

Consultation CP22/15

Summary

In our response to CP22/6 we argued that

- the FCA's basis for determining unsuitable transfer advice was flawed, both in principle and in the construction of the DBAAT form used to test for suitability
- FOS was wrongly using circular logic by applying the critical yield, assuming an annuity at NRA, as a test of probable loss when not buying an annuity.

The significance of these failings, in conjunction with a) the default (in the event of doubt) to a presumption that best interests were met by not transferring, and b) the deferral of decisions (in the event of no fault) to FOS, is that *redress will be given in more cases than is justified*.

This is far more important, in our view, than the fact that the redress calculation is itself open to criticism. Tweaks to the redress method cannot compensate for doubt about the finding that redress is due.

We have no direct interest in this consultation as we have no BPS cases. We are therefore reluctant to spend a lot of time on a response, but we do have several technical observations to share with the FCA based on our reading of the documents.

- There is excessive prudence in several assumptions about parameter values that we believe, individually and when taken together, introduce over-compensation that conflicts with the intended degree of prudence, as set out as Objective 2 and as the basis for the legal opinion
- There is an error in logic where the proposals seek to smooth changes in dividend yields: when considered in conjunction with unsmoothed price changes in the replacement portfolio, it will tend to increase, not reduce, the volatility in the redress amount. Such an effect serves no good purpose.

Excessive prudence

The legal opinion suggests that the FCA's proposed approach to the pre-retirement discount rate 'strikes a reasonable balance between the interests of the consumer, and those of the firms'. This deals with the obvious inconsistency between the *stated* objective of redress, to replicate the DB promise (implicitly at every stage) and the *actual* use of an investment-based pre-retirement discount rate. In the legal opinion the second is justified to avoid the risk of 'overcompensation', 'because the consumer will have a fund of investments which they ought to be able to invest in such a way as to generate a return, pre-retirement, which exceeds the return implied in the post-retirement discount rate'.

Our observations accept that as the intention, rather than a replication of the DB pension at every stage. We also agree with it, because of the lack of certainty (in most cases) of probable loss, as demonstrated in our CP22/6 response.

Viewed as a 'compromise' (as suggested in the legal opinion), it is critical to the *fairness* of redress in all circumstances where the investment portfolio was not indisputably unsuitable or even fraudulent (given the nature of the recommended investments), but rather nuanced, in terms of its likely ability to produce higher sustainable real income than an annuity, at personally tolerable levels of investment risk. We have argued before that the FCA and FOS are wrongly discounting the personal motivation to be better off and hence the chances of higher income via drawdown are not only not given enough weight in the assessment of files and are actively biased against in the DBAAT form structure.

The bias against the economic motivation is potentially 'doubled up' if a further level of bias is introduced to the redress calculation. This is the case, currently and as proposed.

Pre-retirement discount rate

The pre-retirement discount rate as proposed is made excessively prudent at three points:

1. 4.41-43 introduces a margin of prudence relative to the risk-equivalent mean expected return of 9% (a 59% vs 50% probability – no data provided). As Deloitte admits, there is no logic for doing so other than as a function of an externally imposed margin of prudence.
2. The mean expected return is based on a growth model that, though one of many options, is one that produces much lower outputs than observed historical real equity return data. Regression trends for very long time series for real total returns at the level of UK and other market capitalisation-weighted indices are of the order of 5-7% pa. That is why funding decisions in institutional contexts typically assume around 6% real. These observations have never been consistent with a growth model of yield plus GDP growth, other than randomly. The payout ratios are far too variable to support such a simplistic formula and the relationship between GDP and equity return on capital is widely understood to be weak. The proposed formula (4.45) currently implies a real return for the equity component which is only about half the regression trends.
3. The underestimate of equity returns is aggravated by not allowing for the substitution of RPI by CPI. The typical 6% real assumption drawn from historical data is based on deflation by RPI and if notionally based on CPI would be higher, by perhaps 0.5-0.75% pa.

When related to Fowler Drew's unbiased modelling of real total returns from a low-risk allocation of equities and ILGs, we suggest the proposed discount rate is equivalent to a much higher confidence level than the 59% Deloitte suggested. Whilst that might be appropriate if that were the stated intention, it is not. At the level of confidence implied by our modeling, there would be no point taking any risk. It is no higher than the 'theoretical' pure real risk-free rate of around 1% pa, and well below actual index linked gilt yields prior to QE.

Post-retirement discount rate

In terms of the potential for error in the initial fault finding, it is the assumed post-retirement discount rate that creates most of the over-compensation. As set out in our response to CP22/6, this follows logically from the opportunity for improvement in welfare stemming from the exceptionally low or

negative real interest rates at the time. To be consistent with that opportunity, it is only fair that the assumed annuity rate be 'normalised', as is the pre-retirement discount rate. It is the variance in the market-derived discount rate that is a major source of the variance in the redress amounts that so many steel workers have struggled to see as fair or logical.

Now that real interest rates are in fact normalising, this is becoming clear, to the extent that many redress calculations performed on the 'old' basis are producing no settlement amounts. Clearly, deferred members who have already received redress have been over-compensated.

We are reluctant to propose how normalised yields be introduced, as our own work in this area relies on market index linked gilt yields and stochastic simulations based on historical observed real total returns for equities. We do not use the FCA framework of nominal gilt yields, and a point inflation forecast.

Inflation pre-retirement

A bias to excessive prudence is also introduced by discounting the evidence of inflation relative to any applicable caps. This is particularly relevant to BSPS members because they are all subject to some degree of cap relative to CPI and they have now experienced inflation rates above the cap.

The FCA's problem here is that the effect of CAPs on deferred pensions is a function of the whole period to NRA. Whereas this might appear to justify ignoring actual effects in the period up to the calculation date, we believe doing so significantly increases the risk of over-compensation. This is because the probability of any given rate of inflation being experienced over the whole period is not independent of the rate experienced in part.

The higher any excess to date over a cap, and the shorter the period to NRA, the greater the change in the price level in the rest of the period required to match the estimate made before the excess was known. For example, if the price change has already exceeded a cap of 2.5% by 10%, and there is a further 10 years to go, the inflation rate would have to fall to 1.7% over the balance of the term to avoid any excess over the whole period. This is possible but not with the same probability as the original 'forecast'.

This could be described as a Bayesian general approach to new data but it seems more important in the specific case of BSPS transfers that the probability of falling back below the cap reflect the actual circumstances of the recent known inflation increases.

- The origins in post-Brexit and post-Covid supply constraints suggest that the earlier low rates of inflation were unsustainable and that a one-off jump in the price level (not just the rate of inflation) was bound to follow at some point. These sources of changes in the price level are not likely to be reversed.
- The later energy effect on the price level might be partly reversed but that itself depends on supply being fully restored or substituted.
- The main impact of these changes in the known inflation rate is via their impact on wage demands. Here, it seems quite unlikely that we can avoid an increase in the core rate of inflation, backed up by industrial unrest. It is even likely that the Bank of England's inflation target will have to be raised.

The anticipation of these risks of a change in the inflation regime were an important driver for the anxiety of steelworkers at the time they were considering transfer. It may have been intuition, but it was right.

Again, the clear inflation risks, given low inflation caps, need in the first instance to be properly accounted for in the advice assessment process. There is no provision for this in the DBAAT process.

For the redress calculation to take them into account as well, it is necessary to depart from the 'normal' approach of ignoring any past inflation as if it were irrelevant to the whole-period inflation rate. The starting point for the real DB income in the case of BPS (even if exceptionally) should not be at the point of leaving the scheme but at the point of calculation.

Smoothing the dividend yield

This is not about prudence. It appears to be a mistake. Deloitte's advised you to use a rolling average of the dividend yield at the end of the previous 12 months and you agreed that it would 'provide a more sustainable dividend yield and reduce the volatility in both the dividend yield and resulting equity return assumption.' This misses the more important effect of smoothing the yield, which is on the redress amount itself.

This follows mathematically from the fact that the current equity price is common to both the formulaic cost of replicating the DB promise (via the dividend yield) and the market value of the replacement portfolio (via the price of equities held). If you smooth one but not both, the effect is to increase the volatility of the difference between the two, the redress amount. This was not a policy objective. In fact it is a bone of contention with both members and advisers, leading to what has been described as a 'lottery'.