Held to account

David Severn, who recommended the introduction of RU64 to the PIA as a temporary measure, looks at the minefield through which IFAs now have to pick their way to try to avoid any regulatory action in the future with the introduction of Personal Accounts

In December 2006 the Government published its plan for solving the pensions crisis, including the introduction of so-called Personal Accounts. Legislation now before Parliament will set up a Personal Accounts delivery authority, which, among other things will have an advisory capacity on the detailed design of the Accounts. It will then need a Personal Accounts Bill during 2007/08 for the Accounts to take their final form.

If all goes according to plan the Government thinks that people will be able to start saving in a Personal Account from 2012, but there seems plenty of scope for delay. As with stakeholder pensions, the aim seems to be for IFAs to be cut out of the pensions picture, this time through workers being auto-enrolled into Personal Accounts, which will be a type of occupational rather than personal pension.

Meanwhile, there are many workers who are making no or inadequate provision for their retirement. Recognising that the problem of underprovision is with us today, the Parliamentary Select Committee on work and pensions has issued a clarion call for action in advance of 2012.

In a recent report the Committee said, “We stress that people should be encouraged to start saving before the scheme is in place, and not put it off until 2012. A 25-year old on average earnings could see their pension pot at retirement reduced by over £36,000 in real terms - roughly 20% - if they wait to save until Personal Accounts are set up. Government, industry and the financial sector should work together to ensure that we do not inadvertently create a generation of non-savers”.

The message to IFAs seems to be that we need you now to do the “encouraging” but come 2012 we will not want to know you. IFAs may well, however, be wary of “working together” with anyone given the pitfalls set by the FSA in advising on pensions.

Dither and U-turn on RU64

Recently the FSA finally announced that it had decided to retain its rule setting a higher standard of advice for personal pensions, that rule being based on

guidance originally issued by the PIA in its Regulatory Update 64 (RU64).

When RU64 was introduced in 1999 the Government had already introduced legislation into Parliament setting out most of the detail of stakeholder pensions (SHP), which were to be introduced less than two years later. This is quite unlike the situation today. We have yet to see the Personal Accounts Bill and it will be five years at least before the new pension exists.

Also, the personal pensions landscape in 1999 was totally different from that of today. RU64 was designed to address the selling of those regular premium contracts with significant upfront charges, of which some 1.1m had been sold in 1998, mainly by direct salesforces.

The worry was that there would be a blitz of selling such contracts and that those consumers who bought them could subsequently only convert to an SHP at significant financial loss. Intended as a temporary measure by the PIA, the FSA decided to make it a permanent feature of its rules affecting all personal pensions and not just the regular premium contracts with high upfront charges.

Over the years evidence mounted that the FSA rule was tantamount to the regulator imposing a charge cap on all personal pensions and that this was having a deleterious effect on their sale. In June 2005 the FSA noted that sales of new regular premium contracts had declined by 61% since 1998 while the average regular premium paid to those contracts that were already sold had risen by 54%, a situation that led the FSA to propose the abolition of its rule.

In May 2006 the FSA started to dither over abolition of RU64 and announced that it would delay making a decision until there was "greater clarity over the Government's pension reform plans". Then, in March this year, the FSA announced its u-turn, claiming that the publication of the White Paper on pension reform in December 2006 had "removed many of the uncertainties".

Stakeholder failure

If the reduction in sales of personal pensions had been compensated for by an increase in the take up of SHPs then the FSA's decision to keep RU64 might be understandable.

But as the Pensions Commission commented, "A primary policy initiative that focused on increasing participation, the Stakeholder Pension, while achieving some reduction in costs, has not achieved any measurable increase in participation. 80% of all employer designated schemes are 'empty shells', nominated schemes but with no members".

The Government and the FSA had been expecting or hoping that SHPs would simply sell themselves but that did not happen. As a recently published Defaqto pensions report shows, consumers are disengaged from pensions as a subject and are mistrustful of both employers and Government. So, in the absence of an adviser to do the essential task of persuasion, SHPs failed.

The Government's meagre attempt to generate some sales by raising the charge cap by a half percentage point was not enough, and the FSA's design of a 'basic advice' process had to employ some crude filters to identify those consumers for whom an SHP might not be suitable, which reduced the number of potential prospects almost to vanishing point.

The FSA claims that the situation has been saved by GPPs, which "have shown rapid recent growth often reaching lower and middle income groups", and that the existence of an employer contribution (even though, of course, there might not be one), "makes a GPP suitable for most employees".

What this ignores is that 99.3% of UK enterprises are counted as 'small', meaning 0-49 employees; in total these enterprises account for 46.8% of employment in the UK and it is among these enterprises that most of the unpensioned are likely to be found. The FSA was not able to say how far the GPP had penetrated this small enterprise market.

Are Personal Accounts suitable for all?

The value of financial advice is surely that the consumer who receives it should be better off as a result of getting that advice rather than worse off.

Yet, in a complacent piece of guidance, the FSA says in its January 2007 newsletter for financial advisers that, when giving advice, "one factor that you may want to consider taking into account is whether a product will affect a customer's entitlement to means tested state benefits. Principle 9 imposes a broad requirement for a firm to take reasonable care to ensure the suitability of its advice."

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There ought to be no "may" about it. If it is clear that a consumer will end up forfeiting the right to means tested benefits to which they would otherwise be entitled an adviser should make that clear. This issue of means tested benefits is key to the new Personal Accounts.

The Pensions Policy Institute (PPI) has conducted some admirable analysis on the 'suitability' of Personal Accounts for different types of consumer and which it has published in its report *'Are Personal Accounts suitable for all?'* (pensionspolicyinstitute.org.uk).

The PPI identifies two possible criteria for assessing the suitability of savings in Personal Accounts:

- 1) that saving in a Personal Account is the best thing for individuals who stay auto-enrolled. The PPI says that this condition would not be met if another product would have been preferable to a Personal Account, even if an individual would not strictly lose out from saving in a Personal Account. It equates this with the FSA definition of 'suitability', which broadly aims to ensure that, when consumers are being advised on investments, any recommendation takes account of the individual's circumstances.
- 2) a less stringent condition that individuals that stay auto-enrolled should not lose out as a result of their saving and compares the difference between the amount saved and the likely amount eventually received as pension income.

In its analysis the PPI adopts this second and less stringent definition of suitability and even on this basis it demonstrates that there are a host of consumers who, because of their individual circumstances, may not make the right choice by saving in a Personal Account.

The situation is put more succinctly by Steve Bee who is campaigning for the Government to guarantee to everyone saving in a pension that every pound they save will make them at least one pound better off than non-savers. As he comments, "It sounds silly put like that doesn't it?".

And yet, the overall effect of the Government's proposals is that still a third of workers will end up with means-tested support in retirement and while most will lose "only" 40% of the value of what they have saved, for some it will be 100%

Consumers' need for advice

The PPI analysis shows just how complicated it will be for individuals to decide whether they should be auto-enrolled in a Personal Account or if they would do better to opt-out of the arrangement and, similarly for the self-employed, whether it makes sense for them to opt-in to an Account.

The Government seems to be taking the view that it will be all right on the night and that a new national generic advice service will help workers decide on the complex issues. Yet, the work and pensions Select Committee has expressed severe concerns about whether this will deliver: "The Government does not yet know (a) how much the advice system is likely to cost, (b) who will deliver it and (c) what form it is likely to take.

"We would not expect the system to be designed down to the last detail, but the feasibility study of a national approach to generic advice ... will not report until the end of 2007", which means that everyone has to keep their fingers crossed that consumers will get the help that they need.

Guide us FSA

Having decided to keep some specific guidance in the form of the RU64 rule, you might think that the FSA would be prepared to give some hint as to what it expects IFAs to do now, and what its approach will be in the future.

The official view from Canary Wharf is, however, not encouraging: "We currently have no plans to issue specific guidance in relation to Personal Accounts. We do not see a need for guidance because there are existing suitability rules that advisers should follow".

The FSA does, however, confidently state, "It is our view that the existence of a mandatory employer contribution will make Personal Accounts the right thing to do for the majority of people who would be eligible", a view that seems far too sanguine in the light of the PPI's analysis and indeed the FSA's own newsletter encouraging advisers to take account of means-tested benefits when advising.

Mis-enrolment

It seems likely that in future years there will be another term to add to that of mis-selling and that will be mis-enrolment.

There will be many prudent workers, or just apathetic ones, who save in a Personal Account but when they come to retire find that they do not get the full benefit, or in the worst case no benefit at all, compared with their colleagues who decided to opt-out of a Personal Account and live a life of beer and skittles before they reach retirement.

As Personal Accounts will be occupational arrangements there will be none of the obligations to ensure suitability, which fall on an IFA when giving regulated advice and, of course, there will be no compensation for those workers who mis-enrol.

The Humpty Dumpty syndrome

Humpty Dumpty famously said, "When I use a word it means just what I choose it to mean". It is an approach that the FSA seems to be applying to the concept of principles-based regulation.

The FSA excuses its retention of RU64 by saying that it is "an example of a situation in which it is appropriate to retain a detailed, prescriptive rule....in view of continuing concerns over the general quality of investment advice".

If that is the FSA's general view on the quality of advice, why can it not give clear guidance on what it requires and when, instead of giving case studies on which there is no formal consultation?

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What should IFAs do?

In some ways maybe the FSA decision on RU64 is now academic. The more professional IFA firms are moving on to SIPPs and individual pensions for the well-heeled and, to the extent that IFAs service more moderate earners, that is likely to be through a GPP without giving individual advice.

But where advice is being given to consumers who might be regarded as in the present SHP and future Personal Account market the adviser had better watch out. The FSA guidance is clear that:

- Recommendation of an individual personal pension is going to be very difficult to justify
- You must take account of the availability now of SHPs for those consumers for whom they would be suitable
- You cannot justify recommendation of a personal pension by product features that the FSA might regard as "superfluous", in other words you have to be able to demonstrate that the feature is such that it easily justifies any extra cost of a personal pension compared with an SHP
- Your suitability letter must spell out the main consequences and disadvantages of the transaction and link these to the customer's needs and circumstances
- You need to take account of the "wider environmental issues" such as the future introduction of low cost Personal Accounts, despite the absence of firm detail on their design, or in other words you should not be recommending something now that can only be unscrambled at a cost to the consumer should they wish to be auto-enrolled into a Personal Account come 2012.