AJBell

AJ Bell response to FRC Proposed revision to AS TM1

May 2022

AJ Bell

AJ Bell is an investment platform, pension provider and investment manager for retail investors. We provide administration services for our consumers in relation to a range of platform-based tax-incentivised wrappers including Self Invested Personal Pensions, Small Self-Administered Schemes, Individual Savings Accounts (ISAs, LISAs and JISAs) as well as General Investment Accounts. Our platform and investment services are available to direct consumers, as well as through FCA registered advisers.

AJ Bell currently provides services to more than 418,000 consumers representing assets under administration of £74.1 billion.

Executive Summary

AJ Bell supports the development of pensions dashboards, believing they have the potential to help people re-connect with lost pensions and engage better with their pension savings.

However, we are concerned the Pensions Dashboards project risks being derailed over FRC proposals to reform growth projections, which if implemented will create unnecessary complications, be a cost burden on the industry and will deliver no discernible value to consumers.

We agree with the government's intention that dashboards display pension income values in today's terms, projected to the chosen retirement date. However, we have grave concerns about FRC's proposals to change the method for calculating the underlying growth rate assumptions to one determined using fund-specific volatility of monthly returns over a five-year period, these reviewed on an annual basis.

We believe it:

- **Will create confusion for consumers**
  Most consumers don't truly understand the concept of volatility, and even if they do, they won't make the direct link with fund performance. It will not be clear to them why different assumptions are used for different funds and direct investments.

  A platform pension consumer holds many different investments within their pensions, not just one or two funds. The notes explaining what each fund's volatility is over the last five years, and therefore what growth rate has been assumed in the projection could run to pages and pages. Which no-one will read.

  The growth rates and wider assumptions used for SMPI/pensions dashboards will be different (both in amount and construct) from those used in point-of-sale (POS) illustrations determined by the FCA causing confusion. There is no rationale for these two sets of illustrations being different, and it's important all stakeholders grasp this opportunity to make the underlying methodology and assumptions supporting them consistent to smooth the consumer's pension journey.

  The onus is on us all to make sure pensions dashboards are a force for increasing engagement, not confusion.

- **Will be impracticable, unworkable and very costly for platform pensions**
  Regulators too often design regulation from the position of insured pensions and mastertrusts. Wide of auto-enrolment, platform pensions are now the default pension product for new execution only and advised pension savers, and so cannot be ignored. In 2019, the FCA estimated the SIPP market managed £161bn assets under management. A significant part of those assets will be held on platforms.[1]

  A typical open-architecture platform will offer in the region of 4,000 funds and as many equities across a wide range of markets plus a wide array of other quoted investments such as gilts and bonds. To calculate volatility rates every year for each fund will be a considerable administrative burden for these providers.

  There will be many scenarios where platform and SIPP providers will not be able to calculate the underlying growth rate as proposed. For example, if the underlying personal pension assets are managed by external discretionary fund managers (DFM), with assets held under their nominee, the platform pension operator will not know the details of the assets. Hence, they will not be in a position to calculate growth rates.

We acknowledge the level of work the FRC and others have dedicated to researching a new basis for determining growth rate assumptions. However, AJ Bell – along with, we believe, the platform pension market in general – is keen to avoid the introduction of setting rates of assumed growth in line with volatility, for the strong reasons outlined above.

Instead, AJ Bell believes the FRC and FCA should use this opportunity to introduce a simple and consistent methodology to both point-of-sale illustrations and SMPIs that could then be used for Pensions Dashboards. The FRC could either:

1. set one single growth assumption that all providers have to use, with an explanation for consumers that if they hold lower risk assets the growth rate may be lower and if they hold higher risk investments it may be higher; or
2. set a range of assumed growth rates determined by asset class, which could be informed by the research the FRC has carried out on volatility and continues to carry out. This would be consistent with the mid-range FCA's POS illustrations meaning pension schemes can use the same software and approach for both.

Each method has advantages and disadvantages. However, it's important the discussion within the industry on which approach is the most appropriate is not used as the reason to introduce a third much more complex and unworkable solution.

[1] FCA Effective competition in non-workplace pensions Feedback Statement FS19/5 July 2019

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 support the FRC's aim to introduce more consistency between different pension schemes' annual statements and agree this means removing from SMPI calculations providers' discretion to set growth and annuity assumptions. Defining one set of rules will enable consumers to compare projections more easily between different pension schemes and to build up a complete picture of their pension savings. This will lead to more consumer engagement and hopefully better outcomes through increased contributions and more informed retirement options decisions. This is true for both annual statements as well as information shown on Pensions Dashboards.

It's worth noting that consistency can also be achieved by each pension scheme sending the dashboard ecosystem the current fund value, and the ecosystem then calculating the ERI data using the same assumptions – including projection date. This alternative approach would lead to a more consistent outcome.

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

We understand why FRC has proposed this date to tie in with changes to Pensions Dashboards. However, we suggest reverting back to making changes effective from the start of the tax year and suggest April 2024 as the effective date.

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

AJ Bell does not in any way support the proposed methodology to set accumulation rates. Instead, we have grave concerns about the proposed changes to accumulation growth assumptions.

In summary we believe the approach does not meet any of the FRC's stated objectives:

- Being consistent across funds – with the limited guidance proposed there is huge scope for different providers categorising any given investment differently. This goes directly against the aim of the FRC to introduce consistency.
- Helping people understand that taking risk means the potential of a bigger return – this approach will not explain appropriately the relationship between risk and return, especially the downside and the risk that the return could be considerably less than that illustrated
- Being understandable to consumers – generally consumers do not understand volatility. and will not understand its relationship to growth rate assumptions. In addition, the notes explaining the assumptions may run to pages and pages which consumers will not read.
- Not placing an undue burden on providers – this approach is impractical and unworkable for platform pensions which generally offer 4,000 funds.
- Avoiding perverse outcomes – assuming a real growth rate of 0% on direct investments will be confusing for platform pension consumers holding these securities perversely affecting their projected fund value.

The consultation concedes "the future is uncertain and our models for projection are imperfect". In other words, a projection will never be completely accurate – there are too many variables at play. We believe the FRC should accept this and apply broad brush principles to projections, instead of chasing spurious accuracy in one particular element.

Will create confusion for consumers

It will be difficult to explain to consumers how growth rates have been calculated, both on the Pensions Dashboards and also within annual statements. Most consumers will not fully understand the concept of volatility, whether it's a good thing or a bad thing, or the relationship between risk and return. The projections will not help to explain that concept.

To include sufficient notes to explain how accumulation rates have been calculated will mean expanding the number of pages of the illustration. Many platform consumers hold many investment holdings within their platform pension account (in contrast to a member of a defined contribution trust scheme who will probably hold only one or a few). This will also be difficult to document on the Pensions Dashboards.

Platform pension consumers change investments on a regular basis. Under the proposed approach the growth rate assumption for a particular pension pot will potentially be different each time the consumer looks at the Dashboards if their investment mix has changed, and each pot they view via the Dashboards will potentially have a different growth assumption if the investment mix differs between pots. This inconsistency will be confusing for consumers and will not help them engage with their pensions, which is the fundamental objective of Pensions Dashboards.

Using different rates for different types of assets will mean illustrations could change significantly from one year to the next depending on investment changes, meaning consumers will lose faith in the information being presented to them and see it as worthless.

In contrast, the thousands of direct investments held on platforms which consumers hold within their platform pension will have an assumed real growth rate of zero (2.5% growth). Consumers will not understand why these assets have such a low growth rate compared to their fund investments which could be classified as less volatile and therefore should have a lower return.

The methodology also relies on past performance, which directly contradicts the FCA’s central message that past performance is no guide to future performance.

Do not work in the platform pension market (including SIPPs)
The pension market is not homogenous. SMPIs should be designed to reflect all the different types of pension schemes that use them. These proposals do not work in the platform market (including SIPPs) because they do not take into account the wide investment ranges consumers have access to via these products.

Providers of these products will have to categorise thousands of investment funds.

.
This would require ongoing involvement throughout the year and would need to be appropriately resourced.

The exercise becomes virtually impossible when considering the high usage of Discretionary Fund Management (DFM) services via platforms, where the provider will not necessarily know about changes being made to the underlying consumer portfolio.

We are concerned where a fund has insufficient performance history and the suggestion that a similar fund is used. As most funds do not publish their full holdings list this would only be a vague estimate, and a subjective one – different providers will use different proxy funds. To use a shortened history would also be an inappropriate way forward; most risk rating companies will not assess funds until they have a three-year track record.

There is no additional value or clarity provided to the consumer in introducing a new methodology to SMPI calculations and therefore the costs and complexity of implementing these changes is disproportionate.

Risks jeopardising the Pensions Dashboards project
The Pensions Dashboards project is important for both government and industry. It is pivotal in helping people re-connect with lost pensions and engage better with their pension savings. However, the FRC proposals are jeopardising this project.

Every time a person logs onto the Pensions Dashboards and requests their pensions data, if there is a match the pension scheme will submit to the dashboard ecosystem an estimated retirement income (ERI) calculated on the basis defined in AS TM1.

Some older non-platform pension schemes will provide the ERI calculated for the last SMPI and stored since then. But as this involves submitting information that may be up to 11 months out of date, platform pensions will not work that way.

Instead, they intend to calculate the ERI on a regular basis (maybe monthly) and pass this to an ISP to store and use to respond to a dashboard request. This means regularly recalculating ERIs for each pension consumer in case the information is requested. This involves calculating how much of each consumer's fund value is invested in a specific fund and working out the volatility rating, volatility grouping, and therefore growth rate assumption of that specific tranche. Platform pension consumers switch investments on a regular basis and this data has the potential to change for each ERI calculation.

This will be complicated, convoluted and will not work within the Pensions Dashboards / ISP sphere.

Alternative way forward

Instead, the FRC could either:

1. set one single growth assumption that all providers have to use, with an explanation for consumers that if they hold lower risk assets the growth rate may be lower and if they hold higher risk investments it may be higher; or
2. set a range of assumed growth rates determined by asset class, which could be informed by the research the FRC has carried out on volatility and continues to carry out. This would be consistent with the mid-range FCA's POS illustrations meaning pension schemes can use the same software and approach for both.

Each method has advantages and disadvantages. However, both are understandable and simple for the consumer, encouraging engagement, and easy to implement. We all acknowledge that no projection will be accurate, and both methods present a reasonable way of estimating future returns.

It's important the discussion within the industry on which approach is the most appropriate is not used as the reason to introduce a third much more complex and unworkable solution.

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 assumed rate of CPI should certainly be no lower than 2.5%. As we are in a period of high inflation, we believe FRC should review this ahead of the implementation date.

It is hard to say whether the proposed accumulation rates are appropriate as the more volatile the investment is then the harder it is to predict a long-term rate.

However, 7% does not appear suitable given the performance of the FTSE250 over the last 12 months. Furthermore 3% is not suitable for fixed interest when many lower-end cash-like unit trusts are currently paying 4-5%.

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

Pension providers need more information and guidance about how to calculate rates in these types of funds, or an acceptance by the FRC that pension schemes can find the most appropriate way of calculating them. (However, that runs contrary to the aim to achieve consistency.)

The reduced rate of growth could apply only when the de-risking starts, or it could be argued it should be a lower rate for the entirety of the investment period. Historical performance shows lifestyling funds have achieved lower rates of growth.

If the fund is preparing for the member to move to drawdown, it could be argued that in drawdown the funds may maintain the same level of volatility as in accumulation. It would be wrong to assume all types of consumers take the same route in retirement.

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 believe this is only adding another layer of complexity and 'spurious accuracy'. It is addressing a problem that has only been created because of the original proposals and could be avoided by taking a different approach to calculating accumulation rates.

The proposed approach is being taken to avoid consumers seeing their fund investment move from one category to another regularly when they receive a statement or log onto the Pensions Dashboards. However, as platform pension consumers in particular regularly review and change their investments. their projections will never enjoy consistency as they move to different funds with different volatility experiences.

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

No comment

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?

It is difficult to judge what the accumulation rate should be for unquoted assets. Every unlisted asset is different. One could argue they are not volatile until they are incredibly volatile!

The property markets are also volatile and shift in a similar manner to investment markets. Assuming a nil return would affect the many self-invested pension members who choose this particular investment.

One reason why people may choose to invest in unquoted assets is because they expect a higher return. However, the proposed volatility approach fails to take this into account.

The Government is keen to encourage pensions investment in LTAFs giving investors access to infrastructure and private equity with a notice period of at least 90 days. However, the proposed approach would mean these types of assets would have lower projections making them potentially less attractive to consumers.

In addition, we understand that the assumed growth rates for direct investments held by platform pension consumers will also be a zero real growth. This will be confusing for consumers who may not understand why the growth rate is so low for these types of assets compared to investment funds. Especially as (some) direct investments may – arguably – be seen as some as more volatile and therefore deserving of a higher return.

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

This is another complicated solution to solving a problem created by the proposed approach and adding another complicated layer. We are concerned it misses the nature of the platform pension market and effectively requires platforms to run investment-specific illustrations. This would require significant resource to implement.

With the limited guidance proposed there is also huge scope for different providers categorising any given investment differently. This goes directly against the aim of the FRC to introduce consistency.

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?

Given that large numbers of pension savers now draw pension via income drawdown, rather than an annuity ideally this should be reflected in the estimated income calculation. However, perfect should not be the enemy of the good, so our view is we should proceed as proposed, whilst still challenging whether there is a more relevant way to present the estimated retirement income.

We agree the simplest approach is to assume no tax-free cash is taken and a single life level annuity is bought with no guarantee.

The context and wording surrounding any projections – whether in annual statements or Pensions Dashboards - needs to be extremely clear about the assumptions made and how the income shown has been calculated. As well as emphasising that in practice a consumer has other choices over how to take their later life income from a pension.

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 are broadly comfortable with this proposal.

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?

No comment

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

Further confusion is created for consumers by having different methodology for FCA COBS illustrations and SMPI illustrations. For example, FCA point-of-sale rules require 2% inflation to be factored into point-of-sale disclosures, while for SMPIs the figure is 2.5%.

There is no reason why the two sets of disclosure requirements should be different. This might not have been a major problem in a world where most people don’t engage with these statements, but if Pensions Dashboards are to be a gamechanger, policymakers need to make sure what consumers see is consistent.

With the advent of Pension Freedoms more and more people hold crystallised and non-crystallised benefits at the same time. They could therefore be in the position of receiving two different types of annual statement using different approaches and assumptions.

We recommend that a wholesale review of pension illustrations is undertaken as part of the FCA and TPR work looking at the pension consumer journey. Therefore, ahead of this review any changes to SMPI should be kept to a minimum, instead of introducing a new set of expensive and resource-intensive calculations which may not be retained

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

The proposed changes would result in considerable resource costs for platform providers, partly due to the sheer number of funds and other assets which will require ongoing review, especially given the regular calculation of ERI necessitated by connecting to the Pensions Dashboards. Additional ad-hoc reviews will also be required for any new investments added to the platform when they’re released or actively invested in by consumers for the first time.

We believe the FRC has underestimated the impact of their proposals on the platform pension market. There is no additional value or clarity provided to the consumer in introducing a new

methodology to SMPI calculations and therefore the costs and complexity of implementing these changes is disproportionate.