Pension mis-selling review

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The pension mis-selling review has dealt with 1.6 million cases of personal pensions that were sold inappropriately between 1987 and 1994. The deadline for submitting cases to the review is now past. This standard note sets out the background to the review, how the review has been conducted, and its results.

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A. Background

The *Social Security Act 1986* established the legislative framework for new approved personal pensions and the relevant provisions came into force in April 1988. The Act and accompanying tax legislation provided for two broad changes to the existing retirement annuity contract regime. Firstly, the new personal pensions were to be fully portable and capable of making and receiving transfer payments from other approved personal and occupational schemes. Secondly, for the first time it was to be possible to contract out of the State Earnings Related Pensions Scheme (SERPS) and use the contracted out contributions to fund an approved personal pension. Previously, it had only been possible to contract out using an approved occupational scheme.

Personal pensions which could be held independently of an employer were designed to be particularly suitable for the self-employed and those who moved jobs frequently, thus reflecting the Conservative Government's policy of encouraging mobility of labour. They are generally considered to be unsuitable for those who have the option of an occupational scheme as the final benefits from a personal plan are likely to be less. There are three main reasons for this: the commission costs and charges payable on a personal pension plan; the fact that employers are more likely to contribute to an occupational scheme; and the nature of a final salary occupational scheme. By 1994, over 5 million personal pensions had been sold.[1]

By the early 1990s, stories started to emerge that many personal pensions had been sold to investors who would have been better off remaining in, or opting into, an available occupational scheme. Where such investments had been made on the advice of financial services firms this was termed mis-selling.

Two types of pension transactions are involved: those where individuals have transferred funds from an occupational pension to a personal pension and those where an individual has opted-out of an occupational pension into a personal pension. **Transfers** involve people who have been contributing to an occupational scheme choosing to leave that occupational scheme and transfer a lump sum of accrued pension rights into a new personal pension scheme. **Opt-outs** are where an individual who is a member of an occupational scheme decides to take out a personal pension scheme instead, even though they still work for the same employer and would be entitled to remain in the scheme. A similar class of individuals are the **non-joiners**: these are people who do not join an occupational scheme when they start work at a new employer, even though there is an occupational scheme in operation there.[2]

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1 Treasury Select Committee, *The Mis-selling of personal pensions: volume II minutes of evidence and appendices*, 12 November 1998, HC 712-II 1997-8, Memorandum submitted by HM Treasury, p 1

2 Securities and Investment Board *Pension Transfer and Opt outs: review of past business part II*, October 1994 p3-4

B. The Review

The selling and marketing of personal pensions at the time was regulated under the *Financial Services Act 1986*. Powers under the Act were transferred to the Securities and Investments Board (SIB),[3] which recognised a range of self-regulatory organisations (SROs). The main SROs at the time personal pensions first became available were LAUTRO and FIMBRA (replaced in 1994 by the Personal Investment Authority (PIA)), IMRO and the SFA. The SROs and the SIB were responsible for setting the rules and regulations that financial firms were required to adhere to when marketing and selling financial products. These rules set out the duties of a financial adviser to ensure that any product sold was suitable for the investor and that where advice was given, that advice was 'best advice'. The rules were written in fairly broad terms but by 1992 the regulators started to give specific guidance and warned of the dangers of mis-selling.

In December 1993, the SIB set up three committees to advise on the revision of standards which should apply to future pension transfers and opt-outs, and on the conduct of a review of past cases. In March 1994, the SIB published new standards for future transfer and opt-out business, *Pension transfers and opt outs: further safeguards for future business*. Most of the provisions in the new standards took effect from 1 July 1994. The SIB and the SROs initiated a review of past business in October 1994 and issued guidance on how this should be carried out, and a statement of policy. The review aimed to identify cases where investors had suffered loss as a result of a material breach of the rules by the firm which advised them. The applicable rules were those which were in force at the time the advice was given. Where loss had occurred as a result of non-compliant advice, firms were required to provide redress to restore the investor to the financial position in which he or she would have been had that advice not been followed.[4] If some one was still employed by the same employer, the compensation usually took the form of a buy back into the occupational scheme. If this was not possible, or the individual was no longer employed by that company, then the redress was a payment into the personal pension plan in compensation for lost benefits.[5]

Therefore, there were three tests which had to be satisfied if an investor was to qualify for compensation. First, it had to be shown that the investor was likely to lose as a result of taking out a personal pension rather than remaining in or joining an occupational scheme (*loss test*). Next, it had to be shown that the investor was given advice which fell materially short of the regulatory standards in force at the time it was given (*compliance test*). Finally, it had to be shown that the cause of the loss (if there was a loss) was the non-compliant advice (*causation test*). The key point was that there must have been non-compliant advice: this test should not be affected by subsequent economic conditions. The review covered the

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[3] now renamed the Financial Services Authority (FSA), under the *Financial Services and Markets Act 1999*

[4] Securities and Investment Board *Pension Transfer and Opt outs: review of past business part I*, October 1994 p12-13

[5] FSA *Personal pensions mis-selling: the facts* April 2000

period between 29 April 1988, when the *Financial Services Act 1988* came in to force, and 30 June 1994 when the SIB's new rules took effect.[6]

The review has consisted of two phases. Phase 1 of the pensions review began in October 1994 and firms were obliged to submit details of compensation offered by December 1998. Phase 2 began in January 1999 and the target date for completion was 30 June 2002. Investors were given until 31 March 2000 to make a request for their cases to be investigated. The categories of investors included in each phase of the review are contained in the following tables. The ages refer to the age of the investor when they purchased the personal pension.

Transfers	
Phase 1 (priority)	Men aged 50 or over and women aged 45 or over
Phase 2	Men aged under 50 and women aged under 45

Opt outs/non-joiners	**35 or over**		**Under 35**	
	Opt out	Non-joiner	Opt out	Non-joiner
Stayed with the same employer since taking out a personal pension				
Chose to make contributions to the personal pension	Priority	Priority	Priority	Phase 2
Took personal pension out on a rebate only basis (i.e. the only contributions are National Insurance rebates and contracting out incentives provided by the DSS	Priority	Phase 2	Phase 2	Phase 2
Changed employer since taking out a personal pension				
Chose to make contributions to the personal pension	Priority	Phase 2	Phase 2	Phase 2
Took personal pension out on a rebate only basis	Priority	Phase 2	Phase 2	Phase 2

Firms which had advised on, or arranged personal pension plans, were required to conduct a review. Where the plan had been sold by an independent financial adviser rather than by the

[6] Securities and Investment Board *Pension Transfer and Opt outs: review of past business part II* October 1994

product provider itself (such as an insurance company) the adviser was responsible for reviewing the sale. Where the plan was sold by an appointed representative of a member firm, however, the member itself was responsible for carrying out the review. Where firms were no longer trading, the PIA Pensions Unit undertook the review. The aim of the review was to provide a speedy resolution of cases without the need for legal proceedings.[7]

C. Progress

Although the review is now all but complete, its slow progress was the main area of controversy. The first phase was marked by delays in adhering to the review timetable partly because of formidable technical and legal difficulties associated with the exercise, but also some felt because of a reluctance on the part of some firms to carry out the required work. In March 1997, the chairman and chief executive of the Personal Investment Authority appeared before a hostile Treasury Select Committee to explain what action had been taken to date and why progress had been so slow.[8] In the same month, Angela Knight, then Economic Secretary to the Treasury met with the chair of the SIB about the review and issued a press release saying that she would accept nothing less that "huge progress in 1997".[9]

After the 1997 General Election, the new Government took a tough stance over the pensions review. The major pensions firms were warned of the consequences of delay in the review, and monthly progress figures for each firm were published by the Treasury. Each of these firms was also required to provide the Treasury with details of the steps they were taking to complete the review. On 16 February 1999, the government announced that all the remaining firms monitored by the Treasury had made sufficient progress towards their targets under Phase 1 to be removed from the published list.[10] Patricia Hewitt, then Economic Secretary to the Treasury, said that she would reserve the right to resume publication of information about firms' progress during Phase 2. Whilst these larger firms had made good progress with the priority cases in the first phase of the review, the Government remained very critical of the speed with which Independent Financial Advisers (IFAs) had dealt with their caseload.[11]

The guiding policies for Phase 2 were announced on 28 July 1998.[12] These proposed that all investors should be sent initial invitation letters and reminder letters between 4 January 1999 and the 31 March 1999 and that this should be supported by a media campaign to raise awareness. On 5 January 1999, the FSA launched a £10 million publicity campaign funded by the reviewing firms. The campaign was targeted at investors who might have been mis-

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7 Securities and Investment Board *Pension Transfer and Opt outs: review of past business part I,* October 1994, p15

8 HC 381 1996/97

9 HM Treasury press release, *Redress for personal pensions*, 6 March 1997

10 HC Deb 16 February 1999 c 635W

11 HC Deb 7 July 1998 cc 432-3W

12 Financial Services Authority press release, *Pensions review phase 2- key policy decisions announced*, 28 July 1998

sold a personal pension and involved radio and television advertisements in addition to the letters sent to investors.

There were objections from within the IFA sector that the second phase of the review was unnecessary. The Independent Financial Advisers Association (IFAA) said that thousands of its members would be bankrupted by having to pay compensation to investors in the second stage of the review and that many of the younger people included in the review had not lost out financially. The IFAA's concerns were raised by John Whittingdale MP, Opposition Treasury Spokesman, in a debate in November 1999:

> While the bullying and the intimidatory tactics of the previous Economic Secretary may not have been entirely necessary to achieve progress under phase 1, they are wholly inappropriate and unjustified for phase 2. The issues are much less clear cut and mainly concern younger people who are several years away from retirement, and we are considering advice that was given at a time when standards and market conditions were very different.
>
> The burden of the phase 2 review is likely to be crippling for many small firms, but its justification is far less obvious. Under phase 2, advisers are required to seek out claims by writing to clients in envelopes that say on the outside, "Are you owed?" If investors request a review, it has to be conducted not according to the market conditions prevailing at the time, but according to the conditions of today's market which are vastly different.
>
> In the 10 years since many of the transfers took place, annuity rates have fallen dramatically. The result is that those who took advice to transfer accrued benefits into a personal pension in 1988 today require 37 per cent. more in their retirement fund to provide the same pension. Nobody could have foreseen such a change, but under the rules, advisers are expected to provide compensation for its effects, although it is by no means clear that investors will ultimately suffer any losses as a result since investment conditions may well have swung back by the time that investors eventually retire …
>
> Advisers are also being judged retrospectively on today's standards. In the vast majority of cases, advisers may well have made clear to their clients the potential risk involved, but 10 years ago, there was not the stringent requirement that now exists to keep records of advice given. The Economic Secretary said in her speech that the industry was misleading people by claiming that it was not required to keep proper records, but many of the IFAs that are now being criticised for not keeping records were at the time subject to several inspections by the regulatory organisations, and at no point did the regulators make any comment about the lack of records. Yet the burden of proof will now be placed on the advisers to show that they are not guilty of mis-selling rather than the reverse.
>
> If phase 2 proceeds as intended, it will offend natural justice and lead to hundreds of long-standing and reputable firms going out of business. Unlike the big providers,

> they do not have policyholders or reserves to meet the costs of the review, let alone any compensation that might have to be paid.[13]

In her statement opening the debate, Patricia Hewitt, then Economic Secretary to the Treasury, was largely unsympathetic to the arguments of the IFAA:

> I am extremely sorry that every Member of the House, whether in personal meetings with constituents who are IFAs or through the circular letters that have come from the Independent Financial Advisers Association, has repeatedly been misled as to the true situation.
>
> The first thing that I did when I took responsibility for the review of personal pensions mis-selling and encountered the lobbying from the IFA Association was to press the Treasury and the regulators on the issue, to find out what rules were in force at the time. The regulations that were in force at the time, under the regulatory framework--inadequate though it was--put in place by the previous Government, stated that products that were sold by independent financial advisers or by life firms had to be suitable for the investor. The regulations also required those selling products to keep records of the sales. One of the difficulties facing many--not all--of the IFAs in the current review is that they did not keep adequate records …
>
> The IFAA is an organisation whose track record has been to put its members' commercial interests ahead of the rights and welfare of their customers. It went as far as to take the regulators to court over the priority review in 1995. It lost that action, but it held up the review.
>
> In all our constituencies there are people who trusted poor advice by some IFAs, and whose future may well be much poorer as a consequence. On average, in each constituency represented by a right hon. or hon. Member, for each IFA firm in that constituency, there are about 100 victims of poor advice from an IFA or a life office. If the IFAA and its supporters had their way and delayed or even stopped phase 2, those people would be left high and dry. Neither the Government nor the regulators will allow that to happen. The second phase of the review will go ahead. We will not allow the IFAA to wreck people's entitlement to the redress that they deserve.
>
> I take the opportunity presented by this debate to ask the industry as a whole to think long and hard about the consequences of seeking to frustrate progress on phase 2. What would happen if it succeeded? The first damaging effect is that the industry would prolong the uncertainty for the victims of mis-selling, adding insult to injury. Secondly, it would prolong the agony for the industry as a whole. Despite a slow start, many in the industry have come to the view that the sooner it puts the shameful pensions mis-selling episode behind it, the better. The last thing that respectable firms want--or should want--is further delay and postponement of the day when the reputation of the industry recovers.[14]

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[13] HC Deb 3 November 1998 cc 726-7

[14] HC Deb 3 November 1998 cc 718-9

There were some problems and delays with phase 2 of the review. On 17 February 2000, the FSA confirmed that the regulatory guidance for transfers under phase 2 would have to be amended.[15] Research conducted by the FSA had suggested that the existing PIA guidance could be leading to an underestimation of loss for those in phase 2 due to the method of calculation being used. This change also led some insurance companies to increase their estimate of the cost of redress.

D. Free-standing AVCs

A free-standing additional voluntary contribution plan (FSAVC) is a type of personal pension plan. It is designed to allow people who wish to top up their occupational pension rights to do so. The main alternative for someone with an occupational pension, who wishes to build up a larger pension, is to make additional voluntary contributions (AVCs) to their occupational pension scheme. All occupational pension schemes must offer AVCs to their members. Contributions to AVCs are limited to 15% of net pay, the benefits must be an annuity, and total pension income cannot exceed Inland Revenue limits, which are two-thirds of final pay.[16]

The main differences between FSAVCs and AVCs are based around the fees. Someone making AVCs will face lower charges as they are part of the occupational pension fund, while an individual taking out an FSAVC will have to pay the full cost of the fund. Secondly some firms will offer subsidies to members who make AVCs making them more valuable, while it is rare for a company to make contributions to an FSAVC. However FSAVCs are portable, which makes them more suitable for people who move jobs.[17]

A review of possible mis-selling of FSAVCs has also been conducted. It began in 2000 and was carried out under the supervision of the Financial Services Authority, as an extension of the personal pensions mis-selling review. People who wanted their cases reviewed had to apply by 31 December 2001. The model guidance issued in May 2000 set out the terms of the review and the actions that firms had to take.

> 1.1. The Financial Service Authority ('FSA') has concluded that firms should review their sales of Free-Standing Additional Voluntary Contribution ('FSAVC') policies made during the period 29 April 1988 to 15 August 1999. This guidance sets out the procedures and standards to be used.[18]

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15 FSA press release, *Pensions review phase 2: amendment to regulatory guidance for transfers*, 1 February 2000

16 Tolley's *Additional Voluntary Contributions – A Guide* 2000 p7

17 ibid. p23

18 http://www.fsa.gov.uk/pubs/fsavc-review/model-guide.pdf

The review focused on FSAVCs sold to people who might have done better from AVCs offered as part of their occupational pension scheme. The main groups of people who were included in the review were:

1. Employer offered matched contributions into their AVC
2. Employer offered other subsidies on contributions to their AVC
3. FSAVCs converted from personal pensions
4. Where an individual requests a review.[19]

It is thought that the FSAVC review covered 10% of FSAVC sales. It had a target of dealing with 90% of cases by 30 June 2002, which it met.[20]

E. Costs and numbers

According to the FSA, the mis-selling review was 98% complete on the target date of 30 June 2002, and the outstanding cases are likely to be completed by the end of 2002. 1.6 million people have had their cases reviewed under the pension review. In 90% of cases redress has been paid, but 24,000 cases could not be completed by the 30 June deadline due to a legal ruling over the use of windfalls in pension compensation.[21] The cost of compensation has been estimated to be £11.5 billion with an additional £2 billion spent on administration. The FSAVC review is estimated to cost £330 million in compensation and £80 million in administration.[22]

There have been various reasons cited for the scale of mis-selling. In its evidence to the Treasury Select Committee, the Treasury said, "firms simply did not abide by the regulatory rules".[23] The policies of companies involved in pension selling, and the sales techniques adopted by those who they employed, may also have contributed. Press reports suggested that companies operated pay structures which required salespeople to meet specific sales targets in order to qualify for their salary.[24] Any failure to meet the targets resulted in staff owing the company money on the salary that they had been paid but had not earned. Other commentators argued that these problems were exacerbated by the number of personal pension providers in the market.[25] The Treasury Select Committee also pointed to the evidence of several witnesses who said that the extent to which personal pensions had been advocated at their launch had also contributed.[26]

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[19] FSA Factsheet, *FSAVC pension top-ups were you badly advised?* August 1999

[20] FSA press notice *£11.8 billion compensation for pensions and FSAVC reviews* 27 June 2002

[21] FSA press notice *£11.8 billion compensation for pensions and FSAVC reviews* 27 June 2002

[22] FSA press notice *£11.8 billion compensation for pensions and FSAVC reviews* 27 June 2002

[23] Treasury Select Committee, *The Mis-selling of personal pensions: volume II minutes of evidence and appendices*, 12 November 1998, HC 712-II 1997-8, Memorandum submitted by HM Treasury, p 3

[24] "Hard sell increases the costly potential of 'a duff product'", *Financial Times*, 28 February 1994

[25] Fenton et al, *Tolley's Pensions Handbook: second edition*, p 540

[26] Treasury Select Committee, HC 712-I 1997-8, p ix

F. What happens if you missed the deadline for the review?

In order to have a pension reviewed under these special measures, you had to make a request by 31 March 2000. However if you missed that deadline you might still be able to complain or take legal action to get compensation. However this will be subject to time limits, as after a given time a firm may use the time elapsed as a defence. The FSA advises that in general, a claim should be made within 6 years of the date you were advised to take out a personal pension, or within 3 years of the date you could have been expected to know of the problem.[27]

The Pensions Advisory Service (OPAS) provides a free advisory service for anyone with a concern about their occupational or personal pension. It may be appropriate to contact them if there is concern about whether a pension was mis-sold which is outside the pension mis-selling review. OPAS can be contacted by telephone on 0845-6012923 or their address is OPAS, 11 Belgrave Road, London, SW1V 1RB.

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27 FSA *Personal pensions mis-selling: the facts* April 2000