Aegon response to FRC Consultation Paper

Proposed revision to AS TM1: Statutory Money Purchase Illustrations

25th May 2022

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Introduction and high-level comments

Aegon welcomes the opportunity to comment on the Financial Reporting Council's consultation on Proposed revisions to AS TM1: Statutory Money Purchase Illustrations. As we set out here, we are deeply concerned about the proposed changes. We do not agree with the need for changes in the accumulation phase. Rather than being justified by the introduction of dashboards, we believe the changed methodology could potentially damage engagement with pensions, the main purpose behind dashboards. We are aware of discussions the FRC has been having since issuing the consultation. These appear to be around making the proposals 'work' in certain scenarios. We do not believe seeking amendments to the current proposals is the right approach. Instead, we believe the FRC should retain the current approach during accumulation.

Background

We strongly support pension dashboards as a means of better engaging individuals with their pensions. We are actively engaging in other dashboard related consultations and undertaking preparatory work. We are a leading provider of both workplace and individual pensions and as such, pension dashboards and the FRC proposals will affect millions of our customers.

It's vitally important that pension dashboards are designed and implemented to make them engaging, useful and easy to use for pension savers. We see them as having the potential to be a 'game changer' in terms of how individuals engage with their pensions.

It's appropriate to review how the information individuals will access through dashboards compares to that in other, existing communication material for individual arrangements and schemes. As part of this, we agree it is right to compare projections in key features illustrations and Statutory Money Purchase Illustrations (SMPIs) in yearly statements alongside Estimated Retirement Incomes (ERI) in pension dashboards. We note FCA projections are out of scope of this consultation but ideally, there should be no difference in projections across these three areas. Using SMPI projections in dashboards aligns these with yearly statement information and it is critical that an individual does not receive different projections for the same pension from these sources.

Responsibility for calculating projected values

The decision to require the provider or scheme to provide ERI information to dashboards means that it is the provider or scheme which undertakes the projection / SMPI calculation. The alternative would have been for the provider or scheme to have provided current fund value and current contribution level to the dashboard and for dashboard providers to have carried out the projection / SMPI calculation. Had the latter approach been taken, it would have been critical that different dashboards all projected consistently, at the same rates, for any particular fund. The rate for a particular fund could have been determined by dashboard providers based on an agreed methodology. However, unless schemes and providers used the same methodology in annual statements, and there was no room for divergence, this approach could have led to inconsistent projections between dashboards and annual statements. For this reason, we see merit in the ERI being calculated and provided by the provider or scheme.

No need for greater consistency

However, this negates the need for the methodology behind SMPIs to be changed. Pension dashboards will enable individuals to see projected benefits from all of their different pension in one place. It is highly likely that the funds and underlying investments within each pension an individual has will be different. In turn, these will deliver different investment returns. For this reason, we do not accept that there is any need to seek further consistency in the methodology providers and schemes use when projecting funds in accumulation.

The consultation makes it clear that the driver for the proposed changes is dashboards. There is no suggestion that the current projection methodology is flawed or misleading. We believe basing projections on the returns the scheme or provider believes are reasonable, based on the underlying assets, is the most appropriate approach. It is also far more ‘intuitive’ and more likely to be understood by members of pension schemes and users of dashboards than an approach which is driven by categorising funds by historic volatility assessments. Very few members are likely to have any familiarity with such concepts and will simply not understand the rationale.

The consultation suggests dashboards will facilitate or encourage individuals to compare their different plans or pensions. We don’t see this as a primary function of dashboards. The key objective is to allow individuals to easily access information on all of their pensions together, and in doing so to understand their pension provision in totality.

While we see no reason for greater consistency in the accumulation phase, we do understand the need for a consistency in the form of annuitisation between dashboards and yearly statements. The latter could include a wider range of options, provided there is one set in common with dashboards.

Consumer understanding

The proposal to fundamentally change the SMPI methodology and to base this on fund volatility metrics will not be understood by the vast majority of the population. This would be at odds with the FCA’s new Consumer Duty which seeks assurances from firms on consumer understanding. As we explain in our responses to specific questions, it will also create many new complexities and issues which would simply not exist if the current approach of basing projection rates on underlying assets were retained.

If there is any desire for greater consistency, we believe this is best and far more simply tackled by greater guidance or even prescription when setting return assumptions for broad asset classes.

Unlisted assets

One specific issue concerns the proposal to project unlisted assets at a zero real growth rate. The Government is keen for schemes to invest more in illiquid assets which will be unlisted. The proposals in this consultation would mean any such move would require providers and schemes to show lower projected pensions as a direct result of diversifying to include an element of unlisted assets.

Annuity assumptions

We also have some concerns over the proposals for turning projected funds into income. While most people who buy an annuity buy one on a level, single life basis, it is now more common for individuals to take an income through drawdown, rather than buying an annuity, certainly at the initial point of starting an income.

Using annuity rates to turn a fund into an income is a proxy for illustrating what might be a sustainable income if in drawdown. If seeking to illustrate a sustainable income, we believe this should incorporate inflation protection. For this reason, we do not support using level annuities.

Furthermore, the whole concept of SMPI is to project in real terms. Many individuals will live for 20 or 30 years in retirement and to not include an allowance for future inflation over this period is dangerously misleading.

Please don't hesitate to contact me if you would like to discuss any aspect of this response.

Steven Cameron

Public Affairs Director

25th May 2022

Responses to specific questions

1. How supportive are you of the approach to prescribe the accumulation rate and form of annuitisation more precisely, in order to improve consistency across projections from different providers? In particular, do you have any concerns arising from the loss of independence and judgement allowed to providers to set these terms?

We are not at all supportive of the proposals around changing the projection methodology in accumulation. We do not believe there is any need to improve consistency across projections from different providers. While these will be shown side by side on dashboards, the underlying investments for each pension will be different and so will the returns generated. We believe it is appropriate for schemes and providers to allow for their expectations of differences in future investment returns when providing information to customers whether through annual statements or dashboards. While projections can only offer a very broad indication of possible future outcomes, we believe it is only right that providers and schemes differentiate projection rates based on underlying investments and anticipated returns.

The fact that projection rates may differ should be explained within dashboards. This could be through a simple statement that each of your pension providers has provided an estimate based on an assessment of underlying investments and how they may perform in future. Individuals could be directed to the specific providers or their SMPI annual statements for more information on projection rates used or how these have been derived.

We explain later why we strongly favour the existing methodology based on underlying assets over a volatility-based categorisation. This is less about loss of control or judgement allowed to providers, although we do think it is right to reflect views on likely future returns. More important is the great difficulty in explaining the latter approach to pension scheme members. Pension dashboards offer a once in a generation opportunity to make a step change in engagement and we would be very concerned by a move to a projection basis that could not be explained even to a relatively informed member, familiar with investment concepts. This could cancel out any improvements in engagement.

However, we do understand the need for a consistent approach to the form of annuitisation to avoid dashboards using a different approach for a particular pension from that used in the corresponding yearly statement. The latter could include a wider range of options, provided there is one set in common with dashboards.

2. What are your views on the proposed effective date of 1 October 2023?

If the methodology is radically changed as proposed, then this effective date will be highly challenging. Providers and schemes will have to carry out a volatility assessment for every available fund, including fund of funds, and build further functionality to cope with any unlisted investments. The results will then need to be fed into existing calculation engines for use in yearly statements as well as for feeding into dashboards. This comes at a time when providers are facing an unprecedented volume of regulatory and legislative change including the FCA's New Consumer Duty which places much emphasis on consumer understanding.

Alternatively, retaining a methodology based on underlying assets, potentially with some further guidance on consistency, would be far less complex to implement and depending on any adjustments, could be delivered by 1 October 2023. Effectively, doing so would remove one of the challenges to dashboard delivery.

At present, firms are required to review SMPIs for each tax year. If any changes are agreed, to avoid an extra review, we recommend a deadline of 5 April 2024.

Whatever route is taken, we would urge the FRC to take into account the likely earliest date when individuals will have access to dashboards. Requiring any change before then would create significant pressures for providers with no benefit to consumers.

3. What are your views on the proposed volatility-based approach for determining the accumulation rate?

We strongly oppose the proposed volatility-based approach. While it may be possible to justify this broad approach on technical grounds, the consultation highlights many complexities in methodology which arise from it. One example of this is the need to identify 'similar' funds if the fund has less than 5 years of history.

Much more importantly, we are very much against introducing an approach which will be almost impossible for most pension scheme members to truly understand. Even if some consumers understand that taking greater risk may lead to higher returns, they may not connect volatility with risk. Indeed, there are other forms of risk which are not linked to volatility. Overall, linking volatility and expected return is just not intuitive to the vast majority of people.

Dashboards will only deliver on their potential if they encourage greater engagement. Taking this approach runs a high risk of undermining that engagement by introducing complex and unfamiliar concepts.

4. Based on an assumed CPI of 2.5% do you find the accumulation rates proposed for the various volatility indicators to be reasonable and suitably prudent?

The key question is whether the real projection rates derived are appropriate over the longer term. As explained elsewhere, we strongly favour retaining the existing methodology under which providers and schemes will set their own real returns based on underlying assets. This removes the need to set rates for different fund categories.

5. What are your views on the proposed approach to reflect derisking when calculating the accumulation rate assumptions?

We agree with the concept of reducing the projected return to allow for the changed mix of underlying assets invested in under derisking strategies. Dashboards will show the ERI only at specified retirement age so it is that figure which is relevant, not the year on year calculation methodology to get there. For this reason, we see no need to force providers to adjust returns only in the years of derisking rather than adjusting the projection rate over the full term of projection. Both approaches could lead to the same end figure.

We do not believe the consultation provides sufficient information to determine how derisking would be allowed for under a volatility-based methodology. All workplace pensions operate derisking as will the proposed standardised investment strategies for non-workplace pensions. So unless the approach to allowing for this were also standardised, the aim of consistency will not be delivered.

Under an asset-based approach, derisking is already dealt with 'directly'.

6. What are you views on the proposals that the recalculation of volatility indicator should be annually as at 31 December with a 0.5% corridor?

We do not support the use of a volatility indicator. In addition to the issues we have flagged earlier, it is based on backward looking metrics. These backward looking metrics will change with market conditions and could, as is highlighted, lead to significant changes to projections for those funds which cross over the 'margins'. The concept of a corridor may offer a solution here, but it is adding even more complexity to an already complex methodology.

7. What are your views on the proposed approach for with-profits fund projections?

The returns individuals actually receive in with-profits funds will depend on the underlying assets. Smoothing is largely a presentational mechanism, particularly when funds are not being realised. Smoothing certainly shouldn't be taken into account in any volatility metric. This is another area where the volatility approach creates further complexities which don't exist under an asset-based approach.

8. Do you have experience of unquoted assets held in pension portfolios and what are you views of the proposed approach for unquoted assets? In particular do you regard a zero real rate of growth to be acceptable and if not please provide suggested alternatives with evidence to support your views?

If an individual holds an unquoted asset for example in a SIPP, then attempting to project this forward in value is highly speculative and largely meaningless. On these grounds, the proposal to assume zero real growth may be as good as anything else.

However, this is highly problematic if unlisted assets are held within a fund. The Government is keen for schemes to invest more in illiquid assets which will be unlisted. The proposals in this consultation would mean any such move would require providers and schemes to show lower projected pensions as a direct result of diversifying to include an element of unlisted assets.

The rationale the Government gives for investing in illiquids is to generate higher returns and to offer greater diversification. A recent DWP consultation on this included some very high return assumptions. Retaining an approach based on underlying assets would require the scheme or provider to set out an assumed return and build this into the fund projection rate. Here, there would be merit in setting an overall cap on what can be assumed.

9. **What are your views on the proposed approach to determine the accumulation rate assumption across multiple pooled funds?**

This is another example of where the volatility approach creates further complexity. Using underlying assets removes this complexity. The fund of funds can use a weighted average of the assumed returns for each constituent fund.

10. **What are your views on the proposed prescribed form of annuitisation and treatment of lump sum at retirement? In particular, does the recommendation to illustrate a level pension without attaching spouse annuity cause you any concerns in relation to gender equality or anticipated behavioural impacts?**

We agree that there is a need to have a consistent basis for turning a projected fund into an income, so that there is consistency for a specific pension between dashboards and annual statements.

While most people who buy an annuity buy one on a level, single life basis, it is now more common for individuals to take an income through drawdown, rather than buying an annuity, certainly at the initial point of starting an income.

Using annuity rates to turn a fund into an income is a proxy for illustrating what might be a sustainable income if in drawdown. If seeking to illustrate a sustainable income, we believe this should incorporate inflation protection. For this reason, we do not support using level annuities.

Furthermore, the whole concept of SMPI is to project in real terms. Many individuals will live for 20 or 30 years in retirement and to not include an allowance for future inflation over this period is dangerously misleading.

We have less concerns around using a single life annuity provided this is made clear on dashboards.

There are arguments for and against showing tax free lump sum on dashboards. As dashboards are to provide an indication, we believe it would be reasonable to assume a 25% entitlement, rather than to adjust for any special entitlement. This again would need stated on the dashboards. We agree that the ‘lead’ figure should be the ERI if no tax free cash is taken. This could be followed by the reduced ERI if 25% is taken as tax free cash.

11. **What are your views on the proposed approach to determine the discount rate assumption when used to determine the annuity rates for illustration dates which are (A) more than two years from retirement date and (B) less than two years from retirement date?**

We have no particular views here.

12. What are your views on the proposed new mortality basis for determining the annuity rates where the illustration date is more than 2 years from the retirement date?

We agree the most up to date mortality assumptions should be used.

13. Do you have any other comments on our proposals?

Our key concern with the proposals is that however technically sound they may or may not be, they create a huge risk of consumer confusion and disengagement. The primary purpose of dashboards is to better engage members. Anything which puts that at risk is highly dangerous and counter-productive. For this reason, we strongly oppose the proposals.

14. Do you agree with our impact assessment? Please give reasons for your response.

An additional impact will be where providers must amend how they present estimated income in annual statements as a result of the proposed removal of flexibility. This could come with considerable cost.