PO-13359

Ombudsman's Determination

Applicant	Servest Group Ltd (**Servest**)
Scheme	Servest Group Ltd Final Salary Retirement Benefit Scheme (**the Scheme**)
Respondent	Royal London (**RL**)

Complaint Summary

Servest complains that RL intends to apply a substantial charge in the event the Scheme is discontinued. Servest brings this complaint in its capacity as the employer responsible for managing the scheme.

Summary of the Ombudsman's Determination and reasons

The complaint should not be upheld because RL has demonstrated that the contested charge is recoverable under the terms of the policy governing the Scheme.

Detailed Determination

Material facts

1. In June 2001, the Sherwood Cleaning Group Ltd Final Salary Retirement Benefits Scheme was established with Scottish Life (now RL). Later, following a business acquisition, it became known as the Servest Group Ltd Final Salary Retirement Benefit Scheme (**the Scheme**). RL initially provided administration, actuarial and investment services to the Scheme under standard policy terms, "Crest Growth".

2. In July 2003, RL wrote to Camberford Law (**CL**), which was at that time the Scheme's adviser, and enclosed copies of policy documents for onward transmission to the Client/Trustees, and an additional copy for CL's records.

3. On 4 July 2003, CL acknowledged receipt of the documents and said it had forwarded them onto Sherwood.

4. The policy document under Schedule F, Paragraph 3 stated:

> "The Company shall be entitled to make a charge (as determined by the Actuary) where additional and extraordinary work is carried out by the

Company in connection with the Scheme or where the total premium received by the Company in connection with the Scheme or where the total premium received by the Company from the Proposer in any Policy Year falls below a fixed annual amount as determined by the Actuary.

Where the level of premiums actually being received by the Company is such that the administration charge cannot be recovered by the Company in the manner described in Section 1(a) of Schedule G, the administration charge shall be met either (i) by a supplementary premium to be demanded by writing by the Company, or (ii), if the Proposer fails to make payment within thirty-one days of such a demand, by the Company recovering the deficiency by the surrender of such Units as it determines as its discretion.

In no event shall any administrator charge be returnable to the Proposer."

5. The policy document under Schedule H (Part A) Paragraph 8 stated: -

Charges

"The Company shall be entitled to deduct from a unit-linked fund at each valuation such amounts as determined by the Actuary in respect of:

(1) expenses, taxes, duties and other charges incurred in acquiring, managing, valuing and disposing of assets;

(2) tax on the income from the assets of the fund and on capital gains in respect of the assets of the fund not exceeding the tax which would be levied on them if that fund comprised the whole of the Company's Pension Business Fund and no allowance was made for expenses;

(3) interest on any money borrowed for the account of the fund;

(4) any expenses, taxes, duties and other charges incurred in connection with the fund and not previously taken into account;

(5) an appropriate part of any tax, levy or other charge on the Company including any levy made on the Company under the Policyholder's Protection Act 1975;

(6) a management charge calculated as a percentage of the current maximum value of the fund multiplied by the number of days since the previous valuation. The percentage shall be one divided by 365 (0.75 divided by 365 in respect of the period prior to 1 January 1995), or such other percentage as may be specified for each fund by the Actuary.

Where assets of one unit-linked fund are represented by units of another unit-linked fund, the Actuary shall ensure that no double-charging occurs."

6. The policy document under Schedule J, Paragraph 3 stated:

Termination of Scheme accounts and/or individual accounts

> "The Proposer may, at any time, give written intimation to the Company that the surrender value of the Units held in the Scheme Account and Individual Accounts, after deduction of the Company's expenses and other charges, is to be repaid to the Proposer (or otherwise in accordance with the Proposer's instructions) or alternatively is to be applied to purchase immediate and/or deferred annuities in respect of the Members of amounts equal to or, to the extent that Policy monies permit, as near as possible equal to, their accrued entitlements in terms of the Rules, and either on a non-profit or with-profit basis as the Proposer may direct.
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> The Company may make such charge as is considered appropriate from time to time for securing the benefits by means of substitute individual policies and for paying pensions direct to the Members and/or to the Dependants of Members. The amounts of these charges can be obtained from the Company by the Proposer on request. Where such charges cannot be met by the Proposer the Company has the right to surrender all the benefits under the Policy, deduct the appropriate charges and issue individual policies to the Members and/or the Dependants of the Members securing reduced benefits.
>
> The surrender value of Units held in the Scheme Account and Individual Accounts shall be as determined by the Actuary."

7. In February 2006, RL wrote to John Findlater, who was at that time Trustee of the Scheme, advising that it was withdrawing from the compulsory competitive tendering market. This letter was carbon-copied to CL. Following this, it was agreed between Sherwood and CL that CL would administer the Scheme.

8. In June 2015, following an investment review, the Trustee made enquiries about the possibility of moving investment services away from RL. RL informed it that if the policy were surrendered, the Scheme would incur a discontinuance charge of approximately £255,000 (**the discontinuance charge**). The actuarial adviser to the Scheme's Trustees wrote to RL, challenging the basis of the discontinuance charge.

9. In October 2015, RL issued its response under stage one of the Scheme's Internal Dispute Resolution Procedure (**IDRP**). The key points were: -

- The charging structure was designed to ensure that over the lifetime of the Scheme, RL recovered the expenses associated with writing and administering it.

- If the Scheme wound up early, or transferred elsewhere, RL would incur expenses that it could not recover, so it would apply a discontinuance charge. As at September 2014, the discontinuance charge was £294,000 (approximately 23% of the Scheme's value).

- In practice, RL limited the discontinuance charge to 20% of the Scheme's fund value, so the actual charge would be £255,000. This covered, among other things, the cost of historic commission paid to the previous Scheme adviser.

10. In November 2015, the Trustee escalated its complaint to RL.

11. In June 2016, Mr N brought essentially the same complaint to this Office in his capacity as representative of the Scheme employer, Servest.

12. In August 2016, RL issued its stage two IDRP response but did not uphold the complaint.

Summary of Servest's position

13. RL has regularly taken explicit charges from contributions and funds totalling more than £200,000, but contends that it has also incurred costs of about £500,000. These costs largely related to commissions paid to intermediaries and most of them relate to permanent health insurance (**PHI**) premiums which were unrelated to the Scheme and paid to parties who did not actively advise the Scheme.

14. The discontinuance charge is excessive and disproportionate to the Scheme at around 20% of the scheme assets and continues to grow with fund size.

15. These charges were not agreed by, or disclosed to, Servest or the Trustee at any time in the Scheme's history.

16. RL had been unable to provide any formal evidence of a legal basis or contractual agreement with Servest or the Trustee in terms of the charges it assessed when determining the surrender value reduction (**SVR**). Furthermore, it has provided "inconsistent" assessments showing sudden changes in the SVR terms without sufficient explanation.

17. RL had referred to "actuarial discretion for the purposes of determining amounts" but the level of expenses and commissions incurred did not require such interpretation; they should be based on factual events (i.e. actual costs legitimately incurred, the value of time spent by RL personnel and corresponding overheads relating to the Scheme).

18. This pattern of SVR assessments from time to time has been inconsistent with the principles of recouping costs if the contract discontinues earlier than expected, given that ongoing charges are likely to be level (plus some inflationary increases) and the fact that implementation expenses are incurred at the beginning of the contract and should not dramatically increase part way through.

19. RL says it has estimated the level of costs of running the Scheme using the premium level as a proxy for work done. There is no separation in the explanation of the future service contribution rate for active members and the significant deficit recovery contributions over the years to cover the shortfall; Servest can only assume that RL has based its figures on total money going into the fund. But the fact that the Scheme has had a shortfall would have no material impact on the administration required.

20. While it would be academic if Servest's arguments on legality were accepted, it was nonetheless surprising that such high interest rate assumptions had been applied by

RL when determining its charges, i.e. £312,000 (commissions plus expenses) and £510,000 thereafter. Furthermore, RL's costs and the commissions paid to the intermediary were disproportionate for a Scheme of its size.

21. The 2008 actuarial valuation referred to a 3% addition to the liabilities, to cover RL's charges/commission. However, RL never mentioned that this would be insufficient to cover the liabilities, and that there would be a shortfall that would have to be covered later.

22. There is a big difference between what CL says it was paid in commission (about £17,500) and what RL says it paid CL in commission (about £171,000).

23. There is no evidence the Scheme documents were submitted to the Trustee, Servest or the Scheme adviser when the Scheme was set up (or thereafter). RL had a duty to deliver those contractual items directly to its client, the Trustee. There is also no sign of confirmation to any of the parties of the delegation - or, in its view, the "abdication" - of the duties RL considers were passed to the Scheme adviser.

24. Referring to "past practice custom" is irrelevant if the terms of the contract are unfair to the members and unsupported by contractual evidence.

25. Having reviewed my Preliminary Decision (**PD**), Servest said it was very disappointed with the outcome. It said the interpretation of, and application of, RL's contracts terms was very generous to it, particularly given the inconsistency with which RL seemed to have applied the terms.

26. It noted that the surrender penalty was about £68,000 or 10% of the Scheme assets (according to the 2011 actuarial valuation) but increased to about £250,000 or 20% of the Scheme assets (according to the 2014 valuation). It provided the valuation reports so that I could see the respective differences between (i) assets on an on-going basis and (ii) the solvency position. The 2014 valuation took place in the three-year period just before Servest's complaint and was a relevant event in terms of the Trustees and Servest first being notified of a sudden increase in the level of surrender value. This suggested a "dramatic" change in the calculation; and, whilst it appreciated my views in relation to RL's contract terms, it was not fair on the Scheme and its members.

Summary of RL's position

27. Section 3 of Schedule J of the Policy covers the discontinuance charge. In short, the discontinuance charge is the mechanism by which such expenses incurred to date are recovered in the event of the policy terminating prior to recovery of those costs in full.

28. Schedule H is concerned with the policy investments. Part A is concerned with the unit linked investments and Paragraph 8 specifies the nature of the charges (as determined by the Actuary) that may be applied to the unit linked fund as a whole. This provides for the charges that will be applied during the life of the policy. It also reflects how the recovery of charges is supposed to be effected during the life of

the policy. This is intended to ensure full recovery of all expense incurred setting up and operating the policy.

29. Schedule F, section 3 provides for additional charges (as determined by the Actuary) that may be applied during the policy term to cover ad hoc work (special projects) or to cover the assets reducing in size to such an extent that the normal charges are insufficient to cover the ongoing costs. These additional charges do not link directly with the calculation of the discontinuance charge but the provisions are relevant in that they show the consistently broad way in which charges/expenses are dealt with throughout the policy. The policy does not set out precise calculations; it defers to actuarial discretion for purposes of determining amounts (as can be seen with both the provisions above). This is consistent with the wording of the discontinuance charge. RL has provided evidence of correspondence between it and CL back in July 2003, demonstrating it made available the relevant Plan documents. A document entitled "Technical Guide for the Crest Plan" would have been provided to Servest and/or the Trustee, by the Scheme's adviser. (There were two versions, dated December 2000 and June 2001, but they were substantively the same.) The material provision - "Plan discontinuance", under the Technical Details section on p.16 of the guide - stated: "The plan may either be left in 'paid-up' form or a transfer value may be taken. The value of the Accounts may be reduced to recover expenses; and, in the case of With Profits Fund units, to reflect investment conditions at the time. Where the paid-up benefit is taken as a transfer value a further reduction may apply."

30. Further, under page 14 of the "Crest Growth Plan Final Salary" booklet dated July 1998 - which would have been made available to the Scheme's adviser at the time the Scheme was set up, and would "very probably" have been passed to Servest and the Trustee - it stated: "Should the scheme be discontinued the following terms may apply… (a) If the scheme is left in paid-up form the value of the Scheme Account will be determined by the value of the units allocated provided the scheme has been in force for 3 years. (b) If a transfer value is taken, the value of the Account may be reduced to recover expenses and, in the case of With Profits Funds Units, to reflect investment conditions at the time. If more than one quarter of the members leave service within twelve months or are leaving service at the same time these terms may be applied whatever the reason for leaving service."

31. RL is only seeking to recover expenses already incurred, rather than any "advance" on future charges, which would have fallen due had the policy terminated early.

32. Whilst the basis for deducting expenses might appear general, it was nonetheless consistent with other policies at the time and the general language applied to other areas of the policy.

33. Initially RL incorrectly included commission on the employer's PHI policy in its calculation of the discontinuance charge but this has now been removed. The correct charge, as at 16 August 2016, was 9.2% of the Scheme's assets or £168,000. No element of this relates to PHI and no PHI charges have been applied to the Scheme.

34. The potential discontinuance charge is comprised of (i) "income we received from ongoing charges", (ii) "commission we have paid out", and (iii) "amount of expense we have assumed we have incurred in writing and administering the business (including admin, actuarial and investment)."

35. It has provided evidence of how the discontinuance charge is calculated, in the form of a table ('the discontinuance charge table') that shows a breakdown of (i), (ii and (iii) as follows:

Servest Income and Outgoings	At point incurred	Accrued with "interest"
Charge income	£254,000	£341,000
Commission paid	-£167,000	-£283,000
Expenses incurred	-£145,000	-£226,000
Net income to RL	-£58,000	-£168,000

36. It has provided a headline "expenses incurred" figure of £145,000 at the point incurred. It explained that the relevant figure was £226,000 once these expenses were accrued with interest to the valuation date.

37. It has further explained how the £145,000 figure was calculated, and why it considers the charges to be reasonable. The costs used in calculating the discontinuance charge are not scheme specific, i.e. based on the time spent in providing services to each scheme; they are based on the assumed average cost of providing these services to all schemes. The rates are based on the total cost of providing these services across all relevant schemes and aim to allocate costs "equitably" to individual schemes.

38. Its approach is to allocate its internal expenses based on the level of premiums paid by each scheme; this is a reasonable "proxy" for the work involved providing services to each scheme. These costs are reasonable because they compare favourably with the average cost of running a small scheme across the industry, according to independent market data. A report published by the Pensions Regulator in 2014 found that the average (mean) triennial valuation cost was £16,694; by contrast, when RL calculated the discontinuance charge in August 2016, the expenses it had incurred came to about £10,000. Therefore, the expenses allocated to the Scheme using the above allocation method are "entirely reasonable".

39. The level of commission chosen was a matter for the Trustees and their advisers; it was not determined by RL, so it does not agree to waive the charge. In RL's view, the level of the discontinuance charge is appropriate and proportionate.

40. The original adviser was CL but it was replaced in March 2013 by a firm called Spectrum Partnership. RL initially provided information in relation to the Scheme but after 2006 CL became responsible for this.

41. Having reviewed the Deputy Ombudsman's PD, RL confirmed that it had no further comments to add.

Evidence of commissions paid

42. Enquiries were made of CL, which confirmed commissions were paid to it under the terms of the Agency Agreement it had with RL when the scheme was incepted in 2001. CL unfortunately had no documentary evidence of the agreement going back to that date. CL had not retained records from which it could accurately advise what had been received since then but it had no reason to doubt the information provided by RL.

43. It explained that increased commissions which it received in 2008 and 2009 were due to contract wins by Servest, meaning the scheme was increased by several multiples overnight. This added a new layer of complexity as the Scheme then had to accommodate various categories of the Civil Service Pension arrangement in addition to LGPS terms, which required work on Deeds.

44. CL acknowledge they were paid about £172,000 for looking after the scheme for over 12 years, which equates to £14,333 per annum over the duration of their tenure.

45. They have previously explained in a letter to the Trustees dated 21 November 2017 that they worked under no specific contract of services and the employers and Trustees of the scheme could at any time have terminated their services, a fact of which they were aware.

46. It was made clear to all that payment to CL was by commission from the provider and in fact it was a legal requirement at the time that the employer would be made aware of the commission payable.

47. If they had administered the scheme on a fee basis the charges would have been considerably more than the commissions received.

Conclusions

48. I turn first to the complaint about allegedly inadequate disclosure of the policy terms. I am unable to make findings about this element of the complaint. My jurisdiction concerns the administration of the scheme rather than conduct predating its inception. Moreover, the point at issue dates back to 2001. Ordinarily, this Office will only investigate a complaint concerning acts or omissions which occurred less than three years before the complaint was brought to this Office. On the facts which have presented themselves, I see no reason to look back to events which took place in 2001.

49. The investigation of this Office has been limited to the dispute about whether or not RL has calculated the discontinuance charge which it proposes to levy by reference to the underlying policy terms. RL have referred me to previous Ombudsman determinations concerning the same scheme structure, which considered the meaning of the 2000/2001 Technical Guidance. For the avoidance of doubt, I make no finding about whether the 2000/2001 Technical Guidance was provided to this complainant or their representatives. My findings in this case are based upon the policy terms. That said, I do not consider that anything which follows is inconsistent with the technical guidance or the previous Ombudsman decisions.

50. On the basis of the representations which had been made up to the point when I issued my first preliminary decision, it was unclear how the items set out in the discontinuance charge table related to the original terms of the policy.

51. RL has now clarified its position. It is Schedule H, and Paragraph 8 of Part A in particular, which relates to unit linked investments and the nature of the charges that may be applied to the unit linked fund as a whole. I am satisfied that Schedule H gives a broad discretion to the Actuary to determine the amounts which may be deducted from the fund in respect of the expenses, taxes, duties and other charges incurred in acquiring, managing, valuing and disposing of assets. It provides for recovery of those deductions at each triennial valuation. Schedule J then provides an additional power to deduct expenses and charges in the event of discontinuance. Reading Schedule J in the context of Schedule H, I am satisfied that the contractual documentation establishes a basis for deduction of expenses and charges on discontinuance, as determined by the scheme actuary.

52. Servest says it has struggled to understand what the charges are for and wants to be sure they have in fact been incurred, so that it can make a decision about whether to switch investment service provider. I have some sympathy with Servest's position because it was initially told that costs associated with PHI were recoverable. RL has since conceded that this is not the case. It has documented those items which it seeks to recover in the discontinuance charges table. These are essentially commissions paid to CL and expenses incurred as calculated by the scheme actuary, less recovery which has already been made through ongoing charges.

53. From the evidence which has now been provided by RL and which has been corroborated by the evidence of CL, I am satisfied, on the balance of probabilities, that the commissions set out at (ii) of the discontinuance charge table were expenses paid to CL and are recoverable in the sum scheduled by RL, to the extent that they have not already been recovered. I do not find a discrepancy between the evidence provided by CL and RL. It is correct that CL originally confirmed that it had received initial commission of £17,500. However, it has since acknowledged receipt of further commissions during the lifetime of the scheme.

54. I turn now to the costs which RL says it has incurred writing and administering the business. These are set out at item (iii) of the discontinuance charge table.

55. RL explained it was recovering costs and charges which it would recover over the life of the Scheme were there no discontinuance. In the absence of Schedule H and an explanation of how and when those charges had been incurred, I understood RL to be saying the discontinuance charge represented compensation for loss of profit on future services not yet provided. I doubted J3 permitted recovery of a penalty.

56. From the explanation more recently provided, I understand RL to be arguing the right to recoup 'reasonable' charges at a rate of approximately £10,000 per year for services already rendered, with interest accruing on amounts still outstanding. I am satisfied from RL's further explanation of its calculation and cost allocation methods that upon discontinuance RL are attempting to recover costs already incurred which would otherwise have been recovered over the lifetime of the scheme.

57. I am satisfied that under the terms of Schedule H the actuary has power to determine the method by which charges are calculated and recovered. I can see no basis to criticise the proxy calculation method used by RL or the level of charge in fact allocated to the Scheme as a result. In these circumstances, and given the terms of Schedule J, I can see no basis to doubt the level of charge which RL maintain will remain unrecovered in the event of early discontinuance.

58. Servest points out that RL has already taken explicit charges from the Scheme year on year, totalling more than £200,000. That assertion has not been disputed by RL. I am satisfied that charges already recovered are reflected in item (i) of the discontinuance charge table.

59. In summary, I am satisfied from RL's most recent explanation that there will be an element of under-recovery of expenses already incurred upon discontinuance. I have been provided with no contractual, technical or other documentation suggesting that the calculation and recovery approach adopted by RL's actuary is impermissible or unreasonable. Given the breadth of discretion which the policy terms give to the scheme actuary, I do not consider that there is any basis on which I could or should prevent RL from recovering the amounts which it now claims due.

60. Having reviewed Servest's response to the PD, I do understand its dissatisfaction with the increase in the level of surrender penalty. But fundamentally, the amount of the discontinuance charge is a matter for the actuary to determine, as provided for under the express terms of the policy/contract. The actuary has broad discretion to determine the method by which charges are recovered over the life of the policy, accepting that there must be transparency about how the contract operates.

61. As already explained at paragraph 49 above, I make no finding on the pre-contract disclosures. Nor is the fairness of the terms a matter which falls within my jurisdiction, which is limited to acts of management/administration. As such, the representations made by Servest in response to the PD do not change the outcome of the complaint.

62. For these reasons, I do not uphold the complaint.

Karen Johnston

Deputy Pensions Ombudsman
29 May 2019