Submission to the FCA
by Fowler Drew Limited
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Consultation CP22/6:

Consumer redress scheme for unsuitable advice to transfer out of the British Steel Pension Scheme

Executive Summary

CP22/6 does not meet the legal tests of a s404 redress scheme. The FCA's arguments and their QC's opinion are based on flawed transfer reasoning that other experts, whether involved in disputes with the FCA over transfer advice or (like us) exposed only indirectly, have been challenging for many years. They would also be challenged in court, had the FCA not avoided hitherto either a test case or a judicial review.

The central flaw in the FCA's reasoning that biases its entire approach to transfer advice suitability is a specific and narrow definition of a person's *best interests*. The FCA argues that typical transfer advice gives too much weight to the prospects for improved sustainable real income and the identified chance and size of possible shortfall and insufficient weight to knowledge and experience of investment. This line of reasoning shifts the burden of proof from *economics and finance*, that can reference theory, expertise, calculation and evidenced consumer behaviour, to *judgement* that is subjective, vulnerable to bias and inconsistent.

Not recognising that the TVAS income comparison could establish best interests, albeit subject appropriately to personal tolerances and trade-offs, leads the FCA to require a holistic context for testing suitability, including a budget. These were innovations introduced after Time to Choose and only after consultation. If advisers could reasonably be expected to have applied this contextual information, contrary to the implications of the TVAS rules, rule changes would not have been required.

To resist attack by experts, including directly-impacted advisers, the FCA has designed a process for assessing suitability, DBAAT, that negates widely-accepted logic-based practice at the time and builds in biases and hindsight in the stipulated interpretation of what information was 'necessary' or 'relevant' at the time. This interpretation is open to legal challenge, their QC's opinion notwithstanding.

The error in the identification of best interests infects both the assessment of suitability and the probability of loss. On both counts, the 'evidence' presented by the FCA for widespread loss in the case of BSPS transfers is unreliable. Our modelling supports a contrary conclusion. Based on the transfer terms available and the degree of impairment to the inflation protection of both PPF and BSPS2, members transferring stood to lose nothing in terms of sustainable real income on prudent assumptions of real investment returns and longevity, consistent with the TVAS rules. Even on worst-case assumptions for both, the potential shortfall at the time was very small and has already been eliminated by inflation in excess of the applicable caps. These 'inflation losses' from the BSPS pension are just as important as possible investment losses on drawdown and repeated analogies with 'guarantees' are

inaccurate and misleading. Firms would not themselves get away with this. We model one of the FCA's own cases of supposedly 'unsuitable' advice to demonstrate the unreliability of its assessment approach.

Projections of real outcomes, even if extremely prudent, could still be overwhelmed by either excessive product charges or excessive product risk, such as applied to unregulated investments recommended by some unscrupulous firms. But that is not the argument the FCA has made for a s404 redress scheme. The frequency of exploitative or fraudulent advice has probably already been identified by the FCA and FOS.

S404 implicitly requires an *objective process* for firms to assess their own advice, that will produce *consistent outcomes* across the industry. The dispute over how to define best interests, together with a biased and inaccurate regulatory process in the form of DBAAT, means there is no objective basis that can be relied on. This is perhaps recognised by the FCA, as all cases that end with a finding of suitable advice, even after using the flawed DBAAT process, will (as proposed) pass to FOS. Our analysis suggests that because of the biases, most will. FOS is on paper better able to assess nuanced cases than the FCA. It is not bound to use the DBAAT process and it has its own legal obligations to apply contemporaneous rules and practice. However, the scale of the likely referrals makes it highly probable that the FCA will adopt simplifying binary tests that are flawed, as has been the case with cases to date. Most rely on a 'straw-man' argument that the required investment return for an annuity can evidence the unsuitability of drawdown even though the recommendation was based on drawdown not an annuity. More important for the lawfulness of the proposed scheme, though, is that, if the result of the scheme is that most cases will end up being assessed by FOS, it frustrates the intention of a s404 scheme to *replace* alternative means of seeking redress.

Finally, the QC's opinion refers to the necessity for redress to be 'just'. In this case, justice for the adviser relates to *proportionality* (both scale of harm and certainty it was caused by the advice). This test is not met. It cannot be satisfied by i) the DBAAT template for testing compliance and ii) the existing standard redress approach which is widely and rightly disputed. The absence, within the deadline for the consultation, of a specified redress approach (particularly in relation to already-known inflation erosion of the original projections) anyway makes it practically impossible to test the just principle. The question has to be asked whether this alone makes the procedure unlawful.

Justice also requires fairness for both parties. As it stands, there are no means to prevent clients awarded compensation by FOS (or the FCA if it chooses to intervene because it does not like the findings), on the basis their risk tolerance or capacity was wrongly identified by their adviser (even if they did not complain), from then persisting with a drawdown plan. If they persist, it will demonstrate that the basis of the finding of unsuitability was necessarily wrong. Creating a licence to game the industry (both advisers and PI insurers) offends natural justice and will undermine respect for the regulator.

Q1 Do you agree with our assessment that unsuitable advice to BSPS customers was widespread in the period we looked at?

No. We strongly disagree.

We know there were cases of egregious bad advice, if not fraud, at BSPS. The FCA should have been able to identify the scale of such cases by now, from information provided on the ground and from FOS complaints. To the extent such cases were not caught by these informed investigations, a reasonable estimate could be made from more random file reviews conducted by the FCA or by third parties on its behalf. In most circumstances we would defer to the regulator if they had evidence of the likely volumes based on sampling but in this case we think its own evidence is likely to be tainted, for multiple reasons.

1. We know that the FCA's interpretation of unsuitability is generally flawed and that it faults large numbers of competent firms' cases. The FCA's approach is built on inexplicable denial of the economic arguments that explain the transfer opportunity generally, so it gives them very little or no weight in its suitability assessment process. This applies to their analysis of transfer volumes generally: the rationally-expected number of transfers given the economics is probably many times the number that have actually been made to date. It means their claims that general levels are too high cannot be relied on as evidence of widespread unsuitable advice (or indeed bias arising from contingent fees). This central flaw in the FCA's general position on transfers implies the true level of unsuitable advice at BSPS is likely to be lower than the FCA assumes.
2. We have analysed the terms of BSPS transfers using our own modelling of real sustainable income, assuming drawdown, and find that members stood to be better off, at a high level of confidence, by transferring (see our response to Q2). They were not the most generous of terms, as a multiple of income, but this is offset by the impairment of the inflation protection in PPF and BSPS2. A necessary, even if not sufficient, condition was met that should have led rationally to many more members wanting to explore the transfer option.
3. We, as well as the FCA, can guess at some of the contextual personal circumstances and experience typical to BSPS members (though they are not necessarily substantially different from many other DB schemes). We believe that the most likely common definitions of personal utility (or individual welfare) would have made transfer very compelling. The FCA imputes a utility function to DB scheme members generally that downplays the motivation of better financial outcomes, even subject to tolerable shortfall risk, and exaggerates the value people assign to guarantees, as if these carried no personal cost or sacrifice. This imputed safety-first utility is a text-book case explaining how certain investors make decisions and avoid trade-offs. This is easily challenged. It is not much in evidence in the UK's retail investment market and is the opposite of what is assumed in the typical design of default options for AE and other DC pension schemes. The FCA's assumed or imposed definition of utility biases their view of suitability. The bias is then designed into the process by which reviewers are required to assess suitability: the DBAAT spreadsheet and instruction manual (see our response to Q12 and 13).
4. There are particular reasons for faulting the FCA's assumptions about the value of guarantees in relatively low-income cases where a high proportion of expected spending will be met by state pensions. Even very modest payoffs from risk taking are likely to be more highly prized because of the significant difference made at the margin to spending. This is directly opposed to the assumed utility that attaches greater significance to guarantees, the lower is the income, and to a suitability approach that penalises risk taking, the lower is the experience of holding personal investments. We would be surprised if the FCA's assumed utility was in fact exhibited by the majority of BSPS members. We note that this difference, if applied to the first case history in the CP selected as an example of unsuitablity, would tend to justify transfer, were the working shown and the maths correct.

5. We accept that to some extent expectations of volumes based on i) the specific transfer terms and ii) generally-applicable utility could be trumped by a lack of comprehension on the part of members. We also accept that enthusiasm at the point of the decision may not survive contact with bad markets. Since better economic outcomes depend on persistence, it is important to test for likely persistence, including in cases where there is no past experience to check against. This is an important area of professional judgement for the adviser and is necessarily normally nuanced. The FCA has taken a different view, that absence of relevant experience is sufficient itself to indicate unsuitability. It effectively discounts any benefits of future experience (even though all active members of BSPS were about to find themselves in a DC scheme) and discounts any benefits from a future relationship with a financial adviser (which transfer usually assumes). We think the FCA's narrow view is at odds with Parliament's intentions with Freedom and Choice. It is the view, however, that has been designed into the DBAAT form. The result is that the FCA's own observed cases of unsuitability are biased upwards.
6. We know that the FCA will have wrongly faulted virtually all cases of younger members. The FCA took an idiosyncratic view, designed into DBAAT, that the reduced visibility of retirement income needs, being further in the distance, was more important than the economic logic of better outcomes on a TVAS basis. It is at least consistent with the error identified in 1 above. But in applying it to younger case it compounds the error because the longer the period before the start of draw the greater the chance that the worst-case expected real return would exceed the risk free rate that matched the DB benefit. Most experts would challenge the FCA's approach here, for two reasons. First, the contextual information about budgets was not a reasonable requirement given the rules at the time (see 7 below). Second, it conflicts with text-book explanations of the relationship between risk and time (see our response to Q2 for details of the appropriate methodology in a TVAS calculation). It is safe to assume that all or most of the observed cases for younger members were wrongly faulted. We do not know how many total file findings of unsuitability this error explains. The standard redress formula, we note, also compounds this error of logic as its effect is to increase with the number of years to retirement the cumulative cost of i) nominal bond yields below the prescribed inflation assumption and ii) negative ILG yields, as applied to the appropriate segments of the benefits.
7. The cases identified as unsuitable by the FCA result from a DBAAT process that incorporates hindsight (see our response to Q12 and 13). Expert opinion in a judicial context would surely question the very specific meaning and scope attributed to the general and high-level rules and guidance by the Grant Thornton paper that the QC's opinion then relies on. Most advisers would argue that reasonable professional practice at the time did not attribute the specific meaning or contextual application to those general rules. If that was not so, why was it necessary for the FCA to consult on introducing those specific meanings and applications to a set of new rules, taking effect only after the closing date of Time to Choose? If the TVAS income comparison could not assume that the CETV was itself a resource capable of generating the replacement income, and that alternative resources exclusive of the CETV were not necessary, what was the point of the TVAS? So broad is the potential scope of the hindsight, particularly in the circumstances of BSPS members (reliance and budgets), that we can be sure that the level of nominally unsuitable files is significantly higher than the true hindsight-free level.
8. The FCA's track record of quantifying unsuitable advice does not inspire confidence. We know that its past estimates have been reduced over time, from around 50% (excluding BSPS) to 17%.

No good explanation has ever been offered even though we understand the FCA has been asked to provide information. We do not know anything about the consistency of review arrangements on which the data relies. The CP tells us the BSPS reviews were outsourced to Grant Thornton but we do not know if non-BSPS review findings purporting to be internal to the FCA were also outsourced and if so to Grant Thornton or others. We cannot at present tell whether the same large error range applies to BSPS findings but by implication it does. (Please note we submitted a FOI request with various questions relating to Grant Thornton's role on 8th April which was eventually acknowledged on 5th May: 'You have advised that you originally submitted this request on 8 April via our FOI portal, having checked our records we cannot see that we received this email (sic) and that explains why you did not receive our automated acknowledgement. The case reference number allocated to your request is FOI9242 and we are due to respond on 1 June 2022.') We have been told by firms that cases found unsuitable by the FCA have been challenged by external advisers appointed to review the same cases. These experts have supported the adviser's conclusions. Given the scope for differences of opinion as well as errors of fact noted above, this is not surprising. The CP offers no analysis of the frequency of such differences or how it has resolved them. We understand the FCA has hitherto resisted FOI requests for this data. However, it is clearly relevant to the implied s404 requirement of an objective basis for assessing suitability that is capable of generating consistent results.

9. It is striking that in Case Study 1 the FCA has selected a situation that unintentionally advertises the problems when a non-expert attempts to apply general rules to specific cases, without a requirement to show workings. The same case could potentially be presented as suitable. Prima facie, transfer could on reasonable assumptions i) achieve the member's objective to retire at 55 (which without transferring would have been an indeterminate number of years later, partly dependent on experienced inflation), ii) meet the desire for underpinning guarantees because expected spending needs would be largely met by state pensions (or entirely, with topping up from the CETV), and iii) achieve these objectives with a low-risk investment approach. These aspects of best interests would need to be reality-checked against comprehension and likely persistence but these were not arguments made in the case study and it is hard to see how they could be tested for anyway without talking to the client. We don't know if the case study write-up was written by the FCA, FOS (also mentioned) or Grant Thornton. In terms of technical deficiencies, the write-up overlooks entirely the possibility of erosion of projected value of pension by inflation (as has since occurred). Even on the basis that best interests are primarily defined in terms of outcomes, the case may deserve to fail if there was a significant chance of a shortfall in sustainable real income. The write-up asserts: 'While the client couldn't meet their income needs by retiring early from the PPF or BSPS2 at age 55, trying to do so by transferring to a DC scheme put the pension at high risk of running out during his lifetime'. But there are no workings. And no weight is given to the alternative of a high risk of erosion of real spending from the DB pension. In the absence of workings, it seems likely the reviewer has merely imposed an untested prior assumption. We highlight this not to point to the relative competence of each of the adviser and the reviewer but to show how transfer cases tend to be too complex and too nuanced to be objectively assessed by the application of some prescribed criteria or conditions. The question of technical competence is important, however, when it comes to proportionality between the redress amount and the certainty of cause of harm.

10. The CP provides no frequency data for complaints. Anecdotal evidence is that very few complaints involving firms other than those already identified as systematically at fault have been made. Even with letters to all members from the FCA inviting complaint, the numbers are apparently low. Even these are not genuine indications of a complaint, since the redress process offers a gaming opportunity or free lunch. The FCA might argue that the member is simply ignorant of how they have been misled. It could also be that members look at what has happened and have nothing to complain about. Available data about complaints should have been in the CP.

We have considered the statistical arguments for deducing from sample reports the ranges of likely cases. The confidence assumptions based on small samples strike us as highly questionable. In any case they appear inconsistent between groups 2 and 3. On its own merit the report should not influence the s404 requirements. However the main argument against the report is that any statistical approach to gauging frequency is not relevant anyway if it necessarily relies on the accuracy of the observed sampled cases of unsuitable advice and if that is in doubt for the reasons set out above.

Contrary to the arguments made by each of the statistician's report and the QC's opinion, the evidence of widespread unsuitable advice cannot be relied on. The presumption, on generally accepted principles, should instead be that many more members' best interests would have been met by transfer into good DC arrangements with reasonable costs than actually transferred. We cannot estimate the size of the error in the preliminary findings that 46% were unsuitable but we can be confident, given the number of reasoning errors we have identified, that the true number is a fraction of that, probably representing a minority of the transfer cases subject to this scheme.

Q2 Do you agree with our view that BSPS members who received unsuitable advice are likely to have suffered loss?

No. We strongly disagree.

'Loss' in a transfer is logically measured ex post as lower sustainable real income or, ideally, since tax consideration may be a factor for best interests, lower sustainable real spending (ie the real draw had to be cut below the equivalent DB level to avoid running out of money). Ex ante, a probable loss requires assumptions about two sets of sources of uncertainty: i) the risk to real spending from a DB pension posed by inflation above the applicable cap; ii) the uncertainty of the path of real investment returns when drawing at a constant real rate from a volatile portfolio for an identified period of time. Both sets of risks are important to any assessment of a BSPS transfer because of the generality of caps in pension schemes and specifically the impairment of the inflation protection by each of the PPF and BSPS2.

In an article in January 2022, 'Is a British Steel redress scheme workable?', we estimated the size and chance of loss at BSPS by applying our modelling of sustainable real income (equivalent to pre-tax draw) to the terms we had been shown for a specific transfer case. We needed to use third-party data because we did not advise any cases ourselves.

In our real-terms modelling, the present value of the resources is the same and the two income streams, DB and draw, are estimated and compared for any given drawdown plan longevity. The modelling is not specific to transfers, as a transfer is a case of a general portfolio problem of comparing two investments, risky and risk free. The CETV acts as the resources available (input) and the model outputs the sustainable real draw subject to constraints such as not running out by age x (input). Those outcomes are dependent on the risk approach which in our model is differentiated as a risk aversion score. This allows a risk-and-time-specific probability distribution for sustainable draw to be compared with the DB pension. The only variance in the DB is due to inflation relative to a cap. The variance in the drawdown strategy leads to shortfall (or probable loss) and gain (upside) against the DB measured at every confidence level.

The following extract from that article sets out the conclusions derived from cases we did advise on with a similar quantitative relationship between the DB income and the CETV.

- *'For a person 19 years from retirement, our model showed a zero chance of a shortfall versus the DB pension. The median upside (this being a number dependent on the adopted risk approach) was 133% - more than double*
- *For older members very close to retirement, similar cases suggest the downside risk would have looked modest and the upside much more balanced: about 15% of the outcome distribution being below the DB income at 99% confidence.*

But ours is a real-return model and the shortfall risk is calculated on the basis that the DB income will not be eroded by inflation caps. Inflation matters. To an individual, a cut in real spending forced by inflation has the same impact as a cut forced by anything else. Caps do apply to both the original scheme and the BSPS replacement scheme, BSPS2, that members retaining DB benefits should (FOS thinks) have selected. Neither scheme guarantees a real income.

BSPS2 changed the inflation link in many cases from RPI to CPI and imposed a lower cap of 4% pa in deferment and 3% in payment, in the example we saw. As a reference point, the difference in cost for an RPI-indexed annuity and an annuity increasing at 3% fixed for a 55-year-old is currently about 30%. Though not an exact measure of the inflation difference we want to isolate, it is notable that it is more than the likely shortfall in our comparable model runs.

In the context of stress-tested sustainable real income, only a few years of inflation above the cap (provided they are not offset by subsequent absolute falls in the price level, as distinct from falls in the rate of price change) will be sufficient to offset the shortfall risk in real income against a real-terms guarantee. Whereas the outcomes of a drawdown plan are necessarily path dependent, the inflation impact on real outcomes does not need knowledge of the entire path. Probabilities for real outcomes will change as soon as the cap has been breached. Stress tests appropriate to 2.22 of the instruction manual should assume episodes of the cap biting, as well as low real equity returns.'

We have checked these against the terms quoted in the first Case Study. This states an age of 47 and a PPF income in 2017 terms at the desired retirement age of 55 of £12,000 pa. Running this through our model using December 2017 market conditions we generate the following outputs. The cost assumption is 1% pa. The risk approach is chosen to be consistent with the given score of 3/10, which is clearly quite extreme.

- The probability of not sustaining a real draw of £12,000 pa to age 100 is 20% at 99% confidence (this is the most prudent set of inputs)
- The probability falls to 8.2% at age 95 and 1.6% at age 90

- The mean sustainable real draw (as an indication of upside potential) ranges between £13,176 (to age 100) and £14,844 (to age 90)

The probability of loss up to age 95 at 99% confidence, and to age 100 at a slightly lower level of confidence, has already been eliminated by inflation in excess of the BSPS2 cap, note. Over a period of 50 years, the likelihood of such erosion was very high, hence the alarm caused by Tata's attempts to slash its pension costs.

It seems quite likely that Mr A would have wanted to consider a slightly less risk averse approach as long as the downside risk was so low. With only a small increase in likely volatility, he could have improved his mean expected income to between £20,006 and £21,752. Conversations around this would reveal whether the incremental income had value. But the most compelling reason for a riskier approach is that it would (counterintuitively) cut the chance of loss to each age to under 1%. This is because the lower-risk approach locks in more negative bond returns. This is to be expected: it is the same logic as has driven DB pension schemes to close, even when the sponsor is healthy, and has driven demand for transfers.

The methodology behind our modelling of drawdown is itself more robust than the use of deterministic growth rates like the FCA prescribed rates. The probability of shortfall is therefore likely to be even less or zero if applying low FCA rates that are arguably adequately prudent. We believe it is likely that many firms the FCA has faulted did use adequately prudent assumptions in their TVAS. We think the FCA has discounted this evidence of being better off because of its resistance to the whole idea that this is what mainly motivates members to transfer and is the main, if not exclusive, measure of best interests.

The age dependence of the chance of shortfall in our modelling is itself a conventional textbook assumption. It is a function of the relationship between i) a known risk free rate and ii) the upward slope of the band of expected risky returns (itself a function of reversion to a long-term trend, as also assumed by the FCA prescribed rates). The point in time at which the worst-case expected return, the bottom end of the band, exceeds the risk free rate can be thought of as the 'break-even year'. With normal market conditions, assuming (say) a 1% ILG yield across the yield curve and equity markets in line with their past long-term trends of achieved real returns, we would expect the breakeven year to be about 25 years (95% confidence). This is a reminder of how high long holding-period equity risk is, even with mean reversion in real returns and risk premia. What was different at the time of Time to Choose is less the fact that equities were below their long-term trend (and expected equity returns therefore above) but that ILG yields were actually negative (20-years: -1.7%). This feature, a direct consequence of Quantitative Easing, was not alone enough to explain the boom in DB transfers but it was when combined with DB schemes having substantially derisked, as the effect was that CETV multiples then reflected the negative ILG yields.

We have heard that FCA file assessments have dismissed the relevance of low ILG yields on the basis that equity returns will be lower for some common reason. This has to be challenged. The monetary authorities who adopted Quantitative Easing took the opposite view, as its intention was clearly to encourage risk taking by (inter alia) steepening the Capital Allocation Line or risk premium. It is not the job of the regulator to second guess the Bank of England's view of the economics. Even if it were, if the FCA wanted to prevent retail investors and their advisers assuming a higher risk premium as a consequence of unprecedented ILG yields, it had the option to revise the prescribed growth rates and justify the economic reasoning on third-party advice and with due consultation. It didn't and advisers have been perfectly entitled to do what the Bank of England economists expected them to do: assume a higher risk premium.

Reading between the lines of what the FCA has said on many occasions and in many contexts, we do not believe it has ever fully accepted (let alone publicly acknowledged) this economic explanation. If it had, it would not be 'surprised' by the 'high' level of demand for transfers and would not be looking for a scapegoat in the shape of conflicted or unprofessional advisers. Ultimately the appropriate technical knowledge must be the responsibility of the FCA. In light of the role of Grant Thornton that is alluded to in this CP, we wonder whether the failure arose because of its reliance on outsourcing. But if it did, the fault was to do so with insufficient critical appraisal. We appreciate this is not the failure most critics of the FCA seize on in relation to transfers but it is the one vital to the defence of the legitimate interests of advisers and their insurers.

We welcome the BSPS redress scheme proposals as another opportunity to explain to the FCA why it is mistaken about the chance of shortfall in most schemes, including BSPS. However, the regulator has become so entrenched, and the consequences of having to revise its approach to suitability are now so enormous, that we doubt this will be resolved except by legal challenge.

Q3 Do you agree that the legal test for making a consumer redress scheme under s. 404 of FSMA has been met?

No. We strongly disagree.

As explained more fully in answer to Qs 1 and 2, justice cannot be served by the proposed scheme because:

1. Estimates of the frequency of unsuitable advice are not reliable but prima facie it is likely to be low amongst firms not already identified as selling high-risk investments at high charges
2. The very high proportion of cases therefore likely to end up with FOS means a s404 scheme is redundant
3. The probability of loss is very low if not negligible, more so now than at the time, and the upside was sufficient (even with low levels of risk taking) to act as powerful motivation for BSPS members
4. Most cases are likely to be nuanced rather than black or white and in such cases there is no objective basis for independent assessment of files that can generate consistent and just outcomes
5. The redress, which carries potentially devastating consequences for firms, is not proportionate to the certainty of harm being caused
6. The scheme will be gamed by people who in fact have no wish to complain or change their strategy but are motivated by the existence of the scheme to pocket an improvement to their healthy capital position.

Q12 Do you agree that the BSPS DBAAT is an appropriate tool for assessing whether advice to transfer out of BSPS was suitable?

No. We strongly disagree.

The assessment of an advice process after the event from a file necessarily combines binary factual checks (something was either done or not done) and judgement as to whether any deficiencies identified led to the client taking a course of action not in their best interests (which may require redress) or were not material to the course of action (but could require supervisory action). The 'standard' DBAAT form is designed to capture the necessary checks. The template also includes a scoring method based on the checks. Then there is scope for judgement to be exercised in the form of i) a deficiency does or does not conclude the process or ii) adding comments as free text. The BSPS form adopts the same approach but omits from the factual checks scope added only after 1st April 2018, in order, as it claims, to avoid hindsight.

Whilst the intention is clear, we do not believe the implementation is accurate or fair.

- There is hindsight because so much of the information is only relevant in a holistic context that was introduced later.
- Structural bias in dealing with the likely nuance in most cases arises from the imbalance between i) specific questions and a scoring method and ii) the scope for judgement only as comments with free text.
- The form is biased by ignoring the possibility of trade-offs, such as by attaching significance to a preference for 'guarantees' (itself misleading) as sufficient, as if they carried no opportunity cost.
- The TVAS calculation section is biased by attributing significance to the achievability of the critical yields that assume an annuity, which is irrelevant if the basis of the recommendation is transfer to drawdown.

The specific instances that follow adopt the numbering of the DBAAT form questions. We have not cross-referenced in each case the relevant paragraphs of Grant Thornton's generic paper where it validates the treatment in DBAAT. This is because it appears designed to do that. So where we attribute an error to DBAAT, we do not know if that in fact originates with Grant Thornton. The main relevance of the originator is to the QC's opinion, as this appears to have relied heavily on Grant Thornton's paper as if it were an independent expert familiar with adviser practice at different points in time. The role of Grant Thornton in the DBAAT process will be made clear if the FCA provide the information in our FOI request of 8th April.

2. Objectives:

We understand that file reviews have penalised firms that treated best interests as largely a function of being better off, albeit subject to constraints such as shortfall risk (TVAS) and ability to tolerate the required or implied risk to achieve the upside for income valued by the member. Though this objective and its motivation might reasonably be taken for granted, and is itself implied by the TVAS comparison of benefits, DBAAT appears to treat it as needing to be i) stated and ii) prioritised. Whatever this is, it is not a suitability failing that obviously weakens the recommendation. But it does illustrate the dangers of a formulaic approach.

We also query the significance of ordering priorities. Whilst one objective may trump all others and dominate the reasoning, and though it may need calculations provided by the adviser, ultimately it is the client that exhibits how they want to trade off different objectives. The idea they can all be ranked, either at the start or end of the process, is unnecessary to the suitability of the recommendation and may indicate the adviser is imposing its own utility on the client.

3. Information regarding the consumer's preferences regarding risk taking and their risk profile:

It is likely that file reviews rely heavily on assessment of this section. This is unfortunate as the rules were not as clear as they needed to be.

Attitude to risk and capacity for loss should not be made specific to the giving up of 'safeguarded benefits'. Contemporaneous 19.1.17G set out a requirement to explain the generic DC and DB differences by reference to safeguarded benefits, but not to quantify, except to the extent required by the TVAS rules in 19.1 at the time.

Prior to the changes in 2018, capacity for loss needs to look to the general suitability rules (COBS 9 at the time). The following general weaknesses in the rules are particularly relevant in the context of DB transfers:

- COBS 9 did not make any distinction between *path risk* (volatility) and *outcome risk* (eg at some point when the consequences of bad investment returns bite). Even if they did, capacity would logically be common to both the DB and the DC arrangement: a shortfall relative to needs at the time might persist with the DB yet be reduced or potentially eliminated by transfer. The TVAS would identify this.
- No distinction was made between '*paper' losses* and *realised losses*. Paper losses themselves have no impact on living standards yet capacity for loss refers to living standards. The implication was that reactions to volatility, or lack of composure, could turn paper losses into realised losses, which could have an impact on plan outcomes and therefore living standards in the future. Apart from being far less specific than it needed to be about the agency, capacity for loss added nothing to tolerance of risk, as that already relates to composure and persistence.
- No distinction was made between *nominal* and *real* losses, after inflation. The rules only consider nominal changes in value, which is consistent with a myopic focus on volatility. Inflation-induced changes in living standards are more relevant to outcomes.

Prior to April 2018 it was reasonable for advisers to assume that how clients demonstrate the value they assign to guarantees versus the opportunity cost of better outcomes would be revealed by the TVAS element of the advice process. It is not a general characteristic of the client, or the client's personality, independent of the context. That is to make the category error of assuming guarantees and insurance do not entail cost or invite trade-offs.

We further note that a bias is introduced here by implying the safeguarded benefits do not themselves carry risk – in this case the weak inflation protection. If firms did this, they would rightly be accused of misleading clients. Preferences regarding the trade-off can only be made after both aspects have been considered.

Risk preferences are generally treated by the rules as inputs to the advice process rather than outputs. If treated as outputs, they can benefit from (for instance) the TVAS calculations and other information provided by the adviser to inform and modify preferences existing before the process. In response to Q2 we showed in relation to the case study how an iterative approach to the optimal risk approach, informed by costs and benefits, would generate a better decision. Treating risk preferences as an input is an error in the FCA's general approach to suitability rather than just transfer advice. Because transfers involve a higher level of calculation and specification of outcomes it is, however, particularly wasteful and misleading in the case of transfers. The FCA could have addressed these deficiencies before 2018 but it did not.

4. Knowledge and experience:

At the time, the relevant rule is 9.2.2R 1c. This requires 'the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio'. We have to assume it was not Parliament's intention to prevent consumers exercising their transfer rights because they had no specific experience of transferring before, or even no experience of pension or other investment wrappers. That would have been discriminatory.

Experience would be gained as a consequence of transfer, particularly if it establishes an ongoing relationship with an adviser. In the case of BSPS members pre-retirement, experience would also be gained from DC contributions.

The implication of the rule in the case of a transfer is that the key test is *comprehension*, not specific experience or knowledge. We doubt reviewers have interpreted this requirement consistently. Even if they did, it is difficult to see how a third-party reviewer would be able to form a judgement in most cases about comprehension without contact with the client. Even FOS apparently finds it necessary in most cases to have that direct contact. The FCA rightly identified this needed strengthening but this was later than Time to Choose.

5. Planned expenditure:

DBAAT interprets detailed information about planned expenditure in retirement as either 'relevant' information (19.1.3G 1) or 'necessary' (19.2.2R 2b). This is open to doubt based on the implicit reliance on the TVAS report. 9.2.2 refers to a requirement to 'understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provide…' etc. The 'essential facts' do not include planned expenditure in retirement which may or may not be known and, if not known, should not prevent best interests, in the form of higher outcomes established by TVAS, being available to the member.

6. Financial situation:

The same applies to 6 as to 5, in terms of what is necessary and relevant. This is where DBAAT builds in the requirement to test for best interests based on a holistic context of income and expenditure and alternative means of meeting retirement spending. It is this section that effectively allows file reviewers to fault recommendations that did not establish the degree of dependence or reliance on the DB pension, or fault them because they did but the dependence was high. Any reference to 'reliance on the income' is hindsight.

It was reasonable at the time for advisers to assume that a member was better off transferring if the outcomes were likely to be higher, on the basis that, in the event of any shortfall against total requirements, the member would prefer a smaller shortfall or the possibility of eliminating the shortfall.

Assessment of best interests did not therefore in all cases require the identification of the proportion the DB represented of total expected retirement income or total investments.

In our response to CP17/16 we supported making transfers a holistic exercise, based on cash flows, because in our own market segment there are many ways to fund retirement and replacing the DB underpin (logically) changes the investment approach to other investment capital, as that had itself been (or should have been) a holistic exercise. This is actually less relevant, or not at all, to people with no other investments. However, it is more important here to establish the principle that hindsight should not be applied to firms who took a view based on the rules and practice at the time.

As noted earlier, we in any case challenge the FCA's assumptions post 2018 that reliance implies a higher value being assigned to guarantees, consistent with a safety-first utility function. This ignores preferences i) to make conventional risk and return trade-offs, subject to TVAS information about both, and ii) to take risk where State Pension is high in relation to the projected DB pension, because of the transformative effects at the margin of either higher spending or earlier retirement.

9. The transfer comparison:

The DBAAT form builds in a bias by focusing on critical yields for annuity purchase with no corresponding requirement to note the required return for drawdown or the longevity assumption. It is possible, but rare, for best interests to be met by transfer with the intention of buying an annuity. This follows from any clear understanding of the source of the welfare gain in DB transfers and the dependence on time that drawdown provides.

On this point it is worth drawing attention to a difference between Grant Thornton's paper and the DBAAT form, as the former does not at any point suggest the critical yield relevant to a drawdown option should not form part of the compliant advice report. It is a fault of DBAAT that it includes only boxes for critical yields based on an assumed annuity.

We expect most advisers recommending transfer to have based their recommendation on drawdown, not an annuity at retirement. (Drawdown does not exclude the option at any stage to opt for an annuity but it will be based on the terms, as they affect age-dependent risk and return trade-offs, given the asset allocation, at the time. Most advisers do not treat transfer as irrevocable in the sense of always being committed to risk taking and precluding guarantees. It is only the option of returning to the specific form of the DB guarantee that was precluded. It is highly likely during the transfer boom that advisers generally took a view that annuity rates would be better in the future anyway, as a function of the exceptional circumstances of QE.) 19.1.3G then requires calculation in relation to 'the rates of return that would have to be achieved to replicate the benefits being given up and 'rates of return which take into account the likely expected returns of the assets in which the retail client's funds will be invested'. We assume they met this requirement by applying the same investment rates both before and after retirement.

There is a case for saying that 19.1.3G should itself have been much more precise about the requirements in respect of assumptions, both about rates of return for drawdown and about longevity. It is even ambiguous in its use of the term 'replicate' to cover both the transfer-to-annuity and the transfer-to-drawdown option (even though neither is actually replication). Left to work out what is the best way to establish the economic interests, advisers have (we think) coalesced around an approach of

i) adopting a low FCA rate (using it as a proxy for a higher confidence level rather than its designed purpose to match the adopted portfolio risk) and ii) solving for the age at which the capital would run out if drawing at the same rate as the DB pension. The 'stress test' for establishing relative outcomes then depends on both a low enough rate and a long enough longevity. These are matters of judgement.

Because the DBAAT omits a section for data input about the transfer-to-drawdown option, we believe it encourages assessors to test largely or entirely on the transfer-to-annuity option. We assume that this is frequently an area of dispute between firms and file assessors. We observe it is certainly the most common basis for FOS to rule a case unsuitable and even though FOS is not required to use DBAAT we assume the FCA's bias has affected FOS.

In the case of FOS, we believe this is a deliberate device to reduce the assessment to one requiring minimum judgement, as a way of dealing with the logistical challenge posed by the combination of case frequency and case complexity. It appears equally deliberate in the case of the construction of the DBAAT form. Both the FCA and FOS must know (having been told many times by firms or their compliance and legal advisers) that the opportunity cost for a drawdown plan is the scheme pension, not an annuity. The annuity critical yield is therefore a straw man that is easier to fault than the economics of drawdown. In fact, firms advising a transfer on the basis of drawdown would prefer to omit the annuity critical yield from their TVAS report to avoid exposing themselves to the straw man argument. But that would instead expose them to fault for omitting a specific requirement of the TVAS/APTA report.

In the case of the redress scheme, we assume advisers doing their own reviews will use the box 'Commentary on any other comparison of benefits'. It is only because of bias they will need to. Biased third-party reviewers may not even bother. Even if they succeed in justifying their drawdown recommendation, the fact that the same case will end up with FOS means that the free text here will still end up being ignored. It is therefore vital FOS is also challenged on the legality of its illogical straw man test.

We do not believe that the DBAAT form can lead to unbiased reviews (both scores and comments on the implications). This is partly because of flaws in the design of the form, as identified above, and partly because no form is likely to deal well with the nuances of transfer and the importance of judgement in interpreting suitability, even when best interests are correctly defined. We are therefore not surprised to learn that there are disputes between firms and the FCA over assessments based on DBAAT as well as disagreement between reviewers outside the firms.

Q 13 Do you agree that the examples of failures we've identified in the BSPS DBAAT instructions are indications of a failure to comply with suitability requirements?

No. We strongly disagree.

General observations:

There is real doubt about the confidence we can place in the outcome of a templated process for assessing compliance.

- This is inherent in the nuanced nature of the problem and its dependence on judgement.

- This weakness has been exacerbated by the design of a solution that is subject to hindsight and bias in its construction as well as subjectivity and inconsistency in its application by different reviewers.
- In terms of the legal requirements of a s404 scheme, this is relevant to ensuring the redress consequences are proportionate to the certainty of causation.

Specific observations:

Q13 is an extension of Q12, as the examples of unsuitability listed in the instructions are also listed as binary questions in the DBAAT form. Our specific observations follow the numbers given to each example and reference our observations on 12 where the same point has already been made.

Ex 1

- Reliance on the income, is a concept incorrectly applied with hindsight (see Q12, section 6).
- Even for cases after 2018, the FCA's logic is wrong because it ignores the marginal utility of small gains in spending power where total income is low. In BSPS cases, the upside motivation may well take the form of earlier retirement which might have even greater marginal utility. This is one of the reasons why the first Case Study unsuitability finding is probably incorrect.
- In applying the concept, the FCA's treatment is internally contradictory: i) it inexplicably regards the underpinning of the state pension as not relevant to reliance and ii) it chooses to ignore the dependence on employer or individual DC contributions due to be made in the future. This illogicality is particularly relevant to BSPS cases because state pension is likely to represent a high proportion of lower-income members' total retirement funding sources.
- The FCA here falls into a trap of its own making by failing to define what it means by reliance or dependence. Ambiguity is likely to have contributed to inconsistency of interpretation by different assessors.

Ex 2, 3 and 4

These relate to potential benefits of flexibility that are assumed in DBAAT to be capable of being primary motivations for transfer, whereas they are in fact *options* embedded in a transfer whose main justification is higher outcomes, of which the options are only a part. DBAAT formalises this false assumption about the independence of the options from each other and from the calculation of sustainable real income from transfer. They assume the adviser should have adopted the approach to listing and prioritising the objectives that we have criticised in response to Q12.

Ex 5

This is an example of the imposition of a 'safety-first' utility function that may or may not apply and which advisers familiar with how UK consumers typically make trade-off decisions are right to assume would not normally apply.

- It is not sufficient to assume that, if a client's identified needs can be met by guaranteed income, they would not value any upside in outcomes. They probably would value very highly payoffs such as higher spending than they would otherwise have and retiring earlier than they otherwise could.

- They might also be prepared to trade off a degree of shortfall so as to be in with a much greater chance of generating those payoffs, although in BSPS' case this trade-off barely applies anyway, shortfalls being highly improbable.

Ex 6

This exhibits the same error as 2, 3 and 4 as well as the error in 5.

- Retiring earlier does not need to be a different objective from higher income, let alone an objective known at the time of the advice. It is a form of payoff from transfer that is facilitated by higher outcomes, or higher prospective outcomes at the point at which the decision to retire earlier is made. It is the job of the TVAS report to establish the scope for higher outcomes though the adviser must also establish that these would be valued and the implied risk tolerated.
- Ex 6 also contains an error of logic. The fact that there may be alternatives that meet the early-retirement objective alone (10.19R 3, 4) does not negate the incentive to transfer, as suggested here, because they do not replace the other potential payoffs from risk.

These points re 2-6 are implicitly recognised in the instructions because the test that bites in each case is the test of tolerance of the required risk. This supports the view advisers were entitled to take at the time that the TVAS report dealt with i) the key motivation of being better off (as distinct from specific identified objectives or forms of payoff) and ii) the test of the ability to tolerate the risk required to generate those potential payoffs. Ex 8 and 9, we note, do refer to the adviser's TVAS analysis and make the other questions redundant.

Ex 7

This is fundamentally flawed because it can be safely assumed that anyone might express a preference for guarantees (in any case misleading when applied to PPF and BSPS2) before they are shown any implied cost (see our response to Q12). The most common UK-consumer utility function holds that people are risk averse but that they also prefer more to less. The application of this utility to a specific case may be evidenced by risk tolerance discovery at the initial stages but will in any even be revealed by the client's reaction to the quantification of relative outcomes in the TVAS analysis. All the addition of this binary test does is give licence to file reviewers to penalise advice on the basis of a prior that is likely to be wrong.

Ex 10

It is necessary to test for lack of comprehension because it should normally trump an economic or quantitative analysis of best interests. We have already referred to the importance of testing for comprehension rather than specific past experience and we believe this distinction should be made much clearer in 10.28, to avoid prejudicing an entire class of consumers, against the intentions of Freedom and Choice. The scope of 10.28 otherwise looks appropriate. The problem with this as a test of suitability is that it is necessarily nuanced in many (if not most) cases: it is a matter of judgement. But it may not be possible to exercise judgement from the file alone without dialogue with the client (see our response to Q12).

Ex 11

This is fundamentally flawed and is the reverse of the economics of transfer-to-drawdown, considering the accepted relationship of i) shortfall risk against a known risk-free rate and ii) time: the longer the life of the plan, the less the shortfall risk (see Q1 point 6). The FCA argues that the lack of visibility about retirement needs is more important than higher outcomes. That is only an assertion. Advisers were entitled at that time to make their assessment of the value placed by clients on transfer outcomes without making the value dependent on contextual information such as a budget. People prefer more to less. Both arguments have been made in response to earlier questions.

CONRED 3 Ann 16R 11.6G (2)

It follows from our criticism of the detailed form of DBAAT that we see CONRED 3 Ann 16R 11.6G (2) as critical to the requirement of a s404 scheme to establish causation. This guidance allows for the possibility that 'the consumer would still have transferred their BSPS to the proposed scheme in the absence of non-compliant conduct'. The most likely reason why this would apply is that the client understood and was satisfied with the rationale provided in the report and in any dialogue with the adviser. As far as the client was concerned, a persuasive case had been made, on solid grounds. It is also likely that the numbers provided by the adviser as part of its APTA spoke for themselves. Any doubt over causation in such cases therefore attaches to the construction of DBAAT as a basis for testing compliance after the event as it embeds in the process the errors of both hindsight and logic.

Q16 Do you agree that we should require firms in the scheme to pass consumer details to the FCA so we can take steps to facilitate referrals to the Financial Ombudsman Service for all cases that are assessed as suitable?

No: we disagree

As a point of law, there appears to us (as non-lawyers) to be a contradiction between s404 and this intention as it effectively means the redress scheme is not an alternative means of consumer redress to FOS.

In terms of practical effects, we are concerned that the differences in professional and regulatory opinions listed in our response will lead to a high proportion of the cases considered by this scheme being found not to be unsuitable or not to be the cause of loss. We are concerned because the predictable impact of a significant increase in FOS volumes, likely in any event because of the FCA's current campaign to invite complaints on transfers generally, is that FOS will resort to binary tests of suitability that do not admit the nuance or judgement inherently required in the assessment of best interests (as set out in our response). There is already a growing number of judgements that rely, for instance, on the critical yield to an annuity even though the recommendation was based on drawdown.

Q19 Do you have any comments on the high-level proposals for redress calculations?

We had earlier submitted our response by email before its separate due date. We include it here for completeness.

In our response to the rest of CP22/6 we will address the questions over the lawfulness of the scheme, in terms of s404, and the QC's opinion, which we challenge. One of the legal issues we suspect (as non-lawyers) has a bearing is *the appropriateness of consulting on the scheme without a specific redress basis*. This is because the general redress approach on which the FCA plans to rely is designed for DB schemes that are genuinely 'safeguarded'. BSPS is not.

We anticipate that the responses to the other consultation questions, like our own, will assert that BSPS is a unique case due to the exceptional degree of the impairment of the inflation protection. This was also a rational and informed cause of the extreme concern amongst BSPS members at the time. Our own modelling of the BSPS transfer terms, using market conditions at 31st December 2017 and applying a very low-risk investment approach with 'reasonable' costs of 1% pa and prudent longevity assumptions, shows a negligible risk of shortfall against the equivalent DB pension even on a full RPI basis at 99% confidence. That ex ante chance of loss has already been eliminated by inflation above the caps in inflation indexation applicable to either PPF or BSPS2. (This was modelled on Case Study 1 in CP22/6 which the FCA reviewer found to be 'unsuitable'.)

The optimal approach to redress will use as much information as is known and as little as possible that has to be estimated. Given the significance of the exposure to inflation risk to the chance and size of loss, the known inflation erosion, potentially already up to 10%, needs to be incorporated in the calculation in the case of BSPS.

The consultation should also have addressed at outset the question of how to calculate a matching liability cost, given the lack of instruments that replicate the real cash flows of the PPF and, more particularly, BSPS2. The cost difference between full RPI annuities and annuities with a fixed rate of escalation close to BSPS rates for different cohorts is around 30%. It is also well in excess of the likely drawdown shortfall estimated on a full RPI basis. Dealing with this as an integral part of the s404 argument, where it could also be within the scope of the legal opinion, would have pointed to the numerical inconsistencies in the paper and weakened a case that depends in law on the loss experience being widespread. Hence our question whether this treatment can alone render the scheme unlawful.

Q20. Do you agree with our estimates of the costs and benefits of our proposed scheme?

No. We disagree.

The CBA relies on the same assumptions about losses that we argue in this response are unreliable and biased. But this is about achieving a just outcome for both consumers and advisers who are the parties to a disputed set of transactions. The idea that justice, the focus of this proposal, should be subject to a CBA is itself quite arresting.

The direct cost of complaints about BSPS transfers will fall largely on FOS. The true costs of a flawed suitability assessment process at FOS, as validated by the FCA via these proposals, and of a flawed redress calculation, will fall on the industry and, ultimately consumers. In one sense this is a zero-sum game, as the process is a mechanism for taxing a very large number of consumers to benefit a very small number. However, that is to lose sight of the fact that for that to happen many adviser firms will be wiped out unjustly.