Financial Ombudsman Service

complaint

Mr K's complaint is that his annuity in 2007 was not set up on an enhanced smoker rate basis by Investec Wealth & Investment Limited (Investec). Investec admitted liability and offered compensation. It is the amount of compensation that is in dispute.

Background

Investec arranged an annuity for Mr K in 2007. Following a review of its files in 2011 it established that the annuity had not allowed for any enhancement because Mr K was a smoker. It established that the annuity should have been £496.72 a year higher. The additional fund to provide that annuity in 2007 would have been £6,926. Simple interest was added to the lost income bringing the total to £7,185.95. This was based upon his age and underwriting information at the time of advice.

Subsequently, Investec explained that a Purchased Life Annuity (PLA) could be obtained providing a gross annuity of £473.64 a year. This is lower than the pension annuity because a PLA is taxed differently. Part of the income is treated as a return of the capital invested.

Mr K did not accept the offer. He considers that it does not put him back in the position of having the additional income of £496.72 a year.

The adjudicator wrote to both parties and set out a method of redress based on a past loss of income and the capitalised value of the annuity less 20% being paid to Mr K now as a lump sum in order to finalise redress.

Investec's position is that redress should be based on the additional funds required to buy the correct higher level of annuity in 2007. It has said as this will cost more now as Mr K had reduced his smoking and was not entitled to enhanced rates, this was unfair. It made the same offer along the same lines that had already been rejected by Mr K.

Mr K said it is fairer to say that the future annuity should produce the net equivalent of £397.38. This is because the future annuity will be a purchased life annuity which is taxed more favourably than a compulsory purchase annuity. This means that Investec will have to spend slightly less on the compensating annuity. He does not agree that the tax should be deducted from the lump sum if an annuity cannot be set up because he could use the funds to set up a purchase life annuity.

The papers were passed to me to review. I set out the method of redress I intended to use in a letter that both parties have seen also taking into account the alternative method of redress using a purchased Life annuity.

The business replied and confirmed it had no further comments.

Mr K replied and said in summary –

- If the business is given a choice of paying 100% to buy the annuity and 80% to pay a lump sum to cover the future loss, it will simply opt for the lump sum just to cut his costs.

- He asked if Investec cannot find anyone willing to provide the annuity, would he be permitted to try to obtain it himself? And if he succeeds should the business cover his costs and fees of another adviser.

- In its letter of 14 October 2011 Investec reported that Just Retirement had quoted £7,185 for a purchased life annuity. He imagined that it was still possible to obtain an annuity of the sort required to compensate for his future loss.

- Therefore if it proves impossible to obtain the required annuity, how is the cost of the annuity less 20% calculated?

- Should not the lump sum alternative be a reasonable estimate of the sum required to compensate for the future loss? 80% of the putative cost of an annuity is obviously not enough to buy an annuity income stream, which is what he wants, and it hardly seems like a properly calculated estimate of the investment return on such a sum. The income from investing a lump sum will be subject to tax in his hands so reducing the lump sum by 20% has nothing to do with producing the correct amount of after tax income, ie £397.38 a year.

- The average yield from investments managed for him on a medium risk basis by Investec is 3%. If he assumes a 3% return on the investment of the lump sum, the lump sum would have to be £16,557 to produce £496.72 a year. He would pay basic rate tax on the £496.72 income, leaving him with the lost net amount of £397.38 a year.

- What he has lost is £397.38 a year, net of basic rate tax at 20%, from a sound annuity provider. An annuity provides greater security than investing a lump sum in the market. He expects the required annuity, producing £397.38 a year net, can be obtained from a reputable provider so the lump sum alternative will not be necessary. Even if it is, he does not agree that it should be 80% of the putative cost of an annuity.

my findings

The aim of compensation is to put a consumer back into the position, or as closely as the value of money will allow, that they would have been in had the error not occurred. That easily stated objective is not easy to achieve in practise and is complicated in this case because an annuity is a regular income paid over time. It is accepted by both parties that Mr K's annuity should have been paying £496.72 gross a year more since 2007. That additional income would also have continued to be paid to Mr K until his death.

Investec have said that the compensation should be based on the annuity which should have been paid in 2007. That is the correct starting point for assessing the loss. But, using the cost of providing that annuity from 2007 does not place Mr K back into the position he would have been in. I accept that enhanced rates may not be available to him but annuity rates have also changed because of other factors such as lower interest rates.

The appropriate amount of compensation should compensate for the past loss of net income with interest added to each payment from the date it was due until the date of settlement. It should also compensate for the future loss of income based on the cost of providing that income at the time of settlement. If a PLA is used then the capital cost of the PLA should be paid to Mr K to provide the net of tax income he would have received from a pension annuity of £496.72 gross a year. Assuming Mr K is a basic rate tax payer that should be for net of tax income of £397.38. No deduction for tax should be made from the capital cost of the PLA as the PLA provides the correct net of tax income.

If the comparison uses rates for a pension annuity, then the annuity should be for the correct gross amount, but the cost may be reduced by 20% to reflect the fact that the income would be subject to tax at a rate of 20%. As I understand that the payment of compensation is not subject to income tax that should provide a reasonable sum to compensate for the loss Mr K has suffered.

In summary –

- The past loss of income should be calculated net of tax and no tax certificate has to be supplied as the past loss of income is "compensation."

- Whilst the lump sum could be used for a purchased life annuity if the amount is below the minimum for providers then the method of deducting tax to the lump sum is not unreasonable as it allows Mr K to be compensated now.

- If Investec considers that it is legally obliged to deduct income tax from the interest, I agree it must send a tax deduction certificate with the payment. Mr K can reclaim any tax overpaid from HMRC, depending on the circumstances.

The only reason an annuity could not be set up now is if the payment required was below the minimum purchase price, and the provider would not accept redress payments. If this is the case then the "costs" could be calculated by pro rata the annuity amount to establish the capitalised value (even if it is below the minimum purchase price).

I have taken note of Mr K's points about the calculation of fair compensation. Clearly, if a PLA is used this will provide him with the additional net of tax income he was entitled to receive. If that is not possible and a pension annuity cannot be arranged then the calculation is more complex and unlikely to be as precise. In my view, using the cost of the pension annuity, but deducting 20% to allow for the fact that the income would be taxable is a reasonable approximation of the loss.

my decision

I order Investec Wealth & Investment Limited to compensate Mr K now using the following method of redress –

<u>Future loss</u>

Pay an amount to a competitive annuity provider, so Mr K has an additional income of £496.72 a year gross going forward.

If for any reason this cannot be established (as below minimum purchase costs) the cost of the annuity less 20% should be paid now as a lump sum to Mr K.

If a PLA is used to compensate for the net of tax income Mr K has lost then no deduction should be made to the cost of providing that annuity.

<u>Past loss</u>

1. When the annuity or redress has been established/paid then calculate the additional income payments (£496.72 a year) netted down for tax at Mr K's marginal rate from 2007 until the date of calculation, plus interest at 8% a year simple (as previously agreed) until the date of calculation.

2. The past loss of income should be paid as a lump sum to Mr K with interest added until date of payment at 8% a year simple.

Roy Milne
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