FRC – Proposed revision to AS TM1: Statutory Money Purchase Illustrations

Response from Nest Corporation

1 About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 975,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high-quality, low-cost pension scheme helping over 11.1 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £20,600 per year on average and roughly 55% of our members are aged under 40 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.[1]

[1] Employer and member numbers correct as of 31/03/22, Nest in Numbers; Member earnings and age data correct as of 31/03/22, quarterly briefing data pack, Scheme MI.

2 Response

Introductory comments

Nest welcomes the efforts by the Financial Reporting Council to improve the consistency of Statutory Money Purchase Illustrations and supports the policy objective underlying this consultation. We are supportive of pensions dashboards and agree that improving the consistency of estimated retirement income is an important intermediate step in ensuring dashboards' usefulness. The utility of those estimates will depend in large part on uniformity of assumptions across all scheme types.

Whilst we support the policy objectives behind the consultation, we do not support the specific accumulation rate approach proposed in the document. We see significant risks from the proposed volatility-based approach, including the potential harm to members from transferring funds and the encouragement for schemes to invest in riskier assets.

We recognise that arriving at an approach that is acceptable to all commenters will be difficult. We would welcome additional work to achieve the right balance of trade-offs between different approaches.

Pensions dashboards

Question 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 supportive of the efforts to prescribe accumulation rates and annuitisation options. Limiting the discretion afforded pension providers in these areas will likely improve consistency in the income projections presented to consumers. This is a laudable objective, particularly given the connection with pensions dashboards and the important role that retirement projections will play on dashboards. Providing consumers with a retirement income projection that includes all of an individual's outstanding pensions should be immensely helpful for retirement planning purposes. This projection will be meaningful only if there is uniformity in the method for calculating projections across all pension providers and scheme types.

We are mindful, however, of the significant implications of the assumptions that are ultimately adopted. There is a substantial risk of member detriment from whatever assumptions apply. Whilst SMPI is intended to be used in the pensions dashboards context (among other uses) for providing a meaningful retirement projection, it may be used for other purposes that pose risks to consumers. There is a high likelihood that providers will attempt to compete for members based on SMPI projections. This could result in providers advertising higher returns and future incomes based on Government-sanctioned assumptions. Consumers could be induced to transfer pensions into schemes with higher projected incomes even if those schemes provide poor value (however defined) or offer investment strategies that poorly align with the member's needs. By extension, the opportunity to trumpet higher projected incomes could also lead providers to modify their investment strategies to align with the assumptions that would allow them to project the highest returns into the future. At its most extreme, the effect would be an investment strategy designed to maximise projected incomes for marketing purposes rather than maximising actual incomes. We view this risk as highly significant. In response to Question 3, we discuss the practical implications of the proposed SMPI modifications.

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

We are fine with the proposed effective date. We would encourage FRC to publish the final version of the revised AS TM1 as soon as possible to give providers enough time to comply.

Accumulation rates assumptions

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

We disagree with the proposed accumulation rate approach, which relies purely on historical volatility for assigning accumulation rates to investments.

First, we are concerned that the proposed accumulation rate approach will have a detrimental effect on members. As noted in our response to Question 1, any approach that encourages pension providers to compete on various metrics poses risks to members, but this is particularly the case where those metrics do not necessarily align with better outcomes, improved value for members, or members' own preferences. DWP has made clear that it envisages pensions dashboards as enabling consumers to compare the performance of pension schemes. Under the proposed approach, we think members will likely compare schemes based primarily on projected retirement incomes. Because this projection depends on historical volatility, the highest risk investments strategies will appear to members as the best performing.

Higher risk funds, however, may offer an inferior investment proposition than other schemes. A DC scheme could have a highly sophisticated, diversified, investment strategy with strong risk-management controls and could be achieving excellent risk-adjusted returns. Members may be enticed to transfer pots out of these schemes into those that can display higher projections. But there is no guarantee that higher volatility schemes will deliver higher actual incomes in retirement. Moreover, these schemes may not align with the member's personal circumstances or investment preferences. For instance, income projections could prompt a member nearing retirement to transfer funds into a high volatility scheme, which would contradict the accepted wisdom of derisking closer to retirement. The potential harm is greater for members who are less engaged and/or less financially sophisticated. These members may in some cases also have lower incomes and pot sizes and would be disproportionately affected by a poor transfer decision.

Moreover, members could be subject to higher risk investments even if they do not transfer money between schemes. Under the proposed accumulation rate approach, schemes will be incentivised to implement investment strategies that maximise volatility so they can use higher accumulation rates for projected retirement incomes. Members' existing schemes could alter their investments to take on additional investment risk. Again, risker investment strategies would not be appropriate for all members, and the low engagement levels observed in pension savings suggest that many members would take no action to find a more suitable fund. Nest's research with its membership has shown a low-risk appetite in relation to investments.[2]

We are also concerned that the proposed approach will provide unreliable projections to members. This is a risk with any projection, which is inherently speculative. However, we are not convinced that there is a sufficient connection between historical volatility and future returns to justify the proposed approach to accumulation rate. Whilst the academic research referred to in the consultation may show a simplistic, historic relationship between volatility and forward-looking investment return rates, this relationship is unlikely to be sustained into the future given growing allocations by DC schemes to illiquid asset classes which are priced less frequently. Corporate Advisor (CAPA) research shows that this relationship is already breaking down, with many lower-risk schemes delivering higher returns.[3] Volatility will be an increasingly poor indicator of risk and using it for this purpose risk providing unreliable projections to members.

Further, the emphasis on volatility risks undermining work across Government to foster greater investment in illiquid assets. Schemes are already seeking higher returns in infrastructure and other illiquid assets and should continue to pursue this strategy if consistent with members' interests. The proposed approach may limit or reverse this trend.

[2] Nest April 2021 YourWay survey of community members.

[3] **Risk/Return - Younger saver, 30 years from retirement, 5-year annualised - capaDATA (capa-data.com)**

We would urge FRC to consider alternatives to a pure volatility-based approach. One alternative is for schemes to all use standardised accumulation rates that would apply uniformly to all assets and fund types. FRC could require schemes to publish the rate they have used and include low-, average-, and high-return options to provide members with a potential range of outcomes. Data could be taken from FCA's triennial review of expected returns, which are used to inform their own assumptions. This approach would need to be tested as well but would retain the benefits of consistency whilst removing the overemphasis on volatility inherent in the proposed approach. It would largely eliminate the opportunity for schemes to compete based on projected retirement income and could reduce the risk of member harm from this competition. This would be our preferred approach but would need to be accompanied by clear explanatory information notifying members that the income resulting from this projection is merely indicative of what might actually be available at retirement. It may also pose a risk of overestimating retirement income for members invested in low-growth assets such as cash.

As another option, FRC could adopt an asset class-based approach in which accumulation rates are assigned based on an assumed return for each asset class. We believe this approach is feasible and could be devised based on common asset classes (e.g., listed equities, government bonds, corporate bonds, property, cash, etc). Assumptions could also be made regarding the accumulation rate of illiquid assets that accounts for an illiquidity premium. For example, private equity could be assigned an accumulation rate of 2-5% over public equity depending on the stage of investment. This approach would also eliminate the ability of schemes to compete based on projections. It would, however, introduce additional complexity that may be difficult for members to understand.

Regardless of the approach to retirement income projections, there is a significant risk that members accessing information on pensions dashboards will not understand or will misconstrue the information presented. Any projection is inherently speculative and runs the risk of members taking actions based on events that are yet to occur. Whilst further work is needed to ensure that members understand the data presented, we would encourage FRC to seek a simple approach to SMPI projections that makes clear that the projections provided are illustrative only. Any implication to the contrary could have significant consequences for members. We would also encourage significant member testing to understand the consequences of projecting income with the different potential methodologies.

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

No comment.

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

We agree that, depending on the overall approach adopted for accumulation rate assumptions, it is sensible to use a lower assumed growth rate to accommodate derisking. We would note that an asset-class based approach would inherently account for derisking. As members are usually transitioned into less risky assets as they approach retirement, the accumulation rates assigned would be lower than their prior holds. This derisking would automatically be captured. A standardised rate approach (e.g., showing low-, average-, and high-return illustrations) would forego accounting for derisking. This potential omission highlights the tradeoffs between approaches: additional nuance is sacrificed in favour of simplicity and uniformity. We would support additional work to find the right balance of these factors.

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

No comment.

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

No comment.

Question 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?

Nest currently invests in unquoted assets and intends to continue to seek these investments in the future. However, we do not agree with the proposed approach for projecting returns on unquoted assets.

The assumption that unquoted assets will not realise any real-term growth poses some of the same risks of member detriment as outlined in response to Question 3. All else equal, income projections for schemes holding unquoted assets will appear lower than those for schemes without them. This may cause members to transfer out of schemes with unquoted assets even if those schemes provide better value for money. The disparity in projected income will be more pronounced for schemes with higher proportions of unquoted assets, which may offer higher returns at lower levels of risk than, e.g., listed equities.

The effects of this approach may be felt at the scheme level as well. As with our concerns with the overall accumulation rate approach, the approach to unquoted assets may influence schemes' investment decisions. Being required to, in effect, exclude unquoted assets from estimated retirement income projections, schemes may opt to divest those assets or abstain from investing in them in the first place. The proposed approach thus confronts the emerging trend with DC schemes seeking out higher returns through unquoted assets. It also confronts the Government's ongoing efforts to encourage greater investment in illiquid assets.

Our preferred approach – using a standardised accumulation rate – could address these issues. This approach would eliminate the need to consider unquoted assets separately and would merely assign a uniform rate to all investments. Under an asset-class based approach, higher accumulation rates could be prescribed for unquoted asset classes. For instance, private debt could be assigned the rate of public debt plus 1%. Private equity could be assigned the rate for listed equities plus 2-5%. These rates could incorporate research on the illiquidity premium for various assets classes. Again, this would add complexity beyond a simple, standardised approach.

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

The proposed process for plans with multiple funds – whilst simplified – is still complex, given the large numbers of self-selectors and blends of funds in certain schemes. We would suggest that our own approach of using standardised accumulation rate would remove all of this complexity.

Annuitisation assumptions

Question 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?

No comment.

Question 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?

No comment.

Question 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.

Other considerations

Question 13: Do you have any other comments on our proposals?

We are concerned about the potential for member confusion due to the lack of consistency around a definition of retirement date. The consultation acknowledges that it is not proposing a change to the current definition of retirement age. This can be any date that the member has specified to provider and that is acceptable to the provider; or where no acceptable date has been specified by the member, a date specified by the provider. Anecdotally, we are aware that schemes have different rules in place for when and how a member may change their intended retirement date. In practice, this means that a member could have a different retirement date for each scheme in which they have a pot. Allowing these disparities amongst different schemes could undermine the overarching goal of the proposed revisions. The estimated retirement income returned to the dashboards will not be directly comparable across schemes and could differ based on the estimated retirement period. As with our concerns above, this may result in member detriment if the figures presented induce behaviours that are not in members' best interests. We recognise that there may not be an easy solution to this problem. We would encourage user testing on how this information is understood by members and how it will be presented on dashboards so that members are not misled.