Proposed revision to AS TM1: Statutory Money Purchase Illustrations: Cushon's response to consultation

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 suggest this is evolved into a standardised approach and an alternative framework whereby a "standard formula" for projection assumptions by asset class with providers / fiduciaries given the option to use their own assumptions derived via an "internal model" provided that model has been approved by an appropriate body.

The approval body could be FRC/FCA/TPR, or they could issue accreditation to certain investment consulting firms who can demonstrate appropriate capability and independence. The standard formula projection assumptions should be risk premia and volatilities at asset class level.

Using risk-premia (rather than actual forward-looking returns) makes the framework much more practical because it strips out the effects of variation in risk free yield curves meaning the assumptions can be stable long term.

[Providers] would then build up actual forward-looking return assumptions themselves as risk-free (=observable market gilt/swap curve) + standard formula risk-premia.

The internal model methodology should be relatively open, but the key controls are that:

1. Approval of methodology by appropriate body (per above)
2. Providers/trustees must disclose a table showing the results that their internal model gives for all of the investment options they offer (risk premia and volatilities for default, self-select range, etc) compared to the same results obtained via the standard formula.

This provides a simple mechanism for externals to check how "racy" any internal model methodology is. Note that this disclosure is really for industry/regulatory consumption to act as a control on behaviour, not for members.

This same framework could then also be adopted as part of the Value for Members (VFM) framework.

In regard to annuitisation, given that most pension members do not take out annuities at retirement, we do not believe that this is an appropriate approach to converting to retirement income and that drawdown would be a more suitable approach.

QUESTION 2:

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

We're comfortable with the proposed effective date.

QUESTION 3:

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

We believe this approach has a number of flaws. Firstly, it could result in unintended consequences, with the recent example of bonds experiencing high levels of volatility compared to equities which could create counter-intuitive and confusing growth rates across different asset classes and pension funds. Similarly, there are illiquid asset classes that confound these volatility / return groupings – forestry is an example within the private markets space, which has seen returns in line with volatility group 4 but levels of volatility in line with volatility group 2, based on data provided in Gresham House's 2022 UK Forestry Fundamentals report. We believe that not adequately accounting for these runs contrary to the Government's aims to drive investment in illiquid assets to help improve member outcomes

Secondly, we believe this relies too much on past investment past performance despite generally understanding that past performance is not an indicator of future performance. This disclaimer couldn't be truer as we move towards a net zero world. If the future is going to look very different to the past, historical investment performance is going to tell us very little about future investment performance. We expect climate change to reward strategies differently in the future - current past performance assessments cannot capture the significance of these likely effects.

Whilst we appreciate that past performance feels certain and quantitative, moving from a historically poor performing fund to a historically better performing fund is fundamentally flawed and ignores the FCA's own guidance which makes it clear that past performance is not a reliable indicator of future performance. Taking the FCA's own concern, comparing past performance suffers a number of crucial disadvantages when used on its own.

It may also incentivise reckless risk taking. At the end of a bull run in emerging markets, it will elevate and promote strategies with high emerging markets allocations. This is unlikely to be in members' interests.

Finally, a volatility-based approach is very likely to prove to be a challenge for members to understand and runs counter to the purpose of pensions dashboards and other industry initiatives such as the PLSA/ABI engagement season which is to increase understanding and engagement.

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?

They look sensible.

QUESTION 5:

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

We agree with the former approach, making an appropriate adjustment to the rate of accumulation for when a member is scheduled to reduce risk.

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?

We agree that these should be regularly reviewed and a 0.5% corridor is sensible for "standard formula" projections, however we believe scope should be provided where providers are using more sophisticated "internal model" projections providing there is an appropriate governance and quality assurance framework in place.

QUESTION 7:

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

No comments.

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?

We are just about to launch a private markets portfolio in our default investment strategy, which will make it the largest allocation in the DC Master Trust Market. We feel very strongly that assuming a zero rate of return for unlisted assets runs counter to the drivers for DC schemes introducing them – the potential for higher rates of return and greater diversification. As well as crystallising inaccurate assumptions into the projections it could have the impact of nudging members away from fund strategies with private market allocations for the wrong reasons. Similarly, this runs counter to UK Government's own desire for greater pension investments into illiquid assets.

We propose that illiquid/unquoted assets are projected in line with listed equity returns + X approach, for example + 1-3% depending on the underlying asset class (e.g. PE at the higher end, infrastructure at the lower end).

QUESTION 9:

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

We think this is sensible, notwithstanding our comments in relation to modelling and to illiquid/unquoted assets.

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?

There are a number of reasons for the gender pension gap but one of drivers is the purchasing of single life annuities which leaves surviving female partners with no pension. We believe that using a single life basis for the annuity assumptions could inadvertently encourage male members to purchase a single life rather than a joint life annuity, thereby leaving their female partner without adequate pension provision on their death.

We believe that members would be better served by detailing alternative annuity figures – simply providing level single life annuities could be irresponsible and have the unintended consequence of encouraging members to make inappropriate retirement income decisions, without appropriate consideration of the impact of inflation or personal circumstances.

Similarly, it could lead to members becoming complacent if the 'best' retirement income projection is provided with no consideration to alternatives.

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 comments.

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 comments.

QUESTION 13:

Do you have any other comments on our proposals?

1. We believe that pensions dashboards require stronger and clearer risk warnings. It is now more critical than ever to ensure that members understand that their projections are just that, projections and that they are not guaranteed. It is also important that they understand some of the assumptions used in producing the projections (e.g. the basis of calculating any income projection) and that they understand the implications of those assumptions (e.g. the risks of purchasing a single annuity).

   As such, we believe that it is important that there are standardised risk warnings that go beyond investment risk.

2. In terms of the presentation of projections, it is important that they are presented in way that leads to understanding. At Cushon we present information to members based on three, probability-based scenarios:

- The "most likely return" column compares the returns that investments are likely to deliver if market conditions are relatively stable. There is a 50:50 chance that returns are higher or lower than this.

- The “bad case return” column compares the returns that investments are likely to deliver if market conditions are bad. There is a 1-in-6 chance of returns being worse than this.

- The “good case return” column compares the returns that investments are likely to deliver if market conditions are good. There is a 1-in-6 chance of returns being better than this.

The information is designed to be accessible and useful to a range of different types of stakeholders with different levels of sophistication:

- For less sophisticated users of the tables, the “most likely return” enables simple comparison of providers in a way that is relatable to the rates of interest that are obtainable on cash savings via online comparison sites. The “bad case return” provides an intuitive way to understand the potential downside risks.

- For more sophisticated users, the information in these tables can be combined with member-level data about current pot sizes and contribution rates to produce a full cohort analysis of likely member outcomes in £ terms across different providers under multiple economic scenarios. Risk adjusted returns can also be derived, alongside other common investment metrics like forward looking Sharpe ratios.

It is also relatively easy for technology providers to build on top of this data to provide personalised projections for individual consumers and enable them to compare providers.

QUESTION 14:

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

No comments.