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AEGON Response to FSA Consultation Paper CP12/10

Product projections and transfer value analysis

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Introduction and High Level Summary

AEGON welcomes the opportunity to comment on FSA's Consultation Paper CP12/10 on product projections and transfer value analysis. We have already responded to Chapter 2. We are responding separately to the FRC's consultation and include that response as an Appendix to this response. We support consistency between FSA and SMPI projections both from the perspective of customer understanding and of systems maintenance.

Product projections

AEGON agrees that where projections are provided, the rates used should realistically reflect the investment potential of each fund's underlying assets. We accept it is unhelpful to consumers for projections to be overly optimistic, but we also see real risks of consumer detriment if likely future returns are artificially suppressed because of an inappropriate 'cap'.

What is viewed as 'realistic' as a medium to long term investment potential will of course change over time. The FSA should be setting a framework which allows for this while avoiding creating inappropriate distortions.

We believe the FSA proposals would stop firms from providing what are currently realistic projections to clients who are considering investing (or already invested) in equity-based funds, and as a result risk misleading consumers, discouraging saving and causing them detriment.

We propose an alternative way of ensuring customers receive realistic projections. This combines leaving the maximum central projection rates in the framework unchanged, but with strengthened emphasis on making sure funds do use asset specific projections. At the present time, this would suggest funds not entirely or primarily invested in equities should not be using projection rates approaching the maxima.

We believe there is currently a disproportionate focus on pensions charges, rather than other aspects of pensions that matter more in terms of good customer outcomes. Investment returns are one aspect that matters more. Some comments made or the way these are being reported in the media are inaccurate, misleading and potentially harmful to consumer confidence in pensions. It is important to consider this consultation in that broader context.

The CP suggests the costs involved in making the proposed changes will not be significant. While this is true relative to implementation costs of RDR, they are far from trivial. It is not simply the monetary costs which need considered but the extreme shortage of resource the industry faces right now as a result of regulatory and legislative change. We explain in our response why we do not support many of the proposed changes. If the FSA proceeds with any change to the derivation of growth rates, we urge it to allow a transitional period until not earlier than end 2013. This has the added benefit of giving the industry and regulator time to understand the direction of travel of PRIPs requirements.

We would be more than happy to discuss any aspect of our response with you further.

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Responses to Specific Questions

We previously responded to Questions 1 to 3 in Chapter 2. We are also responding to the FRC consultation on Assumptions for Statutory Money Purchase Illustrations included in Chapter 5, and include our response in the Appendix to this response.

Q4: *Do you agree with the assumption for CPI-linked revaluation in deferment? If not, please state the level at which you believe the assumption should be set and why you believe it is more suitable.*

Based on PricewaterhouseCoopers' (PwC's) findings, we agree this approach is appropriate.

Q5: *Do you agree with the approach and level of the assumptions for pension increases based on CPI? If not, please explain what alternative basis you think is more appropriate.*

Based on PwC's findings and the existing approach for collars and caps that apply to RPI increases, we agree this approach is appropriate.

Q6: *Do you have any comments on the cost benefit analysis for our proposals in Chapter 3?*

We have no comments.

Q7 : *Do you agree that this change of wording provides sufficient additional emphasis for providers regarding our longstanding requirement that they use appropriate projection rates?*

We accept that prior to the 'Dear Compliance Officer' letter, providers had not generally projected at rates below the standard FSA projection rates, even where the customer was unlikely to achieve these rates if they remained in their initial fund until retirement.

AEGON believes all providers should now fully appreciate the need to comply with this requirement.

Therefore, as things stand, we are not convinced that additional emphasis is required. However, we explain in our response to Question 8 that we believe the FSA should adopt a different approach to setting maximum projection rates to that proposed. Under our alternative suggested approach, additional emphasis would be beneficial.

We support the broad change in approach to the wording. COBS 13 Annex 2 now refers to the specified rates as 'maximum' rates. This is appropriate as this is what they are. We believe it is now misleading to refer to them, as is done in paragraph 4.8, as 'standard rates'. We expand on this in our response to Question 8.

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We would also suggest other wordings in COBS12 Annex 2, 2.3R be reviewed. In particular, we suggest 'accurately' might be replaced by 'realistically' or 'reasonably'. We also believe the reference to investment potential of the 'product' should instead refer to the 'fund'.

Under our suggested approach, the wording might be further supplemented to highlight the need to regularly review assumptions in light of changing expectations of medium to long term asset class returns. This would suggest that at the present time, it is only funds invested heavily (or entirely) in equities that should be using projection rates at or close to the maxima within COBS.

Q8: *Do you agree that the proposed changes to these assumptions are appropriate? If not, what changes would you propose? Please explain why you would make other proposals.*

We do not agree that the proposed changes are appropriate. Our concerns are not in relation to the assumptions in themselves, but relate to the context or framework in which the FSA specified rates are then used.

Historically, the FSA specified rates were adopted by the market as 'standard' rates. Many providers used them in all cases. Even those who did adjust them downwards for certain funds did so only by exception, meaning they were the standard rates used for the majority of funds.

Against this background, it was reasonable to base the 'standard' rates on a fund with a 'typical' fund asset mix of 67% equities and 33% bonds.

However, since that methodology was developed, we've seen a marked increase in the range of funds customers can access. These often have asset mixes very different from that used within the PwC analysis. In addition, there is now a clear understanding that projection rates should reflect the likely return of the underlying asset mix of each fund, subject to a maximum specified by the FSA.

In light of these developments, we believe it is highly inappropriate to base the maximum projection rates on what has been regarded historically as a 'typical' asset mix.

The PwC report suggested future equity returns might be between 6.5% and 8% per annum over the medium to long term. On this basis, we do not think it is appropriate for the FSA to require providers to cap their central pension projection rate at 5% where the individual has chosen a fund which is 100% invested in equities.

If an individual has chosen a fund which has an asset mix in line with the 'typical' mix, the requirement to use asset specific projection rates might currently bring the central projection rate down closer to 5% although we note the PwC report suggested 6% as the central rate.

In AEGON's view, customers and their advisers do use the projections shown in key features illustrations to form a view on what they might get back. It is

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clearly wrong to present customers with an artificially high indication of what they might get back. But we believe it is equally wrong to provide an artificially low indication. At present, capping equity fund returns at 5% would do this.

Paragraph 4.21 of the CP identifies two possible customer reactions to lower projected returns – deterrence from investing or increasing pension savings. We agree these are two likely reactions. In the current economic climate, we believe the former will be the most common response. Few individuals have the ability or desire to save 'even more'. We also believe it would be wrong to mislead customers investing in equity funds into thinking they needed to save more that would be inferred from PwC's expert analysis into likely future returns on these assets. This concern extends to those already invested in such funds if, as is proposed and as AEGON supports, the FSA's approach is replicated in SMPI projection rates.

A third consequence of the proposal is that customers will be given an unrealistic impression of the relative risk / return profiles of investing in different assets – most notably equities compared to alternative investments such as bonds or cash. Most customers view equities as more risky than bonds or cash (although this depends on how risk is defined – i.e. loss of capital v failure to keep pace with inflation). If FSA projection rules mean the indication of future returns is little different between investment strategies, then customers will receive misleading indications of risk / reward trade-offs.

For the reasons given above, we believe the proposals in the CP would mislead consumers and potentially create detriment. We believe the maximum central projection rate for pensions should remain at 7% but that FSA should make clear to firms that the use of this maximum has to be justified on an ongoing basis based on realistic assumptions of investment potential. At the present time, this would makes it clear that funds not primarily invested in equities should be using a lower central projection rate.

We accept the rationale behind reducing the difference between pensions and less tax advantage products. However, in light of our proposal to retain the pension central maximum rate at 7%, we would not be in favour of increasing the maximum rate for less tax advantaged products above the current 6%.

Similarly, we agree that the greater element of uncertainty over future returns would justify a wider span of flanking rates. Again, however, we are not suggesting the upper flanking rate for pensions should currently be increased above 9%. There is more of a case for reducing the lower flanking rate but the cost of making this change in isolation should be considered against the benefits.

Q9: *Do you agree with the cost benefit analysis for our proposals in Chapter 4?*

There are many disclosure and projection systems across our industry and whatever the reason, it is a fact that they are costly to amend. This is true even for what may appear to be a simple change.

Compared to resources we are devoting to the Retail Distribution Review, Solvency II and Pensions Reform, the costs of implementing these proposals are

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not ‘significant’ but equally, they are far from trivial. It is not simply the monetary cost which needs considered but the sheer availability of resource as well as the further opportunity cost.

Costs would become significant if any of the projection rates became negative, including those used for Statutory Money Purchase Illustrations. This could occur if the lower flanking rate for any fund fell to 2.5% or below and if real projections (for example in key features) retained an inflation adjustment of 2.5%. A projection rate of 0% would require a different form of words to describe what it meant. A negative projection rate would require different explanation again. The wordings would need to be considered carefully. While we believe it is appropriate to inform an individual that long-term cash investment within a pension contract is unlikely to keep pace with inflation, negative projection rates will be difficult for many customers to grasp and could simply confuse.

Paragraph 4.23 suggests the proposals will mitigate the risk of misleading consumers on potential future returns. We highlight in our response to Question 8 that artificially capping projections, currently for equity-based funds, could actually create consumer detriment. Paragraph 4.23 refers to distorting the process of product choice. We believe it would be more appropriate to focus on fund choice. As explained in our response to Question 8, an unrealistically low projection rate for (say) equity funds could significantly distort fund choice, to the potential detriment of consumers.

Paragraph 4.22 suggests an indirect ‘benefit’ of lowering projection rates might be to encourage consumers to focus more on the impact of charges. We are concerned at some of the current alarmist commentary around pensions charges. Much of this, or the way in which it is being reported in the media, is inaccurate and misleading. Unfortunately, the vast majority of consumers will be unable to separate fact from fiction and will be left with the general impression that pensions charges are a ‘rip off’. We believe most current pension contracts offer good value. We also strongly believe that there are many other aspects of pensions which have a much greater impact on eventual return than charges, including starting saving early, saving enough, investing wisely, continuing to save and securing an employer contribution. An out of context or disproportionate consumer focus on charges is not necessarily beneficial. We do not believe it is appropriate for FSA to claim this as a benefit.

One criticism which has been raised regarding the increased emphasis on asset specific projections is that providers have made different assumptions about future returns on different asset classes. The proposals do not address this potential source of consumer confusion. An alternative methodology would be to use an independent body (possibly commissioned by the FSA along the lines of the PwC report) to set standard projection rates for each of the main asset classes. Firms would then use these to determine asset-specific projection rates for each of their funds.

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Appendix

AEGON's response to FRC Consultation on Assumptions for Statutory Money Purchase Illustrations

Q1: ***Do you agree that the assumptions in AS TM1 should be consistent as far as possible with those specified in COBS 13 Annex 2 of the FSA Handbook?***

Yes. Customers should have a consistent view of their investments throughout the policy cycle. We therefore agree the two should be consistent.

One other difference between FSA and SMPI assumptions concerns salary increases. The FSA basis uses 2%, 4% and 6% per annum whereas SMPI uses 2.5%.

Q2: ***a) Should AS TM1 continue to specify a maximum accumulation rate?***

Yes, but we do not support the FSA's proposals in this regard. We attach our response to the FSA's CP12/10 in the Appendix to this response. We explain in our response to Q8 why we believe reducing the maximum rate would be wrong.

b) If AS TM1 continues to specify a maximum accumulation rate, should it be the same as the FSA's intermediate projection rate?

Yes. This follows from a desire for consistency between the two.

c) If your answer to b) is 'No', what rate should be specified in AS TM1?

N/A

Q3: ***Should the wording for the mortality assumption in AS TM1 be changed along the lines of the wording proposed in Chapter 2?***

We agree it would be appropriate to have consistent wording.

We note that in the Board for Actuarial Standards 'Answers to FAQs version 1', the answer to question 5.7 "When producing Statutory Money Purchase Illustrations in line with version 2.0 of TM1, how should the male and female mortality assumptions be blended?" gives the option of using what is, in effect, the basis detailed in Chapter 2, as well as the TM1 wording, and states that other approaches might be possible.

It may be useful to firms if the FRC highlighted this in its response, as it appears the option of using the basis in Chapter 2 existed from May 2012, when this version of the FAQs was published.

Q4: ***Given the proposed nature of the changes to AS TM1, do respondents envisage any difficulties with a four-week consultation period for an exposure draft of a revised version of AS TM1?***

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We do not see any difficulty with this. What's important here is the timing of the response to confirm any changes and the date of implementation of those changes.

Q5: Do you agree with our proposals for the timing of any changes?

We believe the proposed changes to the mortality basis should be considered separately from those to the growth rate.

For changes to the mortality basis, we have already diverted resource to implement the changes as prescribed in AS TM1. Given that the FRC Q&A (as highlighted in our answer to Q3 above) already provides firms with the option of moving to the basis of calculation in Chapter 2, while this is an additional change, we see no major difficulty in changing this any time from now to 6 April 2013.

For changes to growth rates, April 2013 is simply too soon to make any changes. A response confirming any changes will not be published for some time. The FSA has not been more specific regarding implementation than '2013'. We believe that allowing firms to implement using a transition period (along the lines of the current AS TM1) up till end 2013 would be helpful, and more realistic.

Q6: Do you have any comments on the impact assessment for our proposals?

We are concerned by the FRC's stance that capacity exists to change systems and processes without incurring significant costs. While it's true these changes can be made, it's more the timing of both the changes and resource required alongside other mandatory changes which is the issue. We also have to consider potential customer communications – both proactive and reactive – not just alterations to internal systems.

To reiterate our earlier point, April 2013 is too soon to make changes to growth rates. We believe there should be a transitional period ending not earlier than end 2013.

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