Assumptions for Statutory Money Purchase Illustrations

NEST's response to the FRC's consultation 30 August 2012

Summary

NEST welcomes the Financial Reporting Council's consultation on Statutory Money Purchase Illustration (SMPI) assumptions. Only by having realistic expectations about what they may get out of saving for retirement can individuals be empowered to make informed decisions, including how much they may want to contribute over and above the minimum required under automatic enrolment. NEST is committed to making it easier for our members to make sensible decisions that will impact their futures.

We support the development of the requirements regarding accumulation rates in Actuarial Standards Technical Memorandum 1 (AS TM1) to date. NEST believes that future refinements should build on this direction of travel. We would like to see a focus on adopting rates that reflect the specific underlying investment strategies at stake, rather than allowing for rates that may not be justifiable against what a strategy could realistically be expected to deliver.

We believe that prescribing a maximum accumulation rate expressed in percentage terms creates the opportunity for providers to adopt these upper thresholds as their default. It also pulls focus from the responsibility of schemes to develop reasoned and transparent investment return assumptions. While we see the benefits of consistent and comparable projections across investment vehicles, whether workplace pensions, personal pensions or retail investment funds, we do not believe that future iterations of AS TM1 need necessarily be wedded to the FSA's point of sale assumptions.

NEST recommends that rather than reducing the maximum accumulation rate for SMPI calculations to 5 per cent, the concept of caps should be reconsidered entirely. We believe that the onus ought to be on providers to justify their expectations for what an investment strategy is likely to deliver, rather than a framework that provides tacit permission to anchor to a given upper rate of return. NEST would welcome requirements that set out a new framework for the rationale and review of accumulation rates that providers choose to use for their SMPIs.

NEST will continue to look for improvements in providing savers with easy to understand and useful information about the way their savings are invested. We would welcome further industry debate on developing innovative ways to describe not just the benefits of saving and realistic pension outcomes, but also the characteristics of different methods of investment and the risks and uncertainty associated.

Introduction

From October 2012 onwards, employers in the UK will have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. In many cases they are required to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that's available to any UK employer that wishes to use it to meet their employer duties. It has been specifically designed for people who may not have saved in a pension scheme before and has a public service obligation to accept any employer that wishes to use it to meet its new duties. More information about NEST can be found at:

http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

NEST and other providers of qualifying schemes face a number of challenges in communicating with the new types of pension savers created by automatic enrolment. The annual statement – and the SMPI that features in this communication – is among the key channels through which providers can engage savers with meaningful and actionable information and potentially improve their pension saving experience. Equally, if inappropriate assumptions inform SMPIs in annual statements, this can create unrealistic expectations that do not support savers in making empowered and informed choices about saving for retirement.

NEST's approach to member investment projections

NEST currently provides investment projections for both members and potential members through two online pension calculators, as well as providing SMPIs in members' annual statements.

In developing the underlying assumptions for these calculations we carefully considered the different ways in which the end user consumes the material, best practice as set out by the FRC and FSA, but above all the precise nature and objectives of the investment strategies that underlie the NEST proposition.

The pension calculator available on NEST's public website to any potential member of the scheme assumes the user would be invested in our default strategy – one of our NEST Retirement Date Funds – and the user is able to project their final pot size and retirement income based on any allowable values for retirement age and contribution rate. The SMPI and the pension calculator available to current members of NEST provide projections based on the individual's specific circumstances, including which NEST fund they are invested in.

The calculation methodologies underpinning these projection tools, while operationally different, are both grounded on the principles set out in AS TM1 and, where relevant, legislation. The accumulation rates have been carefully selected to reflect the nature and objectives of the investment strategies in question.

The primary assumption is that NEST funds will meet their stated investment return objective. For NEST funds that don't target a specific level of return we've selected accumulation rates based on both forward-looking assumptions and historic data, weighted appropriately for the different asset mixes in those funds.

Our assumptions also consider the way different NEST funds are likely to be used. For example, the NEST Pre-retirement Fund is for members who are near their retirement date, start saving with NEST in the next few years and intend to buy a retirement income. It's a relatively short-term savings vehicle, so looking at the shorter-term prospects for bonds and cash provides the most appropriate projection.

Responses to specific questions

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?

In principle we see no reason for differences in assumptions or methodology between projections prescribed by AS TM1 and those by the Conduct of Business Sourcebook (COBS).

NEST and many other pension schemes invest in pooled vehicles that are available for personal pensions and so have their own FSA-prescribed point of sale communications. It's reasonable to expect advisers and current and prospective pension scheme members to benchmark the strategies offered by occupational pension providers against familiar retail products.

Indeed, it might seem odd that an individual could obtain a point of sale projection for a product through a personal pension based on different accumulation rates than the SMPI they receive when investing in the same fund through their workplace pension. We recognise, however, that the purpose and context of SMPI and point of sale projections are different.

In an environment of automatic enrolment, workplace DC pension provision will reach all sections of the working age population. In due course the annual statement and SMPI will become a part of life for the majority of the working population and an important financial planning tool for many. On the other hand, we anticipate that personal pensions will primarily attract a smaller and more engaged audience. The COBS-prescribed accumulation rates – low, medium and high – may be a useful rule of thumb within the array of other information that accompanies retail investment products.

Ultimately, the priority for AS TM1 should be setting requirements for SMPI that are fit for its specific purpose and consistency with COBS being a second order aspiration.

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

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

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

We agree with the suggestion in the consultation that removing a maximum accumulation rate will reduce the likelihood of providers adopting it as a default. We believe AS TM1 should enhance its requirement that providers use a justifiable accumulation rate rather than specify a maximum accumulation rate.

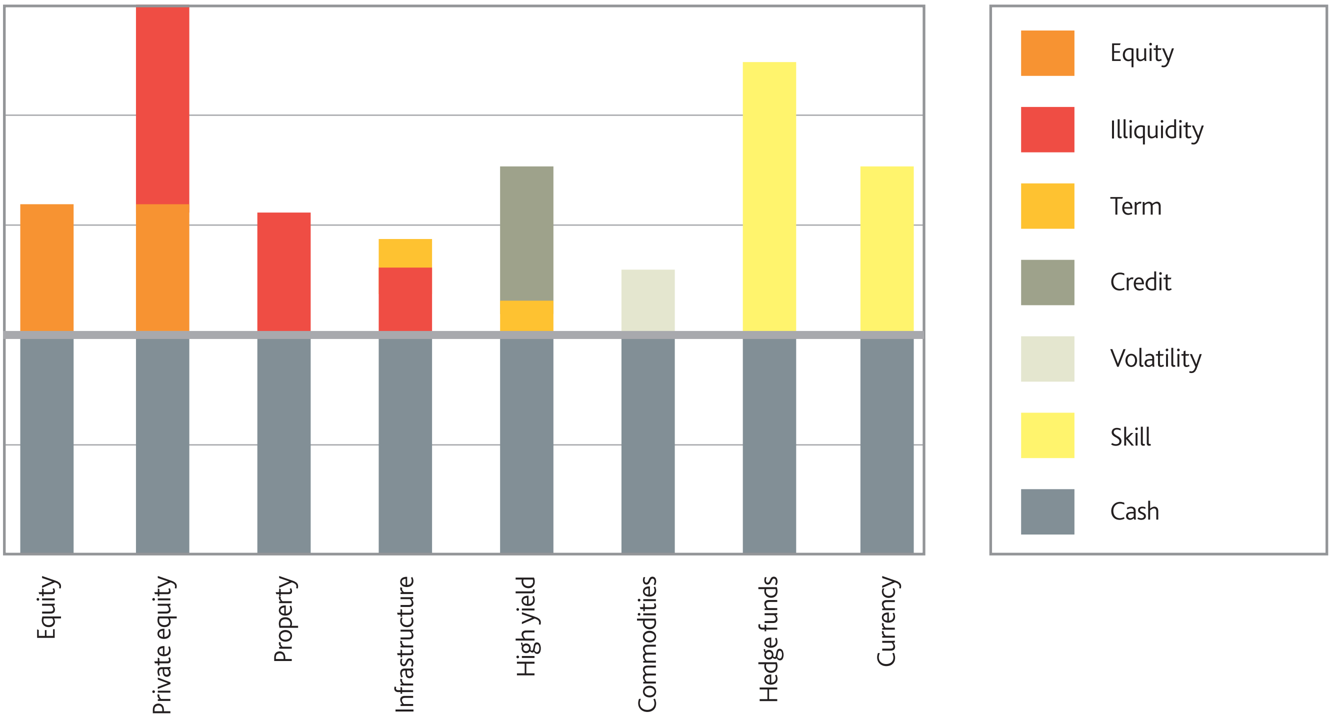
We believe that the traditional anchoring of projection rates to a specific figure could be a symptom of the presumption that DC pension strategies are uniform, for example, a 100 per cent equity allocation that will continue to deliver the historical long-run return realised by that asset class. DC investment strategies are evolving – notably with a shift in emphasis towards diversified growth building blocks underpinning lifestyle options[1] – and so too are the prospects for returns from a number of asset classes.

[1] FTSE 100 Defined contribution pension scheme 2012 survey results; Towers Watson.

Estimates of the equity risk premium over the risk-free rate of return vary significantly depending on the analyst, and change with time. It is hard to argue that anyone has the 'right' answer, but seeking to understand risk premia is an essential part of managing an investment strategy and, ultimately, the assumptions used in a projection.

The diagram below was included in our findings document following the consultation we ran when designing NEST's investment strategy[2] to illustrate just some of the components of the risk premia for different asset classes. Only by seeking to understand in detail the various drivers of returns to different assets can one be more certain about predicting those returns and harvesting them.

Components of risk premia in different asset classes



Earlier iterations of AS TM1 implied that 7 per cent was the norm. This was the return on equity and, traditionally, equity was what DC schemes invested in. 'Equity', however, is shorthand for a range of sub-categories each offering their own risk return profile, and there are many other asset classes and strategies to consider.

It is our firm belief that providers of pension schemes should move away from simplistic assumptions about what constitutes a standard investment strategy. Providers should begin with:

- principles on developing best estimates of the returns they are likely to achieve for their customers
- the amount of risk they are prepared to take on behalf of their customers to achieve these rates
- the probability of achieving these returns in various economic and market regimes
- the methodology and justification for using any particular figures.

[2] Building personal accounts: designing an investment approach. Key findings of the public consultation. PADA 2009.

NEST's approach to developing projection rates has been to seek to illustrate what we are trying to achieve with our investment strategies. Our investment objectives – for example CPI plus 3 per cent for the Growth phase of a NEST Retirement Date Fund – are the primary determinant of our projection rate assumptions. Our investment objectives are our best estimate of what members will achieve by saving in a NEST fund because we carefully manage the funds to achieve those stated objectives.

Where NEST funds target a level of volatility or benchmark performance rather than absolute return we consider the breadth of characteristics of the investments in the funds. This includes both forward-looking estimates of asset class performance and historical performance, as well as the time horizon over which members are likely to invest in the fund.

We recommend that AS TM1 is phrased to emphasise the requirement that providers arrive at best estimates of the returns they are likely to achieve from the investment strategies they employ within relevant timeframes.

We would also be supportive of a requirement for providers to make available a comprehensive rationale to support the rate or rates they have chosen to calculate projections. This would provide consumers – as well as employers, intermediaries and future members of schemes – a means of holding providers of projections to account. It would also allow for a better understanding of how they invest and why.

We agree that the method used to set the projection rate should be consistent from year to year, but would recommend that AS TM1 includes a requirement that providers review their assumptions periodically, particularly for those funds with dynamic asset allocations. Where the risk/reward profile of a pension vehicle such as a balanced managed fund materially shifts, we believe that in line with the principle of best estimates, the projection rate associated with it should also be re-evaluated.

We also strongly believe that lifestyling strategies should be reflected in the SMPI calculation. Factoring in the risk glide path often has a significant impact on the final projected pot size. Simply averaging out the return does not reflect that a glide path will have a different impact on savers depending on how long they save in a scheme. NEST seeks to address this by using a matrix of investment returns in our calculation for those NEST Funds that have strategic asset allocations.

However, the pot size a saver might achieve and the average rate of return that gets them there is only part of the story. NEST continues to gather evidence on the best approaches to communicating investment risk to our members, including the way in which probabilistic projections may be interpreted. We are conscious that the ways the risks of pension saving are framed could result in the end user making inappropriate decisions.

Our research suggests that the inherent uncertainty in any DC scheme is undesirable to the lay investor.[3] Risk is perceived to be random and unpredictable, not unlike gambling.

[3] Various sources. See our website.
http://www.nestpensions.org.uk/schemeweb/NestWeb/public/whatIsNEST/contents/research-and-insights.html

When it comes to the risk of saving in a pension scheme, many individuals evaluate this more in terms of potential loss than potential gain. Given what we know about how risk can be perceived by the lay investor, presenting uncertainty alongside a deterministic outcome is likely to be interpreted negatively. For example, it could be interpreted as a chance that they'll get less than their contributions or that they'll lose everything. Even though the latter possibility is highly unlikely, anecdotal evidence exists in the popular imagination and makes it feel more likely than it really is.[4] In addition, existing secondary evidence shows that people tend to overweight the improbable[5], which leads them to interpret the concept of risk as 'anything (bad) can happen and indeed it recently has'.

However NEST's most recent research suggests that when probabilities are given alongside outcomes within a range, the most improbable and upsetting outcome – losing everything or having less than was contributed – do not loom as large.[6] It would seem that stochastic projections can help people to adopt a more neutral interpretation of risk and therefore, uncertainty.

The challenge remains, however, as to how best to present stochastic projections, and we concede that this is still something that requires a great deal of further thought in order to be executed correctly.

Even while the industry works towards more effective methods of communicating uncertainty of outcomes – with the aim of empowering individuals rather than putting them off saving – we believe that projections that use higher rates of return and reflect riskier investment strategies should be accompanied with an acknowledgement of this riskiness.

We would also welcome efforts by the pensions industry to develop means of articulating different types of risks facing investors. For example, we are concerned that inflation risk is little understood by many savers. Though it is possible for members to understand inflation in terms of rising prices, they tend not to think of it readily in terms of their pension and future retirement income.[7] Given how they feel about uncertainty and how they perceive risk (see above), even after being presented with an illustration of the impact of inflation, many individuals will favour certainty over a chance to keep up with or beat inflation over the long term.[8]

Providers must strike a balance between highlighting the riskiness of different ways of saving, with the risk of not saving at all.

The ultimate goal of the annual statement should be to reinforce the benefit and importance of continuing to contribute to a vehicle that is likely to keep pace with inflation, whether it is by 2 per cent or 5 per cent.

Regarding the specific issue of the rate of inflation to be used in SMPI calculations, NEST would welcome a less prescriptive format in AS TM1. This should give providers the flexibility to choose either CPI or RPI as the measure they feel is most relevant to their members' saving and decumulation journey and the investment approach adopted.

[4] This is known as the 'availability' heuristic. It is possible that risk and uncertainty are particularly problematic for people in light of the current economic climate. It would seem possible for the unthinkable to happen. See Tversky, A and Kahneman, D (1973). Availability: A heuristic for judging frequency and probability. *Cognitive Psychology*.

[5] Kahneman, D and Tversky, A. Prospect Theory: An analysis of decision making under risk. Econometrica, Vol 47, No 2 (Mar., 1979), pp.263-292.

[6] This research is expected to be published in late 2012.

[7] Understanding reactions to volatility and loss. Sept 2010. Independent research conducted by Opinion Leader for NEST.

[8] Ibid 6.

NEST bases its default strategy investment objective on keeping pace with and exceeding CPI. As well as being consistent with the direction of travel for Government policies and Bank of England monetary policy, we believe, crucially, that CPI best represents the changing cost of consumption for our membership. This is especially so given we expect the vast majority of members to either take their pot as cash or buy a level retirement income when they take their money out of the scheme.

We would like all providers to include their rationale for the rate of inflation they are using in their explanations of their underlying assumptions.

For the reasons outlined in response to Question 1, we do not believe that AS TM1 needs to be consistent in all respects with FSA's COBS. We are particularly concerned with the prospect of AS TM1's maximum accumulation rate aligning with the newly-proposed FSA mid-point of 5 per cent. An implied real return of 2.5 per cent is a very conservative rate upon which to perform long-term projections for higher-return assets such as equity.

While we firmly believe in erring on the side of prudence, particularly for assets with significant downside risk, we would urge the FRC to consider the possible unintentional inferences of such an upper rate. One inference might be that providers should project negative real returns for cash funds; another is that the equity risk premium is, at the very best, 2.5 per cent.

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?

We are comfortable with the proposed four-week consultation period for the exposure draft.

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

Depending on the nature of the revisions to AS TM1, NEST and other providers may need to implement significant changes to procedures and systems to bring annual statements in line with the new requirements.

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

For many schemes, the annual statement requires a major allocation of administrative resource. As noted above, we believe that a change to AS TM1 that requires either or both a revision of the basis of SMPI calculations and drafting of the content of the annual statement would not be trivial. Furthermore we believe that providers' efforts to improve the annual statement/SMPI should aspire to be comprehensive and thorough.