged in the paper, how can you be confident that every Ombudsman decision is correct?

The higher the sums at stake, the more likely it is that customers will be less prepared to disclose documents and other information that is unhelpful to their case and more likely to give an account of the transaction that is at best optimistic and at worst untruthful. Without the safeguards available to the courts, in particular the ability to interrogate oral evidence and the strict rules on discovery etc., the Ombudsman can have no confidence that he is making the correct decision in a substantial number of cases.

The cost benefit analysis does not factor in the cost and injustice that would be caused by upholding complaints for sums over £100,000 that would have been rejected had proper justice been delivered through the courts.

This proposal paves the way for significant injustices to be made for very little benefit. A customer who has a good case is able to effectively, economically and with little difficulty secure justice through the courts. There are plenty of solicitors who take no win, no fee cases and can arrange After The Event insurance to protect the downside of losing. If you have a good case the current Civil Procedure rules with their pre-action protocols and focus on early mediation provides them with an effective way of securing justice. Whilst the Ombudsman may well be even easier for the claimant





this has to be measured against cost and fairness and we believe IFA's should not be deprived of very substantial sums of money without any opportunity to have their accuser's evidence examined in an oral hearing. Because the Ombudsman has no 15 year longstop limitation period, IFA's are exposed to claims against them for many years even after they have retired when they are unlikely to have professional indemnity insurance.

When Lord Atkins originally proposed an Ombudsman scheme he understood very clearly that establishing this system would depend very much on the availability of professional indemnity cover.

The PI market insures legal liability. The proposed substantial increase in the FOS limit without any improvement to FOS procedures, in particular the right to an oral hearing, will make the IFA class less attractive to insurers.

There is already some evidence of a contraction in the market place and if this gathers and capacity drops we could see a return to the situation where the financial adequacy of IFA's, who rely on PI, is thrown into question. Where that occurs, a claimant could be thrown onto the compensation fund where the limits are much lower and less protection afforded to the consumer than is available where the IFA is covered by professional indemnity insurance.

For these reasons we believe the limit should not be changed.

Taking account of Ombudsman Decisions

It seems clear that this proposal is intended to give a greater prominence to this aspect of the rules. Whilst the general proposition that firms need to consider and learn from their experiences with the Ombudsman is unobjectionable, we do have concerns that the very real limitations of the Ombudsman are not being explicitly recognised. At 3.22 you state "this requirement is not intended to mean that firms should treat every decision by the Ombudsman service as a binding precedent", this does not do this issue justice.

As commented earlier in this letter and as recognised in your paper, the Ombudsman service has been tailored to deliver a lot of decisions quickly and relatively economically and this does come at the expense of the quality of the decisions being made. The Ombudsman is quick to point out that it is not a precedent setting organisation. The Ombudsman jurisdiction being what is "fair, just and reasonable" is not conducive to a precedent setting regime. When confronted with, on the face of it, clearly inconsistent decisions, the Ombudsman's standard fall back position is that no two customers are alike in terms of their individual circumstance and therefore it is simply not possible to compare cases.

The Ombudsman is determined to reserve the right to "make it up as they go along" and it simply does not employ the calibre of staff or have the systems in place that would be capable of providing a consistent, predictable and reliable decision making process akin to the court system. Indeed for them to attempt to do so would on the face of it undermine the whole point of the Ombudsman regime as being a cheap "rough and ready" alternative to the court.

This reality is, it seems to us, an inconvenient truth that your proposals are determined to ignore. The Ombudsman is not a precedent setting organisation and is not capable of becoming one. If it is not able to reliably deliver consistent outcomes to very similar cases, this does seriously undermine the credibility of a proposal that significant resources should be expended by companies in reviewing cases and trying to reconcile the irreconcilable. With such shaky foundations it is difficult to see how much weight could properly be placed on any apparent pattern that is gleaned from the exercise.

These proposals have clearly arisen out of the work you have done on PPI. This seems to us to be a fairly exceptional case where the large institutions are individually receiving many thousands of fairly similar complaints. Independent Financial Advisers simply do not receive anything like enough similar cases to draw a reliable view of how an Ombudsman would determine a particular case beyond some very broad generalisations.

So whilst the proposed clarifications themselves appear perfectly reasonable it seems to us there is a real risk that unless you recognise the inherent difficulty in trying to draw precedents from a non-precedent setting body, who is operating under a fair, just and reasonable jurisdiction, with great latitude to "make it up as they go along", you will compel firms to produce flawed precedents. These will then hamper the firm's ability to defend cases that ought to be defended for fear of regulatory criticism.

Clearly whilst it is not in the industry or their customer's interests for firms to defend the indefensible, equally it is not in the industry or their customer's interests for firms not to defend cases that should be defended. Given the compensation costs of the industry are ultimately born by the consumer, it does need to be recognised that every time an unjustified complaint is upheld that compensation is being paid by all consumers.

In conclusion we feel that the existing rules adequately deal with the issue. It does not seem very cost effective to us to expect hundreds of individual complaint officers to spend hours trying to reconcile irreconcilable cases in a vain attempt to glean what, if any, precedent the Ombudsman may be suggesting exists based on their own small sample of cases. Given the Ombudsman has seen all the cases and must surely know their own mind the best, if they think they are capable of setting precedents then you should amend their terms of reference to make them a precedent setting body. If they are not capable of doing this, which is our understanding of their position, then the prominence you are trying to give this issue seems entirely misplaced.

Collegiate Underwriting is a trading name of
Collegiate Management Services Limited
Registered Office:
Mint House
77 Mansell Street, London E1 8FE

Telephone: 020 7459 3456
Facsimile: 020 7459 3455
E-mail: cms@collegiate.co.uk
www.collegiate.co.uk

Collegiate UNDERWRITING