PENSION & FSAVC REVIEW REDRESS - A VIEW FROM THE PATHOLOGY LAB

by Adam Samuel[1]

These are two papers presented in 2001 to Derek Adams Pensions Review and FSAVC Review Forums. Many of the same issues continue to apply. Besides, apart from the material in my Consumer Complaints book, much of the history of these reviews has been lost. The authenticity of the views expressed seemed best preserved by not editing the papers except in a very minor way.

I: THE FAULT LINE

Any coherent analysis of pension review compensation runs directly into a structural problem at the heart of the review. There are competing tensions in it that have never been resolved and probably never could be.

In one corner, there is the idea that the review is to be done pro-actively and quickly with as little customer involvement as possible. In the other corner are the general principles of compliance and compensation. The first is set out in rule 7.2.1(3)(c) PIA Rules:

> "Where the Member becomes aware of a material breach of compliance or conduct it must take all necessary steps
> (c) to ensure that any customer who has suffered loss or damage as a result of the breach receives redress.."[2]

Firms were reminded of this in both PIA Opt-outs and Transfers Guidance. An example of the former is

> "It is possible that, in the course of the review of a pensions case, (whether or not there is found to be noncompliance or a loss within the scope of the review exercise), a compliance problem of some other type might come to light. Members are advised to follow their normal practice in considering and acting upon any such situations... PIA's monitoring teams will be looking at the findings of the reviews and checking that Members follow up any problems identified."[3]

The compensation principle is stated clearly in the Redress Guidance.

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1 BA LLM DipPFS FCIArb.

2 PIA Redress Guidance 1995 at pp. 8-9.

3 Pension Opt-Outs and Non-Joiners: Guidance for Review of Past Business, PIA, April 1995 at p. 4. See also Transfers Guidance at p. 6.

> "The aim in each case should be to restore the investor as closely as possible to the position he would have been in if there had been no failure of compliance, taking into account any known changes in circumstances since the original advice was given."

This is neatly enough butressed by PIA RU33 which says:

> "Firms are well aware that, in the absence of evidence to the contrary, the most plausible assumptions will include the following:
> .. (b) the investor's principal motive for taking out a personal pension was to be better off in retirement".[4]

The role of the referee or promoter is played by the population rules. These say that essentially personal pensions, section 32 buy-out bonds, pension term assurance, rebate-only policies advised on or arranged between 29th April 1988 and 30th June 1994 fall within the review subject to a number of well-known exclusions. So, all these sales are subject to the general compensation rule. Any other non-compliant advice or policy that the review team encounters during that process must also be subject to a similar review process under rule 7.2.1(3)(c).

The problem is that the data gathering process prescribed by the Guidance does not lend itself to any such task. It works on an assumption that all losses for which compensation will be paid under the review will represent the loss of OPS benefits. The only very marginal exception relates to distress and inconvenience payments.

This limitation of the data gathering process is not unreasonable. First, the review has to be finished at some point in the future. Already stretched resources, particularly amongst small IFAs, cannot extend to asking every customer to explain precisely what they have lost because of bad advice.

The biggest criticism of the Guidance in this area is not that it leaves this awkward fault line in place between the data gathering rules and the redress test. That is basically unavoidable. One's annoyance stems from the fact that the Guidance does not articulate the problem. Nor does it gave any indication of how to solve it. This has already had adverse consequences for everyone in relation to change of employment problems. The original data gathering process seemed to work on an assumption that there was only one employment with which review teams had to be concerned. The redress test produced precisely the opposite result. The outcome was that most firms followed the data gathering approach except perhaps where a complaint had been received. Then in 1997, the regulators changed their mind and required a great deal of largely futile re-work.

There is a way to reconcile the two sides of the fault line. Unfortunately, it would not have produced the right answer in most pre-97 change of employment cases.

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4 PIA Regulatory Update 33 at p. 8

However, it is the best method we have for sorting out future issues. Review teams have to assume that the only losses requiring redress are OPS benefits, unless as part of the data gathering process, they discover otherwise through doing the review or receiving a complaint. It is up to the regulator to indicate the pro-active investigations that have to be carried out. One can only wish that it had done so with regard to change of employment and pension mortgages. These are two areas where standards vary hugely.

II: EVIDENCE OF TROUBLE - LIABILITY FOR LOST GPP BENEFITS AND CHURNED TRANSFERS

(i) Churned Transfers

Striking evidence of this fault line can be found in recent guidance on churned transfers. (Another way of interpreting it is just that the regulator appears to have lost the plot.) The problem concerns the situation where a customer has been advised to transfer benefits by company A and then company B recommends that he transfer his transfer policy to another provider. This all assumes that the first sale is non-compliant and could not be justified by any other means.

The only hint at an answer to this common problem came in the original PIA Opt-Outs Guidance:

> "The total loss to the investor should be assessed taking account of the actual benefits arising from exercising an open market option. This applies even where advice on the option was given by a different investment firm."[5]

This suggests, as does the basic redress principle, that the first firm is liable for the difference in value between the contract that the customer currently has and that of the preserved benefits. If A had not given non-compliant advice, the client would not have considered transferring his benefits to B and the reduction in pension that the customer has suffered would not have occurred. By the same taken, as the extract quoted indicates, the client should not be over-compensated by disregarding a gain made by the investor through the second transfer.

The contrary argument was always that the first adviser should be liable only for his sale leaving it up to the customer to claim the rest of the loss from the second firm. In that way, the first company did its redress calculation on the basis of a hypothetical fund value that the policy would have had if it had remained in place. The biggest objection to this approach is that it leaves up to the customer to bring a complaint against the second firm to recover redress that follows from the pension transfer which firm A was supposed to be reviewing pro-actively.

The FSA in its recent bizarre Bulletin 14 manages to come up with neither solution

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5 PIA Opt-Outs and Non-Joiners Guidance 1995 at Appendix B-2

suggested here. It produces a stunning level of incoherence.

> "There are two acceptable approaches reviewing firms can use to value the personal pension for the purposes of a loss assessment where the personal pension has subsequently been transferred:
> 1. Determine a figure for the value of the personal pension that takes account of the
> subsequent transfer. In the case of a subsequent transfer to another personal pension, the current fund value of the policy held with the new product provider would be used. In the case of a subsequent transfer to an occupational pension scheme on an added years basis, the value (on the prevailing FSA basis) of the occupational scheme benefits granted in the new occupational scheme would need to be calculated.
> 2. Use the notional value of the fund that would have applied had the subsequent transfer not taken place."

The first approach given at the start is clearly the correct answer. So, why go any further? Why give firms the right to choose whichever option puts them in the best position? Firms are not even required to be consistent. It cannot be right to allow a firm to use whichever method produces the lowest redress costs.

Then there is the catch:

> "In this case, it may be appropriate to amend the notional value derived to reflect any surrender penalty that was applied by the product provider at the time of the subsequent transfer."

When and by how much should the value be amended? I wrote to the FSA about this and was told that no such amendment was required! If so, this should be in the Bulletin. Dangling threats are obnoxious for review teams trying to do the review properly. Such vagueness makes it virtually impossible for the regulator to enforce the Guidance. So, firms who are trying to do the right thing find their competitors able to cut corners with impunity.

Things become worse.

> "Reinstatement
> Where reinstatement is available and redress is due, the reviewing firm should offer both of the following options:
> 1. Reinstatement in the occupational pension scheme. However, if the amount available from the second personal pension is less than the notional fund value (ie the value of the fund available had there been no second transfer), then the reviewing firm may make reinstatement conditional on the investor meeting the difference between the notional fund value and the actual amount available from the second personal pension."

Conditional reinstatement is actually a new concept for the review where partial

reinstatement is not available. It is not the customer anyway who should be making up the difference. It should really be the second company.

> "2. Augmentation of the personal pension. The augmentation amount may be calculated using either of the methods discussed above. The reviewing firm should explain to the investor the basis of the offer made. It would not generally be appropriate to suggest that the investor should seek the balance of the reinstatement cost from the second advising firm. This is because the reviewing firm will not be in a position to know whether the second adviser gave good advice."

Those of us who have been involved with cases where clients are invited to make up the difference in under-contribution cases know how messy this whole process is with allowances for tax and charges and potential problems with the Inland Revenue with respect to clients who are currently ineligible to make personal pension contributions.
Incidentally, how is this point 2 to be reconciled with claims made with respect to joint liability? These are just as difficult to determine. Such a suggestion will not cost the client anything except an envelope, a stamp and some paper. Doing nothing would probably cost him much more.

There is a final sting.

> "Where a firm is advising an investor who is having their case reviewed under the pensions review (based on advice from an earlier adviser) the firm should take the above approach into account. Reviewing firms should inform investors of the possible consequences of making a second transfer before the pensions review process is completed."[6]

This is a complete muddle. Reviewing firms who a paragraph ago were supposed to be unable to advise clients to complain about the churning of their policies are now supposed to be informing investors of the consequences of making a second transfer.

(ii) Transfers of AVCs

The Guidance is virtually silent here too. The only exceptions are:

> "No deduction should be made for investor's contributions included in an associated transfer.."[7]

> "For the purposes of assessing the defined benefits of the occupational

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6 FSA Bulletin 14 at p. 2.

7 PIA Opt-Outs and Non-Joiners Guidance 1995 at Appendix B-4.

scheme, Additional Voluntary Contributions should be excluded only when made on a money purchase basis."[8]

I approach this by saying that the Transfer of the AVC as being part of the main scheme benefits is in the review and, therefore, the redress test applies. These two extracts of the Guidance merely mean that money purchase AVCs should not be included in the main comparison between scheme benefits and personal pension or section 32 which must make sense. Unfortunately, the Guidance is internally contradictory as regards added years.

The problem is that the consensus in the industry seems to be to ignore AVCs and just shove them back into the main scheme if reinstating. Otherwise, firms are just keeping the AVCs without augmenting them to take into account the lower charges under the AVC scheme. Again, the vacuousness of the Guidance produces some very odd results. Why should an FSAVC falling within that review be treated differently and more favourably than a transferred AVC? They are basically the same animal. Furthermore, if the AVC is somehow outside the review, doesn't rule 7.2.1(3)(c) require in all cases that the AVC be compared with what it would have been worth in the OPS AVC facility?

(iii) Transfer non-joiners and GPP benefits - silence!

Reading the Transfers Guidance, one would have thought that the only comparison required is between the OPS (or transfer club equivalent) and the transfer policy. However, where a firm has recommended a transfer to a policyholder who could have joined an OPS, without selling the client a regular or single premium personal pension, APP or term assurance, the Guidance has nothing to say. The answer should be that one applies the redress principle and treat the case as a non-joiner. The only exception here would be if the adviser expressly limited his advice to the area of transfers. It is only way to reconcile the Guidance with FSA Bulletin 4's inclusion of rebate-only policies within the review regardless of whether the OPS was contracted-out. The justification given was that the advice rather than the nature of the policy sold was all-important.

If you want to upset a Pension Review team in a hurry, mention group personal pensions. The immediate reaction that everyone has is that they are not in the review. This is not correct.

> "PIA has been asked to clarify whether personal pensions sold in the context of a group personal pension scheme are included within the opt-out and non-joiner review. Such cases can be excluded where the member is satisfied from evidence on file that the investors were not eligible for membership of any

8 Annex K-5 Redress Guidance

occupational pension scheme at the time of sale."[9]

Group personal pensions are in the review where the client could have joined an occupational scheme or opted out of one. However, that has nothing to do with redress. What does is the situation where a client has lost GPP benefits as a result of being opted-out of or not joining an OPS. This can happen in two ways. First the scheme may change from being an OPS to a GPP. Secondly, the client may change jobs and fail to join a GPP arrangement.

Following the redress principle, the firm is liable for the lost GPP benefits. If compliant advice had been given, the client would have been led to join the employer pension arrangement knowing why, with employer subsidies and death benefits, it would be better. When offered a GPP, the client would probably have then been attracted to that arrangement over a personal pension. Certainly, the FSAVC Guidance makes a similar assumption in relation to the not dissimilar money purchase AVC arrangements.

The Pension Review Guidance is absolutely silent in this area. Without using a questionnaire, which is probably outlawed by Regulatory Update 33, firms would never be able to discover the GPP. The right answer seems to be to review the case in the ordinary way and only compensate for lost GPP benefits if these losses emerge during the investigation through either the customer, an employer or a scheme indicating that the client may have foregone such benefits. This is not very satisfactory and is a direct result of the Guidance Fault Line. It does, though, fit the Guidance's approach to distress and inconvenience payments.

III: WHOOPS - THE EARLY RETIREMENT PROBLEM

Here the Guidance is fairly vocal. Unfortunately, it appears to have missed the point in a number of cases.

> "Where the investor has exercised an option e.g. to retire early or to commute part of his pension for cash... and equivalent options were available under the occupational scheme it should be assumed that the investor would have taken equivalent action...
>
> When assuming commutation under the scheme, the scheme's commutation rate should be applied to the cash taken under the personal pension and the resulting annuity deducted from the full scheme pension to determine the scheme benefits to be valued." PIA Opt-Outs and Non-Joiners Guidance 1995 at Annex B-1.

PIA Regulatory Update 46 at pp. 3-4 then says:

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9 PIA Transfers Guidance at p. 4.

> "Where the personal pension has been vested prior to scheme retirement age and it is assumed that the investor would have retired early under the scheme at the same date, the redress offer letter must clearly explain the approach adopted and confirm the overall actuarial reduction factor that has been applied. Alternatively the scheme benefits that would have been available at scheme retirement age may be valued."

This all seems fairly innocuous until one realises why people typically took early retirement: bad financial advice. People were advised to transfer in order to take benefits early. This had the effect of messing up their pensions. If poor, it also tended to reduce their state benefits. So, the commutation factor should not be used where a compliant sale would probably have resulted in the client retiring at the normal scheme retirement age. The Guidance does not say this and one can imagine some pensioners distinctly worse off as a result. Again, the redress principle should lead the client to be compensated for lost state benefits from taking early retirement. Only if the firm knows of these losses, will it actually compensate the client. The Guidance does not tell us how pro-active to be.

IV: FORMS OF REDRESS

(i) Reinstating into a different scheme - Guidance in a muddle

Where the scheme for which the client is now eligible is inferior to the one in which the customer was or should have been a member, the Guidance seems unsure as to whether the client should be reinstated at all. A few sample pieces of Guidance can illustrate this.

> "In the case of opt-outs where the investor is still in relevant employment reinstatement for past service at reasonable cost should be offered and is the preferred approach." PIA Redress Guidance 1995 at p. 11

> "Is full reinstatement and readmission for future service available on same terms as if opt-out had not taken place? [If] no, consider augmentation of personal pension/other forms of redress." PIA Redress Guidance 1995 at p. 5.
> "Identify how, if at all, reinstated benefits will differ from those that would have applied if the investor had not opted-out/failed to join." PIA Redress Guidance 1995 at p. 10.

> ".. It is possible that reinstatement.. will be offered .. on different terms. This is acceptable provided the reinstated benefits and the future benefits on readmission are equally valuable as the benefits would have been had he/she not opted out. .. If the reinstated benefits are less valuable, the balance of the redress may need to be provided by an augmentation of the personal pension.." SIB Pension Transfers and Opt-Outs Review of Past Business: Part II: Specification of Standards and Procedures at p. 79 adopted in PIA Opt-Outs and Non-Joiners Guidance 1995 at Appendix C-3.

On grounds of age and sanity, I go for the last of these. However, augmentation of the personal pension is likely to be the wrong answer. After all the pension may very well have been transferred in its entirety to the OPS. Would it not make more sense for the customer to have the benefit of the lower charges in the AVC? There should, though, be an adjustment for future charges on the personal pension to avoid that problem. So, it is not serious. What is annoying is the regulators' inability in six years to clear up a confusion in its original guidance.

(ii) Money purchase scheme opt-outs and non-joiners - rewarding bad record-keeping

The origins of the FSAVC Review's disastrous approach to redress can be found in the RU 46 treatment of opt-outs and non-joiners where the OPS was a money purchase one.

> "When calculating the loss for opt-outs and non-joiners from money purchase schemes, the likely causes of loss are heavier expense loadings under the personal pension and the value of lost employer's contributions. In addition, any loss or gain from contracting in, when opting out or not joining a contracted out scheme should be taken into account. The lost employer contributions can be valued by accumulating them at either
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> - the actual return they would have earned under the employer's scheme
> - the return they would have earned if they had been invested in personal pension, suitably adjusted for the difference in charges.
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> The latter approach may be used on the basis that the investor understood the investment risk and chose to accept it. The latter approach may be adopted if there is no evidence to the contrary on the file."[10]

A short-cut is a short-cut. We all have to finish this review before doomsday. What is spectacular here is that firms can assume that the client was happy with the investment risk if there is no evidence to the contrary on file. If the adviser was daft enough to keep the fact-find, and it records a cautious risk profile, his company may have to do the long-version of the redress calculation. This is rewarding bad record-keeping, a strange approach for a regulator.

III: CHANGE OF EMPLOYMENT - THE PRICE OF LOBBYING

This subject was not the regulator's finest hour. The redress principle made it reasonably clear that a client's change of employment would not affect the firm's liability in opt-out/non-joiner cases. In either situation, the adviser's bad advice and failure to disclose the benefits of OPS membership, not to mention front-end charges on the personal pension are likely to have substantially contributed to the customer's decision not to join subsequent schemes. There was a hint of this in January 1997 in

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10 RU46 at p. 4.

a question drafted as part of the SIB Simplification Guidance.[11] However, it was not until FSA Bulletin 1 the following year that the regulator finally broke cover. It expressed the view indicated here about the basic redress approach.

> "When an opt out or non-joiner who has been mis-sold a personal pension subsequently changes employment this may, but does not automatically, have the effect of limiting the financial loss suffered from the original non-compliant advice, and so the liability for redress.
>
> The general position in law is that a firm that mis-sold a personal pension is liable for all loss subsequently caused by its actions which was reasonably foreseeable at the time. This liability could extend to loss incurred as a result of the investor's failure to join the occupational scheme(s) of subsequent employer(s). This might be, for example, where the investor continues to rely upon original bad advice as to the relative merits of occupational schemes and personal pensions.
>
> Once the original non-compliant advice is established or conceded, the onus is upon the firm to establish whether there was loss subsequent to change of employment and, if so, whether its original advice was responsible for it."

Then it wrecked it. It introduced three assumed exceptions, each of which was wrong in different ways.

> "... Firms may assume that their liability is curtailed following a change of employment where it is established that:
> - the investor joins the new employer's scheme; or
> - the new employer does not have a scheme to join, or the investor is not eligible for it; or
> - the investor received advice regarding pension arrangements from another adviser at the time of or prior to changing employment."

The first point is that the introductory words to the bullet points could mean two totally different things about the date on which liability ends. Is it after the relevant period of employment or after the relevant event? It makes a big difference to bullet point 3. My view is that it means the end of the period of relevant employment at least for bullet point 3. If a firm opts a client out of the ICI scheme, he should logically be liable at least for all of the ICI period. It must, however, mean the event for bullet 1 or that makes no sense at all.

The problem with the first bullet point is purely a drafting matter. Surely, joining the first employer's scheme would have the same effect. It would have helped if the Bulletin had said what the FSAVC Guidance makes clear, namely that if the client

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11 SIB Simplifying the Pensions Review: Amending Guidance, January 1997 at p. 6.

starts up payments into a pension with the firm, liability will probably re-start.[12]

The second bullet point does not make sense and was expressly abandoned in the FSAVC Guidance.[13] It has never been clear what it means. However, the FSA, in spite of submissions on the subject has never accepted that it should be deleted. The best it managed was two bulletins later:

> Q4: If an investor moves from pensionable employment into non-pensionable employment (or unemployment) and then back into pensionable employment, does a firm have to review the second period of pensionable employment?
> A4: If the investor has not joined the occupational scheme offered by his employer in the second period of pensionable employment, the reviewing firm needs to consider whether this is caused by its initial advice and review accordingly."[14]

I presume that this kills bullet point 2. Since we all make mistakes, it would have been good for the regulator to own up to this one.

Bullet point 3 is the nightmare. The FSA confirmed its existence in Bulletin 3:

> "Q1: The guidance in the November bulletin suggests that where a change of employment takes place and at that time or before a second adviser was involved, the liability of the first adviser may be curtailed. Does this mean that the first reviewer no longer has to review the whole period?
> A1:.. Where an investor received later advice regarding pension arrangements from a second adviser and then or later changed employment, the FSA takes the pragmatic view that it is reasonable to assume a strong likelihood that the causal link between the original advice and any ongoing loss has been broken. It is therefore not necessary for firms with cases in these circumstances initially to assume that they may have some liability for all service."

This is wrong in principle. If the first adviser had acted in a compliant way, the customer would probably have joined or remained a member of the OPS and would not have accepted the second piece of advice. The first piece of advice reinforces the second and vice versa. Where there are a number of advisers and changes of employment, the review process is carved up into little pieces with different firms looking at arbitrarily determined periods of employment. Where firms differ in the Option they take, it creates even more chaos with customers losing compensation for periods of service at random intervals. It should be noted that the FSAVC Review

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12 Para 6.20.6 & 12-13.

13 Para 6.20.11.

14 FSA Bulletin 3, p. 2

has effectively abandoned bullet point 3 by limiting it to advice given "on" change of employment.[15]

Instead of telling firms who had done the review wrongly first time around, that they should remedy these problems, the regulator failed to be true to its mission of running a pro-active review. FSA Bulletin 1 goes on:

> ".. Where firms have not assessed their liability for loss.. for periods following change of employment, they should contact all investors who may be affected and explain that their previous offer.. took into account only.. the employment at the time of the original sale. Investors should be told that if they are concerned about their pension position with respect to any subsequent periods of employment they should contact the firm, who will then conduct a further review...
>
> For Phase 2 cases firms may choose either of the following approaches:
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> Option 1
> Where firms perceive that they are unlikely to be able to establish a break in the causal link between their advice and any loss from periods of subsequent employment, they may investigate all periods of employment before informing the investor of the outcome of the review.
>
> Option 2
> Alternatively they may assess the position with regard to the first period of employment and then communicate the results of this investigation to the investor. As part of this.. firms should explain that their investigation has only taken into account the benefits lost in respect of the employment at the time of the sale. Investors should be told that if they are concerned about their pension position with respect to any subsequent periods.., they should contact the firm who will carry out a further review."

The bizarreness of this choice between doing the review properly and not doing it properly must have become apparent later in 1999 when the case closure rules were set up differently for Option 1 and Option 2 companies. Again, if the regulator felt that Option 2 was too generous, it should have withdrawn it at least for future cases.

As it is, Option 2 companies have what can be politely described as a "leaky discharge" in their change of employment cases and are technically exposed to a future claims. In reality, though, many companies will regard that as a cheap price to pay for not clearing up substantial periods of subsequent employments.

Finally, we have the curious assumption that if, had compliant advice been given the client would not have received preserved benefits, on leaving an occupational

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15 Para 6.19.2.

scheme after less than two years OPS membership, no loss will have been caused to the client.

> "Firms are not required to carry out a loss assessment where an investor would only have been entitled to a refund of his own contributions had he joined his occupational scheme instead of taking out a personal pension... However,.. firms should consider subsequent periods of employment for 'no loss' cases before concluding that the investor has not suffered a prospective loss overall."

This may be true in many cases. It very definitely is not true in a fair number. Where the client non-joined a scheme within a year of leaving the job and sensibly joined the scheme at her new job straight away, she is likely to have suffered the loss of her pension premiums plus interest. These will have been eaten up in the front-end charges. Some companies give no value to clients who have not maintained their payments for five years! The true loss in these cases is the refund of OPS contributions that the client would have received accumulated at base rates less the premiums contributed plus interest at bank base rates. Any pension fund left over can be deducted from the compensation.

The point of all this is that where a client queries the "no loss" assumption, firms would be well-advised to do the calculation manually. Otherwise, these policyholders, often with modest losses, can be a huge drain on resources and source of embarrassment to firms.

V: OVER- AND UNDER-CONTRIBUTION TO THE PERSONAL PENSION - TOO MUCH, TOO LITTLE, TOO LATE....

(i) Over-Contribution

(a) Reinstatement

Starting with the original SIB Guidance, there has always been a certain lack of coherence in the regulator's treatment of over-contributions.

The Basic SIB Rule was effectively to transfer the over-contribution plus interest to the AVC scheme.

> "Where the investor has paid more.. to the personal pension than he/she would have paid to the occupational scheme, the accumulated value of the 'overpayment' should not be used as part of the reinstatement cost, but should be paid into an additional voluntary contribution fund."[16]

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16 SIB Pensions Transfers and Opt Outs Review of Past Business: Part II: Specification of Standards and Procedures at p. 80

This was based on the erroneous assumption that bank base rates and AVC performance were identical. The latter with the advantages of equity investment and tax breaks should do considerably better over the years.

PIA seems to have become aware of this. In its Regulatory Update 46,[17] firms were now required to take into account pension fund performance of the one type of pension the client would never have had if compliant advice had been given, a personal pension.

> ".. where there is an excess of personal pension contributions, the proportion of benefits arising from these contributions should be deducted from the personal pension thereby taking account of the personal pension fund performance.
>
> Where a firm uses an alternative method.. it should be able to demonstrate that the approach adopted does not materially understate the redress.. where good personal pension fund performance has been achieved."

This would probably not matter much if charges on the personal pension are taken into account in the calculation. Unfortunately, they are not. So, the client loses the benefits of the lower charges on the AVC as compared with the personal pension, not to mention any matched or subsidised benefits. Compensation for these types of losses are at the heart of the FSAVC Review. It is a little strange to see them apparently ignored in the Pension Review.

Bizarrely, the Inland Revenue delicately found the right answer. In PSO 21, it said:

> "14. There will be individuals who were (or would have been) required to contribute to their OPSs at a rate of say, 5% of salary but who, when they became members of PPS, were able to pay contributions at the rate of, for example 20%. In the event of reinstatement or instatement, sums representing such "excess" contributions should to the maximum extent possible,.. be placed in the receiving OPS's AVC facility..
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> 17. In the examples given above, income "build-up" should be calculated by having regard to the actual returns achieved by the scheme's main fund or AVC facility or other suitable indicators.."

The regulator missed it.

(b) Top-ups

I have searched long and hard for any coherent guidance on taking into account over-contributions in augmentation cases. I do not think that any exists. The

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17 RU 46 at p. 5.

calculation software which the regulator would have objected to by now all seems to work on the basis that one deducts from the OPS and personal pension values the contributions that would have been made or were made to them respectively adding bank base rates to both sides. The result is the loss and the redress is that figure divided by the value of the personal pension. This has the same effect as RU46. It calculates the loss with regard to the over-contributions on the basis of growth on the personal pension and not the AVC or OPS where the money would have been paid had compliant advice been given.

Curiously, a more accurate result could probably have been achieved by excluding the over-contributions from the calculations initially, producing a redress percentage and then applying it to the whole pension policy. This would give the client the growth that the OPS would have generated. Again, though, there is no provision for compensating investors who have lost matched or subsidised benefits by not paying over-contributions to the AVC.

(c) Pension contributions relating to different concurrent employments

We are concerned here with a customer who has two employments and typically has never joined the second employer's scheme and is either an opt-out or a non-joiner from the first one. The proposal form typically states that the pensionable earnings come from the first employer. The first scheme in many of these cases is Local Government. When changing authorities, the employee may be persuaded to join the scheme. Since the client still has other earnings from the evening job, she can continue contributing to a personal pension and does so. This is a messy situation and the Guidance perhaps could not have anticipated it. All it says on the subject is the following:

> "The accumulated value of contributions to the personal pension (including the DSS) in respect of earnings other than in respect of the relevant employment should be excluded. That part of the fund representing these other contributions should be excluded."[18]

This looks much easier than it is largely because there are so many possible answers. My personal preference is to offer the client a "smorgasbord" of offers.

The first question, though, is whether the client is a non-joiner of the second employer's scheme. If she is, it may raise an awkward question for option 2 companies if the second employment was acquired after the firm's advice. Is the acquisition of an employment, without leaving the original one, a change of employment? I do not think it is although the arguments are evenly divided. Since the Option 2 approach is fundamental unsound, one has to assume that the regulator will not want it to be extended where there is any doubt. For example, nobody would suggest that an Option 2 company is not liable to review the whole of a Local

18Annex K-5 Redress Guidance

Government period pro-actively where the client has moved from one authority to another.

If the customer could have joined the second employer's scheme, reinstatement or augmentation will be required in respect of that loss of service. It could very well generate a nasty under-contribution problem as a result.

We will assume that the client is not eligible for an OPS at the second employer. The Guidance requires firms to offer to keep the personal pension separate from the calculations insofar as it relates to net relevant earnings at the second employer. However, from what point, should this occur - the date of joining the Local Government Scheme or the start of the second employment? The logical answer is the latter.

Firms will, though, have to calculate, the level of personal pension premium which the client could pay with respect to that employment. The rest, at least after the date of joining the Local Government Scheme, has to be offered to the client as a refund with interest as an illegal premium.

The PIAOB has rightly ruled in a case that, where there is concurrent membership, the client is entitled not just to a refund but effectively reinstatement into the AVC arrangement of the OPS if available. So, that should be offered for premiums paid after joining the first scheme.

The other alternative is to treat some or all of the personal pension premiums as if they were over-contributions in respect of the Local Government Service regardless of whether they were paid before or after the customer joined the scheme. This, of course, assumes that the personal pension payments were at a higher level than would have been required under the OPS.

To obtain a safe closure, I would offer all these alternatives.

(ii) Under-Contribution

(a) The Basic Rule

The SIB Guidance laid down the basic rule on under-contributions. The PIA Guidance has always been curiously silent on the subject.

> "Where the investor has saved on past contributions, he/she should be offered a choice, either:
> M himself/herself to pay the extra 'underpayment' of contributions, accumulated at clearing bank rate; and be granted full reinstatement; or
> M not to pay the extra contributions and have an appropriately reduced

pension on reinstatement."[19]

There are a number of problems with this. First, it looks as though it only applies to reinstatement. Secondly, it wrongly assumes that partial reinstatement will be available when it usually is not. Some firms developed the habit of offering the client reinstatement only if he made up the under-contribution. Where partial reinstatement is not possible, the strict wording of the SIB Guidance does not permit this. The client has to be offered a choice between full reinstatement and partial reinstatement. Where the latter option does not exist, no deduction can be made.

Anyway, firms always had the option of arguing that the reinstatement costs were unreasonable. This was confirmed by FSA Bulletin 6.

The apparent vacuum in relation to top-ups was partially closed by PIA Opt-Outs Guidance.

> "Where there is a shortfall of contributions then the accumulated value of the shortfall, accumulated at clearing bank base rate without deduction of tax should be deducted from the scheme value."[20]

Then it all went very wrong. In FSA Bulletin 2 in December 1998, the FSA suddenly decided to extend the requirement of inviting the customers to make up the difference in under-contribution cases to top-ups. This was more significant than it appeared. Many companies had waived the investor savings in reinstatement cases. However, the calculators all had a built-in arrangement for making a reduction in redress for top-up cases. Although firms could have extrapolated from the SIB Guidance that an invitation to make up the difference would be required in top-up cases, it was far from obvious. Anyway, there are plenty of logical "extrapolations" which the regulator has never required firms to make in other pension review contexts.

FSA Bulletin 2 said:

> "Where an investor has a contribution shortfall the FSA guidance provides that reviewing firms may take account of this under-contribution (i.e. make a deduction for it) in assessing whether the investor has suffered a loss and in calculating any redress.
>
> In assessing loss, it should be assumed that where a contribution shortfall has occurred the investor will mitigate his loss by making good that shortfall. Due allowance should therefore be made for future charges on contribution

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19SIB Pensions Transfers and Opt Outs Review of Past Business: Part II: Specification of Standards and Procedures at p. 80

20 PIA Opt-Outs and Non-Joiners Guidance 1995 at Appendix B-4

shortfalls in loss assessment."

This approach is very different from the approach to mitigating loss that one finds in PIA RU33 in connection with opting people back into schemes. There, the view is more accurately taken that the investor has to do very little to mitigate their loss. The approach taken here defies all evidence. Very few people have ever taken up such an invitation to make up the shortfall. In some cases, they could not afford it if they wanted to. The idea of making an allowance for future charges for an imaginary contribution smacks of fantasy.

Those firms who had failed to make this allowance now had to write to clients whose cases had already been completed inviting them to make up the difference on a charge-free basis. They were then supposed to

> "suggest investors consider making good their under-contribution and offer to meet relevant future charges on the personal pension if they indicate that they will do so."

Whatever happened to the rules on only giving investment advice while authorised?

Other firms who had made the appropriate charges allowance did not have to re-open any files. Everyone, though, presumably would have to allow for future charges on contribution shortfalls. That is the wrong answer again:

> "Future cases
> Although the FSA believes that future charges on contribution shortfalls should be allowed for in loss assessment calculations, to does not believe it would be proportionate for regulators to require firms now to amend their calculation software and/or procedures to allow for this. Firms should however inform investors when offering redress in the form of a policy augmentation that the redress amount has been reduced by the amount of their contribution shortfall (if this is the case). They should that investors consider whether they want to make good their under-contribution and either offer to meet relevant future charges on the personal pension if they indicate that they will do so; or confirm that their redress has already provided for such future charges."

(b) Two Exceptions provided by Law

Anyway, the Guidance was quite wrong to allow deductions for under-contributions in the first place. In R v ICS ex p Bowden,[21], the Court of Appeal said:

> "We are satisfied that the common law principles of compensation require that there should in the present case be no deductions for the sums which were paid to the investors in accordance with the transaction which they had

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21[1995] 1 WLR 157

> entered and which were subsequently disbursed by them. Whether dissipated benefit is a recoverable loss must depend on the circumstances. But here the very purpose of the transaction.. was the achievement of an increase in income... That being so expenditure of the money, once it had been paid to the investors was plainly foreseeable and if that expenditure was on ephemera so that no lasting benefit accrued there was a loss which sounds in undiminished damages against the financial advisers."

The PIA Ombudsman, in one of his News from the Ombudsman Bureau not unreasonably suggested that the Bowden principle should knock out any deductions for under-contributions so long as they were substantial:

> “The employee might have been advised by a representative that 3% was sufficient to provide him with an adequate pension on retirement. Such a situation would fall with the possible spectrum of actual circumstances at one of which is the investor who is promised more performance for less money to the other end where an investor truly is unwilling or unable to afford a contribution at the Occupational Scheme level. Depending where the case falls on its facts within that spectrum would depend whether the common law principles applied in the Bowden case operated. Under the PIA Guidelines where the compensation is to be made by topping up a Personal Pension or the funding of the necessary transfer value to reinstate an Occupational Pension, the topping up or funding obligation would be reduced by the amount of the saving from the lower level of contributions. The Bureau regard the Bowden case as authority for saying that, in certain circumstances, compensation should be calculated without regard for the payment of a reduced contribution. .. The Bureau recognises that if the under payment was a very modest sum it might be difficult for the complainant to argue that he has adjusted his spending pattern accordingly with the result that the saving has been irretrievably dissipated and that he would suffer financial hardship even where the company was prepared to provide some period of credit over which the under payment could be made good.”[22]

It remains open to his successor to take the same view on the basis that “the particular circumstances of the case are not addressed by the standards”.[23] More surreally, the FSA in its Policy Statement on Mortgage Endowment Complaints has almost ruled out the deduction of cost savings from compensation in that area on the basis of the Bowden judgement.[24] The inconsistency makes absolutely no sense.

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22 PIAOB Annual Report 1998 at p. 74.

23 PIAOB Terms of Reference, para 5.2A.

24 “2.2.8 The circumstances in which it may be appropriate to take some or all of the “savings” into account are those where .. the complainant is of “sufficient means” such that it is **reasonable for a firm to assume that the “savings” have contributed to those means**.” (Emphasis added.) Paragraph 2.2.7 seems to knock out any serious prospect of a deduction

Following the principles in the recent FOS Mortgage Complaints Assessment Guide, not to mention the House of Lords decision in the Equitable Life case, would lead to a different result in a further group of under-contribution cases where the adviser promised to the client that his pension would be as good through the personal pension as under the OPS. Promises made during the sales process can change the contract terms or create a separate agreement or guarantee.[25]

VI: CUSTOMERS WHO CANNOT BE REINSTATED FOR FUTURE SERVICE - GUIDANCE WHERE ARE YOU?

This is just the story of the missing Guidance. The original PIA Guidance said:

> "Where there is no readmission to the occupational scheme for the future, use RPI and 2% plus any extra merit or promotional increases for whatever term is agreed between the firm and the investor."[26]
>
> "Where the investor is still in relevant employment and readmission is not available, the expected future service must be assessed on an individual basis. PIA proposes to issue guidance.... Members are requested to discuss their approach to such cases with the Pensions Unit."[27]

The Guidance has just never been issued.

VII: DEDUCTING THE VALUE OF REPLACEMENT POLICIES - AND THE ORIGINS OF THE DEMUTUALISATION FIASCO

The recent discussion about the deduction of demutualisation benefits had a curious origin with the Guidance's erroneous treatment of replacement policies.

(i) Replacement Policies

The original Guidance permits firms to deduct benefits from policies set up to replace employer-provided benefits.[28]

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when it says that it is unlikely to be reasonable to bring savings into account if the client was told that the endowment approach would be cheaper and the customer has "dissipated" the savings on the strength of this.

25 Equitable Life v. Hyman [2000] 3 All ER 961; Sun Life of Canada v. Jervis [1943] 2 All ER 425; Wake v. Renault (UK) Ltd, Times, 1st August 1996; PIAOB Annual Report 1996-1997 at p. 44. See FOS Briefing Note on Mortgage Endowment Complaints 2000 at p. 6 & the Assessment Guide at p. 53.

26 PIA Redress Guidance 1995 at Annex K-1

27 PIA Redress Guidance 1995 at Annex K-5

28 PIA Opt-Outs and Non-Joiners Guidance 1995 at p.78 & B-2: Transfers: Guidance for Review of Past Business,

> "This adjustment should be strictly limited both in terms of claims and premiums to that proportion of the benefits under the additional policies that replaced those under the scheme."[29]

The PIA Legal Department was told that the Guidance contradicted the House of Lords's decision in Parry v. Cleaver.[30] That decided that no deductions could be made from a damages award with respect to a pay-out under an insurance policy. It was in the public interest that people insure themselves against risks. It could not be held against them if their premium payments produced a reward. A legal opinion was obtained to the effect that Parry v. Cleaver could not apply to pensions. Since the Court of Appeal had applied it to reinsurance in the early 90s[31], this was all very curious. As the Vice-Chancellor said in Needler Financial Services v. Taber after quoting from a judgement of Lord Bridge:

> "Lord Bridge went on to point out that the classic exceptions to the general rule are (1) moneys accruing to the claimant from insurance for which he has paid... The reasons for these exceptions are explained by Lord Reid in Parry v. Cleaver [1970] A.C. 1, 13 and depend, ultimately on considerations of justice, reasonableness and public policy."[32]

Coming in the case on demutualisation and the pension review, this extract does not suggest that the PIA Legal Department was right to conclude that Parry v. Cleaver would not be applicable to a pension review case.

The problem was exacerbated by the fact that nobody knew what was meant by a replacement policy. Some strange deductions made by firms led the PIA to say in Regulatory Update 46:

> "Only life cover specifically purchased to replace life cover that would have been available under the scheme, can be taken into account to offset against any loss."[33]

What did one need to make a deduction? Need there be a fact-find indicating clearly

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PIA, July 1995 at p 67 & B-3 & C3.

29 PIA Opt-Outs and Non-Joiners Guidance 1995 at Appendix B-2

30 [1970] A.C. 1

31 Brown v. KMR Services [1994] All ER 385 at p. 399. This point was not even argued before the Court of Appeal [1995] 4 All ER 498.

32 Unreported, 31st July 2001 per Morritt VC at paragraph 15 of the transcript.

33 PIA Regulatory Update 46 at p. 4.

that the policy was designed to replace a scheme benefit? It does seem to be the logical interpretation of RU46. Why should a firm be allowed to deduct benefits paid to the client in return for his premium? This was never answered. It is of course, the rationale behind the rule in Parry v. Cleaver that the client should be rewarded for his premium by not having the resulting benefits deducted.

While life assurance savings plans seemed to be outside the scope of the idea of a replacement policy, what was inside it? Term assurance had to be included or there would be nothing to which one could apply this Guidance. What, though, of whole of life policies? A problem here of parting company with the law is that we have no principles or analogous examples on which to fall back. For what it is worth, whole of life contracts are so different from death in service in the way in which they contain an investment element that I do not think that such a policy can be used. PHI policies can just about be regarded as replacements for early retirement due to disability. That is about all.

(ii) Demutualisation

When PIA first turned its attention to the effects of demutualisation, it expressed itself in curious terms bearing in mind its earlier position on replacement policies.

> "We regard the share value purely as the price paid by the demutualising entity for the exchange of membership rights in favour of shareholder rights. The actual value in the hands of the investor is entirely collateral to the value of whatever investment contract he or she may have. It follows, therefore, that the financial impact of demutualisation should be ignored in calculation of loss or redress."[34]

So, we are expected to believe that replacement contracts are not collateral but shares and cash paid out under the policy question are.
What is annoying here is that the solution was not that difficult to justify. Firms were struggling to finish the review punctually. The Guidance gave them a serious of short-cuts and concessions on replacement policies, under- and over-contribution, replacement policies and change of employment. In the interests of completing the review promptly, firms could be asked to pay perhaps over the odds. Otherwise, they were going to be faced with the horrors of what can be described as "a Bowden exercise"[35]. That would allow deduction only of demutualisation benefits to the extent that they could be traced to assets of the policyholder. Even then, only the re-sale value of that asset could be deducted.

In other words, if the regulator had been open about its motives, much of the recent discussion would never have happened and the review would have been finished

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34 PIA RU33 at p. 6

35R v ICS ex p Bowden [1995] 1 WLR 157

more quickly. As it is, the statement of a broad legal principle in RU33 which contradicts the approach of the Guidance with regard to replacement policies made it much easier to anticipate that the Courts would disagree with the regulatory update if it was ever challenged in court.

At the very least, if the PIA had buttressed its view of the law with a pragmatic argument, the route to the High Court would have been more difficult.

The Needler case reached the High Court by a strange route. Any firm affected by Regulatory Update 33's treatment of demutualisation could have applied to the High Court in 1997 for judicial review of the PIA's actions on the basis that they were unlawful or wholly unreasonable and so exceeded the regulator's powers. No such action was brought within the strict time-limits for such applications.

Mr Taber brought a complaint against Needler to the PIA Ombudsman. There is a curious provision in the paragraph 7 of the PIAOB's Terms of Reference that allows a firm complained against to give notice to the Ombudsman that the complaint may involve a an issue with important consequences for the business of firms generally or an important or novel point of law. The PIA member must agree that if either it or the client starts a court action within six months, it will pay the costs of the complainant. The Ombudsman then has a discretion as to whether to stop looking at the complaint. There have only been two cases brought to court under this procedure, the Needler case and Equitable Life v. Hyman.[36]

What is curious about this whole process is that the Ombudsman could not have found in favour of the IFA if he had applied its own Terms of Reference properly. Paragraph 5.2 requires the Ombudsman to apply the PIA's Standards of Redress if they favour the customer over the law. Regulatory Update 33 must, therefore, be applied in preference to the legal position if it is more favourable to the customer. In other words, the complaint did not raise a point of law at all. This became a point of discussion in the case even though eventually the judge did not express an opinion on it.

The PI insurers had one simple point. The IFA's advice may have resulted in a loss to Mr Taber but it had also caused him to benefit from the shares that he received from the de-mutualisation. They saw no reason why the client should come away better off through the bad advice he had received at their expense.

The policyholder had three arguments. First, he said that the windfall gain was unconnected to the non-compliant advice. Secondly, he argued that windfalls should be treated like the proceeds of insurance. Finally, he argued that under the pension review process, the client was entitled to redress calculated in a way prescribed by the relevant regulator and not the law.

36[2000] 3 All ER 961.

He won on his first point and the judge declined to express an opinion on the other two. He made it clear that it made no difference what form any demutualisation benefit took.[37] The key part of the judgement begins:

> "24. The relevant question is whether the negligence which caused the loss also caused the profit in the sense that the latter was part of a continuous transaction of which the former was the inception..."

This, though, rather begs the question: what is part of a continuous transaction that occurs after the original transaction is completed? What is really going on here is that the judge is making a value or policy judgement as to what events are sufficiently closely connected to the negligence for him to take them into account. The judge goes on.

> "26. It is true that but for the negligence of Needler Mr Taber would not have taken out the PPP. It is also true that but for the PPP Mr Taber would not have received any demutualisation benefit. Even allowing for these factors the demutualisation benefit was not caused by and did not flow, as part of a continuous transaction, from the negligence. In causation terms, the breach of duty gave rise to the opportunity to receive the benefit but did not cause it...The link between the negligence and the benefit was broken by all those events in the mid 1990s and later which led to the directors of the Society formulating and the court approving... the transfer of the long term insurance business of the Society to LP."

Curiously, the first sentence of this paragraph re-states the standard redress position under the Guidance. The judge then seeks to put a limit on it by restricting recovery as a matter of law to those losses caused by and flowing as part of a continuous transaction from the bad advice to transfer. In other words, firms should not use this judgement as an excuse for not offering compensation. It seeks to restrict redress in a way that the PIA Redress Guidance does not. Insurers and IFAs are regulated by regulators, not the courts.

To return to the strict facts of the case, the court does not explain coherently why the payment of benefits arising from the demutualisation did not flow from the advice to take out a policy with a mutual assurer. Maybe, the case hinges on a factually debatable proposition in the next paragraph:

> 27. The matter may be tested in this way. Would Mr Taber have received comparable benefits from his PPP if there had been no demutualisation? The answer is plainly in the negative. Mr Taber was contractually entitled to share in the profits of the society by way of bonus. Such bonus was likely to provide him with a reasonable return on his asset share in accordance with the PRE. But in the absence of the transfer of the long term business.. or the winding up

37 Paragraph 25.

> or closure of the Society to new business it was most unlikely that he would ever share in a distribution of the inherited estate. But by virtue of the demutualisation he did..."

This presupposes that de-mutualisation was not considered likely when the pension sale took place. It was clearly an option then. Was it most unlikely? I do not know.

Perhaps a better way of looking at this is that the law puts a cut-off point on the benefits received by a claimant from the defendant's negligence. However, it usually excludes only events that were unforeseeable when the wrong occurred.

In one case, cited by the High Court, Hussey v. Eels[38], the clients were misled into buying a house which suffered from subsidence. Later, they demolished the house and obtained planning permission to build two new homes on the site. They then sold the property at a considerable profit. The Court of Appeal declined to permit the defendant to take reduce his damages by the profit. It felt that the decision to sell the land for development when they had originally bought it to live on was nothing to do with the original transaction. The idea is that people who give bad advice should not benefit from events which were not foreseeable at the time of the advice. This is particularly the case where the claimant or a third party did something that it could easily not have done.

It all comes down to judicial feel. Strictly speaking, one could argue that this judgement only covers the case where demutualisation was unforeseeable at the point of sale. Where it was definitely on the cards when the sale took place, the answer could be different. However, the PIA/FSA has indicated that it will not create a string of exceptions in this area for different fact situations. Reasonably, it takes the view that if the court approves of RU33's analysis, that will be enough. In regulation, one can create too many exceptions to make things work.

Anyway, the judge concludes:

> "28. For these reasons I conclude that the demutualisation benefit received by Mr Taber was not caused by the mis-selling by Needler of which he complained. Thus, the common law principles for the assessment of damages do not require the value of the benefit of the demutualisation shares issued to Mr Taber to be brought into account in diminution of the compensation to be awarded to him for Needler's breach of duty. It follows that the questions whether if the general rule had applied the demutualisation benefits should be excepted by analogy with the exceptions.. in Parry v. Cleaver.. and whether the Pension Review procedure conferred on Mr Taber an entitlement to compensation in excess of what would have been recoverable at law do not arise."

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38 [1990] 2 QB 227.

It is a shame that the judge failed to deal with the other two arguments. It would have helped to have some indication of the judge's views on them.

The final argument is particularly interesting and important. Regulators in designing reviews cannot allow each case to be treated like a High Court trial. The job would never be finished if they did. So, they build short-cuts into the process. In doing so, sometimes they appear to favour the industry (under- and over-contribution, replacement policies, change of employment and previously closed no loss cases) as compared with the legal position and sometimes it may be the other way around (reinstatement is not required in a court of law). There is a balance involved.

What the test case sought to do was to disturb this equilibrium. The PI insurers wanted to force the regulators to apply the law when it favoured them without being prepared to accept the application of legal principles when it did not assist their cause. The point that the judge did not reach but which would have been open for discussion in any appeal is whether the court should be prepared to decide a case in a way which contradicts the Ombudsman's Terms of Reference and reasonably drafted guidance.

The last thing that PI insurers really want is a pension review based purely on legal principles. That would be seriously expensive. Against that background, the regulator has to be allowed to regulate without interference from the courts unless its conclusions are wholly unreasonable. Where this is the case, an application for judicial review brought promptly is the correct remedy.

One awkward side-wind of the test case as far as the pension review industry is concerned relates to bonuses added to policies. These will have to be deducted for the purposes of loss assessment and kept in place in reinstatements assuming that the PIA/FSA and FOS propose to apply the full logic of the High Court's decision. As the judge says at paragraph 25:

> "The profit in this case is the holding of demutualisation shares issued to Mr Taber, but it might just as easily have taken the form of a cash payment or an additional bonus. I can see no reason for drawing any distinction based on the form in which the benefit was received."

Following the abandonment of a possible appeal, the PIA issued Regulatory Update94 in October 2001. On the pension review, clearly any windfall benefits in the form of cash and shares would not be deductible from any future compensation. It announced that the Financial Services Authority would conduct a consultation exercise as to whether windfall policy augmentations on demutualisation or similar events should be taken into account. It refers to "technical and practical issues". It continues:

> "In the meantime, where an investor has received a windfall benefit in the form of a policy augmentation, firms should continue to progress the case up to the point where the windfall benefit becomes a relevant consideration (i.e. in the

calculation of loss). **Beyond this stage firms should suspend progress pending the issue of guidance and keep the investor informed as to the reason for the delay.** Where an offer has been made for an affected case which has not been accepted firms should withdraw the offer, explaining to the investor that this has been done pending further guidance from the regulator about the treatment of windfall benefits.

.. The Regulatory Update does not require firms to reopen cases where an offer of redress has already been accepted by the investor or no redress is due in accordance with pre-existing guidance."

This last point contains a small trap. No offer including a deduction for demutualisation was permitted under Regulatory Update 33.

The logical position would be to follow the decision in the Needler case and bar deduction of demutualisation benefits in whatever form they take. This will create practical problems. Firms will have to be very careful to deduct the augmentation amounts concerned. However, since the augmentation should be on the records, it should not be that difficult to do.

VIII: PENSION MORTGAGES - ONLY IF YOU REALLY WANT TO TALK ABOUT THEM AGAIN

The regulator must know that many pension sales have left people with no appropriate mortgage cover. It has taken steps to resolve these problems with regard to endowments. Yet, it cannot bring itself to issue guidance on this much more pernicious problem.

The PIAOB has expressed itself forcefully[39] if not entirely accurately on this issue. Essentially, one finds out how much capital would have been repaid from a capital repayment loan, had it been set up for the right amount and the right term at the point of sale. Any mortgage switching costs and the extra cost of any future life cover must be added in. (This last point must follow from the recent "A Briefing Note: Complaints about Mortgage Endowments" and FSA Policy Statement on that subject.[40]) Then, the firm must consider compensating the client for the almost inevitable churning of a pre-existing endowment or decreasing term assurance.

The Ombudsman Bureau has in the past suggested that firms can deduct 25% of the transfer value of the personal pension at least if the client would have had a pension

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39 PIAOB Annual Report 1998-1999 at pp. 29-30 (see also p. 35 for an example)

40 Proposed DISP App 2.5.4; FOS, A Briefing Note: Complaints about Mortgage Endowments at p. 9. For some strange reason, the Assessment Guide seems (at p. 35) to leave this out while purporting to apply the FSA Policy Statement across the board. This item is additional category (a) on page 63. Yet, none of the scenarios point to its application. This is presumably just a slip.

or a mortgage but not both. Since in the pension review context, this either/or scenario is relatively rare, it would make sense to ignore such deductions.

X: PROFESSIONAL FEES

PIA Redress Guidance deals with this issue in simple terms:

> "The investor, in each case where a settlement is offered, must receive a letter detailing:
> ...(e) an invitation to the investor to consider getting outside advice before accepting. The member may indicate that they would not accept any responsibility for the costs incurred in obtaining any such advice."

There are two problems with this. First, it is unprincipled. The firm's advice landed the client in the mess in the first place. He has no reason to trust that organization to calculate his redress correctly. Secondly, in a court of law, the successful party is usually entitled to a reasonable amount for his costs. This is reflected in the PIAOB's normal practice on this subject[41] and recent FSA Guidance on endowment complaints.

All that needs to be said here is that payment of a reasonable fee claimed by an IFA or other expert can save a great deal of money in the long run. When a particularly difficult policyholder's solicitor suggested using Oxford Actuaries to check a calculation, the firm on the receiving end would have been absolutely right to offer to pay both the actuary and the solicitor's costs. Both would have been very good value in a stalemate situation.

41PIAOB Annual Report 1997-1998 at p. 33; PIAOB Annual Report 1996-1997 at p. 39; News from the Ombudsman Bureau, PIA, September 1997 at p. 4

XI: CAPPING LIABILITY - THE END

(i) The Original Guidance

The Guidance on this subject has always had a touch of dual personality about it. The original PIA Redress Guidance said:[42]

> "Where members draw the investor's attention to the desirability of rejoining an employer's scheme, it should be made clear to the investor that the member's liability under the review may be limited to the date by which the investor could reasonably have secured readmission to the scheme.
>
> Where the investor has a personal pension and is currently eligible to join an employer's scheme then the question of whether he/she should rejoin the scheme may be addressed immediately... PIA acknowledges that members may wish to point out to investors that they should take urgent steps to rejoin a scheme for which they remain eligible."

This gave firms the impression that they could threaten to cap their liability and advise customers to join schemes. This seemed all wrong. After all, as the leading author on this subject pointed out:

> "The standard of reasonableness is not high in view of the fact that the defendant is an admitted wrongdoer."[43]

To make matters worse, two other distinguished lawyers had pointed out:

> "In the context of professional negligence a successful plea of contributory negligence.. is relatively uncommon. This may be because the parties do not stand on an equal footing.. If the defendant makes a mistake, it can seldom be said that the /client was negligent not to spot it or correct its effect, unless the client is expected to be wiser than his own professional advisers."[44]

(ii) Not so fast

In 1997, and without so much as an apology, the PIA changed tack dramatically. Regulatory Update 33 said: [45]

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42 At p. 9.

43 McGregor on Damages 16th ed para 322

44 Jackson & Powell on Professional Negligence, 3rd ed at pp. 44-45; see also PIAOB Annual Report 1995-1996 at p. 53 expressing the same view and generally PIAOB Annual Report 1996-1997 at pp. 35-36.

45 At p. 9.

> "PIA is aware that many firms are using standard letters advocating that investors who remain eligible for an occupational pension scheme should rejoin it at the earliest opportunity. Sometimes, these letters are issued before reviewing the investor's particular case.
>
> PIA accepts that firms may write to investors indicating that a failure to rejoin may affect their compensation on the grounds that they have failed to take reasonable steps to mitigate their loss, and this type of letter may help a firm to limit its potential liability.
>
> However, in some cases, firms have purported to limit or "cut-off" the firm's liability for loss, by saying or implying that the firm will not be liable for any loss incurred after the date of the letter or after the date on which the client could reasonably have been expected to respond to the letter by rejoining his or her occupational scheme. This is incorrect and misleading. Firms should not treat the mere despatch of a letter to this effect as in itself operating to cap or "cut-off" the firm's liability. Firms should ensure that their letters do not contain any "cut-off" statement (express or implied) of this sort.
>
> Letters which advocate rejoining must not be used in such a way as to exclude cases or prohibit complaints. Firms may neither exclude nor close cases on the grounds that the investor refuses to rejoin the scheme. Firms must complete the review of such cases in the normal way, but may take appropriate account in the redress calculation of an investor's unreasonable refusal to rejoin.
>
> Many of these standard letters amount to substantive advice (or some other form of inducement to the investor to rely on the firm's judgement) to rejoin in circumstances where the firm has not yet taken any account of the investor's circumstances. This is particularly likely where a suggestion that the investor should rejoin his or her scheme is accompanied by a cut-off threat. In a small proportion of cases, rejoining may not be in the investor's best interests. In those cases, firms can expect to have to compensate investors who have been disadvantaged by rejoining in reliance on the firm's standard letters."

This is all tremendous stuff. Where, though, does it leave project managers with past closures. There is certainly no logical or legal reason why liability should be capped, following an opt-back-in letter, in a shorter period of time than has elapsed between the non-compliant advice and that letter. Everything points the other way. Much also depends on how full the disclosure is in the opt-back-in communications. It is easy for the regulators to take pot-shots at correspondence produced by firms. It is much more difficult for them to be constructive in this area.

Bizarrely, the FSAVC Review sees a return to the original Pension Review

Guidance.

> **"6.9** Provided the position has been adequately explained to investors, firms may assume that the investor will act to mitigate any loss suffered and to which he or she may be exposed in the future. Where an investor is made aware of the availability of employer matching contributions, subsidised benefits or materially lower charges in the in-house AVC arrangement in terms he or she is likely to understand, firms may assume the investor will join the in-house AVC arrangement as soon as they are able.
> **Note to the guidance:** *The FSA has produced a factsheet called 'Joining or rejoining your employer's AVC scheme'. It highlights points that investors may need to think about and details how to get further information...*
> **6.20.6** The end date for the period for loss assessment is the earliest of:
> • The date at which the investor did or could reasonably have been expected to have started to receive the employer's matched contribution or other subsidised benefit by starting to contribute to the in-house AVC arrangement;
> • For cases not involving employer matching or other subsidised benefits, the date at which the investor did or could reasonably be expected to start contributing to the in-house AVC arrangement..
> **6.20.7** Where the investor can rejoin the in-house AVC arrangement but has not yet
> done so, firms should include in the period for loss assessment a period, say three months, that is long enough for the investor to join the in-house AVC arrangement for future service. If the investor can only join at particular dates in the year, this should be taken into account."

The incoherence of the regulator has certain advantages for some firms. It is very difficult for a regulator to take serious disciplinary action where its own Guidance is such a mess. Having said that, teams who have tried to do a good job are being penalised competitively when other organizations have cut corners without encountering the wrath of the PIA/FSA. That is not fair.

(iii) No capping of liability where premiums stopped

There is one subsidiary issue surrounding capping liability that relates to the customer stopping premiums.

PIA Regulatory Update 46 sets out the position reasonably clearly:[46]

> "The lost service liability in respect of an opt-out or non-joiner should not be capped simply because the investor has ceased to pay personal pension contributions prematurely whilst still in service. This includes the situation

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46At pp. 3-4.

> where the investor has vested the personal pension but remains in service. The shortfall in contributions may be taken into account subject to any legal limitations. Any further reduction in liability needs to be justified using... causation."

It cannot be regarded as terribly unreasonable to stop paying premiums into an inappropriate pension policy.

Unfortunately, FSA Bulletin 1[47], without being inconsistent with RU46 on this, manages to muddy the waters. It suggests that evidence of a break in the causal link would be stopping personal pension contributions. This is not helpful.

XII: CONCLUDING REMARKS

As this review comes to an end, it is time for all to reflect on what has been learnt about designing review procedures. At the end of the day, a great number of deserving customers have received a large amount of compensation. This reflects better on this industry than one might think.

Even after seven years of refinements, the Pension Review Guidance remains a bit of a mess. Much of this is unavoidable - the result of a compromise between the feeling that a full pro-active review was justified and the sentiment that such a review was giving customers benefits for which they should have to pay or at least do something to claim.

Some of the problems identified here are the result of Guidance that was not properly checked. After it was found to be faulty, all too often, it was not replaced.

At the end of the review, we have to work with what we have. It is not easy. Now, the greater understanding that we all have has to be put to work in three massive tasks: (1) dealing with the awkward cases that have become stuck at the bottom (2) auditing the projects to see that they are generally sound and (3) helping firms to ensure that it all never happens again.

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47 At p. 2.

REDRESS AND THE FSAVC REVIEW - A VIEW FROM THE PATHOLOGY LAB

Adam Samuel[48]

I: BACKGROUND - SOME POPULATION AND COMPLIANCE NOTES

The FSAVC Review is inherently difficult. One of many reasons for this is that the population to be reviewed does not actually tally with the ideology behind the whole project. The FSA thought that the problem with FSAVC sales was the loss of extra charges and matched and subsidised benefits.[49] However, the scope of the review is not limited to cases where that is the only problem with the sales concerned.

To make matters more difficult, the FSAVC Review Guidance rejected originally the use of a fall-back principle such as we find in the Pension Review: the object of redress is to put the client in the position in which he would have been had the firm acted in a compliant way. That approach, which is also broadly speaking the legal one, was expressly rejected in the Guidance.[50] The difficulty is that when the Guidance's own basic principles do not produce sensible answers, there is nowhere for firms or regulators to fall back on. The result is that regulators will have to fill in the cracks on a piecemeal basis. This all makes results very difficult to predict.

(i) What do we have to review?

The problem starts with population. Once the mailing is finished, firms have to review "all representations or complaints made in connection with, or arising from, the sale of an FSAVC policy during the review period which indicate that the complainant is, or might be, seeking a remedy from the firm in respect of loss or damage."[51]

(ii) Exclusions

Firms can then exclude from their review any cases where complaints or claims in respect of the relevant FSAVC policy/ies have already been resolved on a basis at least equivalent to those set out within this guidance, or by the decision of a judge, arbitrator or ombudsman or a provisionally assessment of the PIA Ombudsman

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48 DipPFS FCIArb

49 Paras 6.3 & 6.8.

50 Para 6.8.

51 Para 2.12.

Bureau.[52] The same applies to cases falling within the somewhat tortured (FSAVC Review) definition of cancelled and not taken up.[53] While FSA Bulletin 4 has further reduced the size of the population to exclude complaints made before 1st January 1998 for those firms inefficient enough not to have informed clients that they would be receiving a review, this does not really help greatly for the purposes of this paper.

(iii) RU20 - the sting in the tail

The FSAVC Review seems to have been crafted on the assumption that advisers could advise all clients either to take out an FSAVC or an AVC. Unfortunately, not only is this not correct, PIA Regulatory Update 20 expressly reminds advisers of the need to compare FSAVCs with PEPs now ISAs. As it says:

> "All advisers should remember that there may be alternatives to AVCs which might suit the client's circumstances. For example, PEPS offer accessibility and, while AVCs benefit from tax relief on contributions, PEP proceeds may be taken tax-free rather than having to be converted into taxable income."

(iv) The Two Redress Tests - Consequences of Not Following the Pension Review!

Reading the Guidance, one gains the impression that there was originally a conscious effort to reject the legal and Pension Review test which requires firms to put the client where he would have been had the firm acted in a compliant way. Then just prior to publishing, the Regulators realised that if they did not install legal "no causal link" and "pure loss" tests, a regulated firm would apply for judicial review. It would be able to argue that the regulators were requiring compensation to be paid where there was no legal liability.[54] This was in effect the first breach in the dyke.

The second came when considering added years arrangements. A charges comparison simply does not work here. One would be comparing apples with pomegranates. Initially, this was faced by requiring reinstatement in added years cases. Only in FSA Bulletin 3 did the FSA realise that in augmentation cases, the charges approach would not work either. So, it sent firms back to the pension review/legal approach.

II: WHICH FUND?

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52 Para 3.2.17 as amended by FSA Bulletin 2 at p. 2.

53 Para 3.1.7 as amended by FSA Bulletin 2.

54 Para 6.25.

With different redress tests and forms of compensation for added years and money purchase cases, inevitably one has to come up with a way of sorting out which approach the client would have followed had he received compliant advice. (We see ourselves falling back on the legal test because there is nowhere else to go.) Clearly, the problem only arises where the employer provided a choice.

The original guidance made a reasonable effort to resolve this difficult issue. 6.15 & 16 provides some reasonably hard criteria such as the fund selected on the FSAVC and retained for the longest period of time and past contributions to a particular AVC. FSA Bulletin 3 seems to add what struck me originally as being reasonably obvious namely that one could consider the risk profile of the client. The original Guidance allows firms to write to the client to ask him or her.[55]

The problem is that a draft letter circulated and then sent to the FSA was so full of leading questions and obscurities that the regulator was quite right to tear into it.[56] Unfortunately, in the process, it may have over-done the job. Its Bulletin 3 does not help greatly in trying to stop firms asking hypothetical questions. Unfortunately, the enquiry is by its definition hypothetical: what would the client have done if he had been given the correct information and advice? It seems a little silly to amend the guidance to stop firms from asking the obvious question to which they need an answer.

Nevertheless, it should not be that difficult to produce a clean letter to clients here. The regulators always like firms to remind clients that their case is being reviewed. So, one can start there. Firms must not manipulate customers into providing answers favourable to the firm. That is a left-over from Regulatory Update 33 and is rightly reflected in Bulletin 3. The advantage here, though, is that until the calculations are done, it is not possible to know which calculation leaves the client in a better position.

So, one has to explain why the question is being asked and give an idea of the consequences of the answers to be given.

"If we decide that compensation is payable in your case, our regulators prescribe two ways of going about this task. Which one we use depends on the type of Additional Voluntary Contribution arrangement to which you would have paid the money you put into the FSAVC. Your employer gave you the option of buying added or extra years service in your occupational scheme or paying into a money-purchase fund. Added years would have provided you with guaranteed benefits. The money-purchase fund would have provided benefits based on the performance of the fund. We cannot say at this stage which would have performed better.

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55 Para 6.15.1.

56 See RU33 at p. 8 the forerunner of FSA Bulletin 3. The latter says "However any further enquiries should be made objectively. For example, it is permissible to ask investors matters of fact to do with their expected career progression at time of sale or about any other investments they had (as an aid to judging likely attitude to risk at that time). But firms should avoid asking hypothetical, subjective or leading questions."

It would help us to conclude the review if you could tell us to which facility of your employers you would have paid your contributions: added years or money purchase. In addition, to check that you have understood the questions here, it would help if you could describe your attitude to investment risk when you took out your FSAVC. Were you cautious in not wanting any significant investment risk? Were you happy to accept some risk in the hope of achieving a greater return?"

I am a great fan of simple tick-box forms. So, I would finish with two questions:

"When you took out your FSAVC, was your attitude to investment risk
Cautious?
Not cautious?

Into which AVC facility of your employers would you have invested your FSAVC contributions?
Added Years
Money Purchase"

Two simple questions should increase the chances of the forms being returned. If the answers to the two questions do not match up, you know that you have a confused investor. So, the double question acts as a protective mechanism.

Clearly, though, you do not need to write to the client where you can make up your own mind from the file. The problem comes with with profits FSAVCs. They are after all the most cautious fund selection available and tend to suggest that added years rather than a with profits AVC would have been selected. Low risk profiles recorded on fact-finds can certainly be used to lead the reviewer towards added years.

A recent May ABI Bulletin appears on the surface to assist but actually creates more problems than it solves. The key paragraph 6 reads:

> "Where there is no indication that added years is an issue, whether through the investor's complaint or otherwise, firms are permitted to assume that the investor would have taken the money purchase AVC option.."

This could mean two different things. It would be entirely consistent with the original guidance to interpret it to say that where the customer's fund choice was a managed fund or higher risk and the fact-find recorded the risk profile as medium or higher, one can assume that money purchase would have been selected. That is entirely the approach of 6.15-16 of the Guidance. Writing to customers is only relevant if there is significant doubt about all this. The other interpretation is that unless the client raises the issue of added years or there is something striking on the file in this respect, one can use the money-purchase approach. That would not be consistent with the Guidance or actually the use of "or otherwise" in the ABI Bulletin. I do not think that it would be acceptable where the fact-find records the investor's risk profile as cautious or the fund choice with the FSAVC is with profits or with the AVC has historically

been added years. The problem becomes serious when the fact-find is poor and the client's fund selection is say 75% with profits 25% managed. Then, I think that you should write to the client.

My only final observation on this is that I think that the regulators have unreasonably high expectations of company marketing departments in expecting them to assist in drafting these letters. Their activity is selling not obtaining objective answers to difficult questions.

III: ACTUAL LOSS

The Actual Loss test is a curious one reflecting as it does the original ideology of the Guidance. Investment performance is to be ignored, at least now in money purchase cases.[57] Firms are prevented from offering compensation that would put the client where he would have been had he put his money into the AVC. Instead, the charges and matched and subsidised benefits calculation must be done to produce the fund at crystallisation. This frankly will be perceived by most clients as "bananas". Anyway, it can be overcome by arguing that with the back payments and the relevant annuity to bring the client's position to where it would have been had compliant advice been given, there is now no loss using the pure loss test.[58] That at least is the theory. Finding out the size of the annuity actually being paid is relatively easy. However, that is what the Guidance tells you not to do when calculating redress.

It creates a problem with any enhancements offered in the event of early death or ill-health. Where these are provided as part of an added years arrangement, the use of the pension review approach to redress deals neatly with the situation. However, the Guidance is actually silent on this whole issue, thereby creating chaos on the rare occasions where enhancements are offered for ill-health early retirement and death. Should one treat those enhancements as if they were matched or subsidised benefits? I think that that is probably the right approach. The danger is, of course, that they would then have to be reported to the regulator as possible additions to Annex A. Personally, I do not think that the regulator could insist on that.

IV: OVERFUNDING AND ILLEGAL CONTRACTS

As indicated above, the Guidance does not consider those situations where an AVC should not have been recommended. Yet, the definition of the review population in broad terms leaves such cases in the review. In the regulatory vacuum, anything I say here could turn out to be completely wrong.

The charges comparison approach in its simplest form cannot be used here. Topping up an FSAVC to make a bad overfunding problem worse is unacceptable. The maintenance of an illegal contract cannot be justified any more easily. A further tricky

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57 Paras 8.3 & 6.23.2.

58 Para 6.2.5.

variation is where there is not yet an overfunding problem as such but the client has complained about not being told of the risk. (In the current regulatory silence, one has to be aware of but then quietly ignore such concerns. Otherwise, a firm will breach the Guidance redress rules.)

Unable to use the Guidance approach to redress here, we have to fall back on legal/ pension review principles. That is what the FSA Bulletin 4 tells us. As RU20 makes it clear, if the firm had acted in a compliant way in most cases, the clients would have ended up with a PEP. (This is also true whenever “flexibility” is used to justify the sale of an FSAVC - one of the most inflexible products ever invented!) It is true that in some cases, the cautious risk-profile of the client would suggest that the client would have had a TESSA or other lower risk investment. Equally, some although surprisingly few FSAVC investors may have used their PEP allowance already. They can be assumed to have taken out an unit trust savings arrangement. However, in this awkward minefield, one has to work with some generalisations.

The purist solution, then, would be to require firms to give the clients cash equal to the value a PEP and an ISA would have had if the FSAVC premiums had been directed to whichever of the two was available to receive the relevant money. This creates problems for firms who have never provided a PEP or ISA and for IFAs who must select one from the market place randomly. It would be simpler just to add the CAPS Index to the premiums. It would be less favourable to the client because of the abolition of the dividend tax credit (not due to be abolished for PEPs and ISAs until 2004). Nevertheless, it would not be too far out.

The client would then need to be compensated for the loss of the relevant tax wrapper. Otherwise, by offering the customer compensation in the form of an ISA, one is reducing his ability to make tax free savings. (For some investors without such sums to save, this problem could be overcome particularly for modest compensation amounts by investing the money directly into an ISA.) So, if cash is paid, an amount for the loss of the tax wrapper and a further sum for the set up costs of any replacement investment should be required. The price of the tax wrapper should logically be in the region of 20% reflecting the different projection rates for ISAs and unit trusts. For those firms unable or unwilling to offer the compensation in the form of a unit trust, a further set up cost of about 5% would be required and this should be added to the compensation. So, an uplift of about 25% would seem to be necessary. If this appears over-generous, the use of the CAPS index instead of a PEP index has not been factored in.

If the investor is low risk, the Nationwide Benchmark Index could be used to reflect the likely value of a TESSA. Similarly, if the client had already used the relevant PEP allowance at the point of sale or was likely to do so, one can take away the compensation for the loss of the tax wrapper and offer a unit trust of a type consistent with the investor’s risk profile or more simply cash enhanced to pick up the set up costs.

The position on illegal contracts could be broadly the same. It might depend, though, on the reason for illegality. If the client was not eligible for any pension, the overfunding analysis would make sense. However, if he was a member of a GPP or eligible to make personal pension contributions, one could put up a case for reinstating into the GPP or buying the client a personal pension of the value it would have had if they money had been paid to the pension arrangement.

It has been suggested reasonably that where the client is told that the contributions are illegal fairly early on and refunded the premiums, he could be expected to invest the money in an appropriate tax free environment. So, where there are a few premiums refunded shortly after payment, interest would be all that was required. This is now reflected in FSA Bulletin 4 which allows firms to assume that no loss has been suffered where the client receives a refund of contributions within 2 years (presumably with interest).

V: COMMISSION RECLAIM ON STAFF SALES

There are two different situations here. First, the client may have been an adviser. Secondly, he may just be an ordinary member of staff.

A PIA Ombudsman has decided (wrongly in my view) in the pension review context that senior advisers cannot make a claim against firms with respect to policies that they sold themselves unless they can show that they were actively misled by the firm. (The correct view is that FSAVC misselling is so widespread that misleading information from the firm in the form of defective training and sales materials is almost certainly to blame in any given case.)

If one assumes that the firm is liable, the argument about commission deduction is not easy. If the customer adviser had been given accurate sales training, he would have been earning commission on good sales elsewhere including selling himself a PEP for example. For that reason, one should not, in my view, make any deduction from the pure loss calculation.

As for the redress calculation, since the Guidance is silent, one cannot safely make any deduction there.

Where the client is an ordinary customer, the answer is stranger. On the pure loss test, one would take into account the reduction in charges or similar subsidies given to staff members for taking out an FSAVC. Such a deduction would not have been available had the firm acted in a compliant way.[59] However, in the absence of any comment in the Guidance, one would be most unwise to make any such deduction when calculating redress where the customer would have chosen the money purchase AVC. On added years, one can argue that the pension review approach[60]

59 Para 6.25.

60 Applicable as a result of FSA Bulletin 3.

does permit a deduction for the countervailing charges advantage. That, though, is not entirely obvious.

VI: UNDER-CONTRIBUTION

This does not pose any huge problems with the FSAVC review in practice. The difficulty is much more serious in the pension review.

Firms must assume that the client would have paid the minimum to attract the matched or subsidised benefits and can then make a proportionate reduction when offering top-ups while inviting the client to make up the difference.[61] The equivalent pension review provision has always been vulnerable to the argument that it is unfair and a breach of the rule in the Bowden case to make a deduction where the premium was recommended by the adviser.[62] The under-contribution calculation has to be adjusted to take into account charges and the investor's highest marginal rate.[63] Neither is easy to do correctly.

Furthermore, where the client does offer to make up the difference, it can generate chaos. The Inland Revenue has wrongly taken the view that such payments are pension contributions for the purposes of the pension review.[64] They, therefore, can only be made by those who are eligible. Where investors are not eligible, unit trusts or conceivably ISAs could be provided. The calculations involved, though, are so horrific that I know of one firm who waives under-contribution where the client offers to make up the difference. Others may simply ignore the Inland Revenue's erroneous position on the subject and hope that it does not catch up on them and their clients later.

VII: END DATES FOR LIABILITY

The Guidance here contains some sensible rules and then one or two which can create real problems.

"6.20.6 The end date for the period for loss assessment is the earliest of:

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61 Paras 8.3.9-10.

62 R v ICS ex p Bowden [1995] 1 WLR 157: "We are satisfied that the common law principles of compensation require that there should in the present case be no deductions for the sums which were paid to the investors in accordance with the transaction which they had entered and which were subsequently disbursed by them. Whether dissipated benefit is a recoverable loss must depend on the circumstances. But **here the very purpose of the transaction.. was the achievement of an increase in income... That being so expenditure of the money, once it had been paid to the investors was plainly foreseeable and if that expenditure was on ephemera so that no lasting benefit accrued there was a loss which sounds in undiminished damages** against the financial advisers." See PIAOB Annual Report 1998 at p. 74 applying this rule..

63 FSA Pensions Review Bulletin 4 at p. 2.

64 FSA Pensions Review Bulletin 4 at p. 2.

- The date at which the investor did or could reasonably have been expected to .. contribute to the in-house AVC arrangement;..
- The end of the investor's last period of employment during which they had access to an occupational pension scheme;
- Where the investor has stopped making contributions to the FSAVC and has not restarted them with the same provider, the start of the first full tax year in which no FSAVC contributions were made (but see paragraph 6.20.8 below);
- (6.20.8 If an investor stops contributing to the FSAVC policy then firms may normally assume the period for loss assessment ceases at the start of the first full tax year for which no FSAVC contributions have been made. Firms should however make an assessment of why the investor stopped contributing to the FSAVC policy to confirm this. For example, if there is evidence on file that the investor stopped contributing because they were dissatisfied with the FSAVC policy in some way (perhaps because of the impact of high front end charges on their early contributions) then the period of liability might continue until the point at which it would have been reasonable for the investor to make alternative arrangements.)
- The date at which the causal link between the original advice and any ongoing loss is broken;
- The Calculation Date.

The calculation date, the end of the last period of employment when they client had access to an occupational scheme are all very sensible.

Unfortunately, the others create real problems. The date at which the investor could reasonably have been expected to contribute to the in-house AVC arrangement seems innocent enough. Unfortunately, as Regulatory Update 33 indicates, this is "incorrect and misleading".[65] Since the firm and not the client was in breach of a duty in putting together the original sale, the standard required of the latter must be lower. Furthermore, the client is not expected to be "wiser than his own professional advisers". That reduces the standard even more.[66]

The firm is required under the Guidance to write a proper opt-back-in letter. It should do so bearing in mind the need to give full disclosure of the disadvantages of the FSAVC as compared with the AVC and contradicting all errors on file regardless of their source. Those with long memories of RU33 know not to advise the customer to pay into the AVC or to threaten to cap liability. Indeed without doing an actual loss test, it is very difficult to write an accurate letter here.

The problem should be less serious here in one sense. Where premiums have stopped, one can assume that the client would not have paid further amounts into the AVC if they have not actually done so.

65 At p. 9.

66 H McGregor on Damages 16th ed at para 322; Jackson & Powell on Professional Negligence, 3rd ed at pp. 44-45.

“Where the investor has stopped making contributions to the FSAVC and has not restarted them with the same provider, the start of the first full tax year in which no FSAVC contributions were made” appears equally straightforward. Unfortunately, it contains a couple of strange traps. First, why should firms have to wait until the following tax year and presumably added up the differences in charges on a premium that has never been paid. Secondly, why is there the reference to the same provider? This misses the important point that if the first adviser had done the job properly, the client would have known not to take out the FSAVC with the second one. Where two advisers give the same bad advice, the first one reinforces the strength of the second advice. Why should the second adviser take the burden exclusively? From a consumer protection point of view, the twice badly advised client has to run the gauntlet of two reviews.

It is difficult to know how this re-writing of the joint liability rules sits with the general rule on that subject laid down elsewhere in the guidance.[67] They can be reconciled just about by saying that joint liability only occurs where there is an illegal overlapping FSAVC or an IFA or product provider has advised a client to top-up an existing policy sold by the other one.

One area that seems to have been missed entirely in all this is where a firm advises the client to transfer their FSAVC to another provider. That is technically an FSAVC sale falling within the review. Yet, on the money purchase side, there is no provision for compensating the client for the churn (any early transfer penalties and set up costs). If the client would have had added years, the recent aberrational FSA Pension Review Bulletin 14 gives the first adviser a choice between using the actual fund values (the correct answer) and the notional one subject to a possible surrender penalty, the scope of application of which is unknown. How the second provider is supposed to behave is not at all obvious if the first provider does not pick up the effects of the early transfer in its calculation and give appropriate credit to the client.

A less drastic impact of the defective end dates in the Guidance is the position on change of employment. There are three rules that have to be reconciled. First, firms are liable for subsequent periods of employment.[68] Secondly, this does not occur where the client has been advised by another firm at the change of employment.[69] The words “or prior to” which appear in FSA Pension Review Bulletin 1 have been cut out, apparently intentionally. It is very unclear what is meant by on a change of employment. Presumably, this is from the date of leaving the earlier job to the end of the first day at the new work. It is so rare that advice is that finely timed that this exception is likely to prove inapplicable in all but the rarest cases. (This begs the question as to why it was left in at all since it contradicts the legal position on joint

67 Para 6.19.3.

68 Para. 6.13.2.

69 Para 6.19.2.

liability and causation. Since 1970, borstal children destroying local yachts on an outing, children trespassing on land and dumping chemicals into a river and prisoners committing suicide have all been deemed incapable of breaking causal links by the House of Lords. Common non-compliant advice is far less unforeseeable.) Finally, where the client has changed from one provider to another, one simply has to look for the break in the tax years.

VIII: PREVIOUSLY COMPENSATED CASES

FSA Bulletin 4 has tried to reduce the problems in these areas in a completely unprincipled way. Pre-January 1998 complaints have been excluded for firms who have not managed to tell investors that their complaints will be dealt with unless the customer has requested a review after that time or no account has been given for the lost matched or subsidised benefits. This has been buttressed by the provisions on illegal contracts mentioned above.

For the cases still left in, the Guidance includes previously settled complaints if they were not resolved on equivalent terms and cases where a refund of more than two contributions has been paid and then contains no provision for taking into account the money paid. The problem does not really arise where the FSAVC still exists. You just do the calculation the way it would have to be done under the Guidance and then compare the outcome with the value of the policy. You then top-up the policy to bring it up to that value. Where the FSAVC premiums have been refunded, there are plenty of different ways the regulator could but has not required firms to react.

One could take the premiums paid add the relevant benchmark index and deduct any amounts paid (by way typically of a refund plus interest) plus interest at bank base rates. That would fit the guidance's preference for such rates. It can be argued that the spirit of the Guidance requires one to add the difference in charges on the FSAVC as compared with the AVC available plus the benchmark index to the policy. However, the FSAVC premiums are not subject to the charges since they have been refunded. So, there appears to be an element of double-compensation in this approach. The benchmark indices are designed to show what the premiums would have earned in an AVC. So, that should be sufficient. There is a further problem, namely the end-date at the beginning of the tax year following the payment of the last premium. There is a case for adding the difference in charges up to that date from the date of the final FSAVC payment. It seems a little artificial. So, though, is the end date concerned. It can be argued that the client needed some further time to find an appropriate replacement investment. All these views could be reflected in subsequent guidance. We look forward to receiving it!

IX: CONCLUSION

It is always easy to criticise regulators. Poorly resourced, they rely more than one might realise on outside consultants and political compromises. Anyway, drafting regulatory guidance is a hellish task. One cannot think up every scenario that may come to light. Very wisely, the FSA when dealing with the FSAVC Review has been

prepared to issue bulletins to amend and clarify Guidance when it clearly is not working. Anyway, the regulators that do their best to assist teams doing the review are probably not the people who laid down the principles behind or drafted the actual Guidance. It is important not to confuse the messengers with the source of the message.

Hopefully, this paper will help regulators close some of the holes in the Guidance by offering possible "man hole covers" to them. Others will almost certainly press their views. Within the FSA itself, there is a strong desire to keep this review short and sweet. The regulator does not want to be responsible for another late-delivered pension review. So, prepare for short-cuts or even exclusions from the population to affect some or perhaps all of the analysis here. The problem is knowing where or even whether the axe will fall.

There are some messages for regulators drafting this type of Guidance and even updating it. The FSAVC Guidance was avowedly aimed to be a break with legal principle. That is not necessarily a bad thing. The law, particularly in the way it limits the range of remedies can be crude and ineffective. The problem is that if you decline to use legal or some other type of rules as a backstop to be applied where the Guidance is silent, black holes begin to appear for which there are no solutions.

It is impossible to draft comprehensive Guidance. Unfortunately, the law is the only residual set of rules of general application in any society. If you remove that backstop, you have to make sure that you have some very robust rules to take its place. Otherwise, two things happen. We either see an unprincipled retreat to the legal position, as has happened over top-ups and added years. Alternatively, nobody knows what to do when they run into a case that is not covered by the Guidance.