

ADVISING ON PENSION TRANSFER

RESPONSE TO CP17-16



EXECUTIVE SUMMARY

EValue welcomes the FCA's Consultation Paper on pension transfers. In the light of the high levels of transfer activity currently taking place and much misunderstanding of the value or otherwise of current historically high transfer values, the Consultation Paper is timely.

The Consultation Paper focuses quite deliberately on the narrow issue of streamlined advice on the merits of transferring benefits in a defined benefit (DB) pension scheme. In this context, the FCA rightly, in our opinion, proposes that advice on pension transfers must be looked at in the context of a consumer's circumstances and objectives and not simply on the financial analysis of the transfer terms.

There is no doubt that pension freedom has increased the degree that pensions are now recognised as an important part of people's total wealth. As a result, pensions have moved central stage in financial planning particularly for consumers at and nearing retirement. For them, the financial merits of transferring DB benefits may be of secondary importance to how the flexibility of pension freedom can help them meet their life aspirations. Here financial advisers will be providing full lifetime planning advice with pension transfer advice being a subsidiary activity.

ADVICE MUST HELP CONSUMERS UNDERSTAND ALL THEIR OPTIONS

With pensions freedoms, transferring out from a DB pension is too complicated to be able to prove suitability with a single calculation or traffic light system. The broader personal circumstances of consumers need to be taken into account when advising them on the merits of transferring safeguarded benefits. EValue wholeheartedly supports the FCA's proposal that a more rounded and holistic approach to advice needs to be taken so that it is not simply focused on the merit or otherwise of transfer. There needs to be an assessment and prioritisation of consumer needs and importantly alternatives, other than transferring safeguarded benefits, should be considered as a means of meeting them.

THE NEW TVC IS BETTER THAN THE CURRENT TVA, BUT IT HAS SHORTCOMINGS

EValue agrees that a mandatory transfer comparator is needed to ensure consistency in the assessment of the value provided by a transfer value compared to the guaranteed benefits given up. The proposed approach is an improvement on the existing critical yield TVA.

However, the FCA proposed approach does not show the amount needed to buy the same income on the open market because an expected investment return based on a consumer's attitude to risk is used as the discount rate rather than a discount rate that the open market would use to price these benefits.

EValue proposes the following revisions to the FCA's proposals:

- A "risk free" market related discount rate should be used to discount safeguarded benefits for the purposes of the TVC;
- The "risk free" market related discount rate should be based on a suitable government bond at the time of the analysis;
- The safeguarded benefits to be valued in the TVC calculation should be as accurate an assessment of the benefits to be foregone as possible, which means that for a consumer with the option of retiring, the benefits to be valued should be those which would be received if retirement took place not those based on what might be received at Normal Retirement;
- The TVC should be presented as the % which the transfer value bears to the "amount you would need to buy the same income on the open market"; and
- The subsequent product illustration should be produced in conformity with COBS 13 reflecting the benefits expected for the amount of investment risk that it is suitable for the consumer to take.

In summary, we believe that the TVC as proposed by the FCA could lead to a systematic undervaluation of safeguarded benefits to the detriment of consumers. We believe that the above proposals would avoid this potential detrimental outcome for consumers.

THE USE OF STOCHASTIC MODELLING

When assessing whether a transfer of safeguarded benefits is right for an individual, forecasting income needs and how these will be met is a significant consideration. However this is done, it is likely to require assumptions about future investment returns, cost of living increases and the cost of potentially buying guaranteed income in the future.

When setting the requirements for any model, it is important that the model builder is clear what the model is to be used for. For transfer of safeguarded benefits, the model, as a minimum, should have the following features:

- As the consumer is typically investing a lump sum transfer value into current markets, the model should be updated to reflect changes to market conditions (for example available government bond yields) on a regular basis.
- For income drawdown, both pound "cost ravaging" and return sequencing risk are important and reflect the timing of returns achieved as well as their average level. This risk cannot be illustrated with assumptions of future fixed annual returns which do not vary from year to year.

- The model will need to reflect future inflation assumptions consistent with the market conditions that produce the investment returns.
- The model will need to reflect future government bond yields consistent with the market conditions that produced the investment returns.

In our view, the only way to satisfy these requirements is with a stochastic asset model which generates simulations of future possible investment returns and economic conditions. The UK is well served with stochastic models that meet these requirements - there being a number of specialist providers (EValue included).

Stochastic models are by their nature complicated, which requires two additional consumer safeguards:

- The model provider should be required to warrant that the model assumptions are "fair and not misleading" for the specific purpose for which they are to be used within the advice process.
- The adviser should be required to ensure that output presented to the consumer is "Clear". This requires the output to be presented in a way that can be understood by the consumer, without necessarily presenting the complexity of the underlying model.

Stochastic modellers were first provided to employees in the UK in 1993. Today it is estimated that well over a million employees with DC pensions have access to a stochastic modeller.

RESPONSE TO FCA'S QUESTIONS

SECTION 3

Q1: Do you agree with our proposal to require all advice on the conversion or transfer of safeguarded benefits to be a personal recommendation? Please provide the reasons for your response.

EValue agrees that all advice on pension transfers should be a personal recommendation. As stated in the consultation paper, the issues are complex and the consumer's personal circumstances will have a considerable bearing on the suitability of the advice given. Guidance is not likely to be adequate as it cannot address the personal issues which could have a significant bearing on the merits (or otherwise) of transferring safeguarded benefits.

Q2: Do you agree with our proposals for new guidance on assessing suitability? If not, what guidance do you think would be helpful?

Yes, we do agree that following the introduction of the pension freedoms, there may be more cases where transferring safeguarded benefits can be in a consumer's best interests. We further agree that suitability needs to be assessed in the context of the consumer's objectives and wider circumstances. Objectives need to be prioritised and alternatives to transferring safeguarded benefits need to be considered as a means of meeting these objectives.

Q3: Do you agree with our proposals to amend the glossary definition and to add guidance to the Handbook to clarify what a pension transfer specialist is expected to do when checking advice on transfers or conversion of safeguarded benefits?

EValue agrees with the FCA's proposals in this area and that the role and duties of a pension transfer specialist should be defined more fully.

Q4: What are your views on how the current qualification requirements for pension transfer specialists operate in practice?

We have no comment.

Q5: Do you have any comments on our explanation of the responsibilities of advice firms and pension transfer specialists?

The consultation paper sets out the contractual responsibilities of adviser firms and pension transfer specialists and these are entirely as one would expect where the pension transfer specialist is an outsourced supplier. From the consumer's perspective, if the sole source of redress for poor transfer advice were to be with the adviser firm, this might not be ideal. However, since both adviser firm and pension transfer specialist are regulated and other avenues for seeking redress are available, these responsibilities seem to be both logical and adequate.

Q6: Do you have any comments on our explanation of the responsibilities of advice firms and independent pension transfer firms?

We have no comments.

SECTION 4**Q7: Do you agree with our proposals on the introduction of an appropriate pension transfer analysis? If not, how could we amend it?**

Yes, EValue welcomes the need for a thorough analysis of a consumer's circumstances before a transfer is recommended. We agree that often there has been too much emphasis on the financial analysis of the transfer value i.e. the critical yield and not enough on the needs and circumstances of the consumer.

Q8: Do you agree with our proposals on preparing and presenting the client with a mandatory transfer value comparator within the appropriate pension analysis? If not, how could we amend it?

EValue agrees that a mandatory transfer comparator is needed as part of an appropriate pension transfer analysis. We think that the current TVA (or critical yield approach) is flawed in that it tends to lead to a binary decision as to whether the return required after transfer to replicate the safeguarded benefits is achievable or not. This approach does not encourage well-reasoned, comprehensive decision making, taking account of all the facts e.g. is this return achievable in the receiving scheme after charges and how much risk does the consumer need to take to achieve this return.

This leads us to the further concern that, on giving up a "risk free" safeguarded benefit, the consumer should have an expectation of some reward for the risk being taken as a result of the transfer. The current TVA completely ignores this with the result that there is a systematic bias in the TVA towards transferring. The comparison is not "like for like" - guarantee on one side but not on the other.

EValue greatly prefers the proposed approach of discounting the safeguarded benefits and comparing these with the transfer value and displaying the results graphically. However, the safeguarded benefits should be discounted at a "risk free" rate of return. Even when there may be concerns about the ability of ceding schemes to meet its obligations, the existence of the Pension Protection Fund should allow the use of a discount rate very close to a "risk free" rate. To use a higher rate of discount is to create a bias in favour of transferring out since the present value of the safeguarded benefits will be understated.

In section 4.16, the FCA proposes that the discount rate to be used should reflect the consumer's attitude to risk. This would have the effect of conflating the financial comparison being made in the TVC with the consumer's attitude to risk. This would be a retrograde step because, for all its shortcomings, the critical yield in TVA is at least an objective assessment of the value of the safeguarded benefits. The problem with the TVA arises with the assessment of the likelihood that the critical yield will be achieved.

In section 4.24, the FCA implies that the discount rate to be used will set in conformity with COBS 13 so that there is consistency between the TVC and subsequent product illustration. EValue would suggest that this objective of consistency will have the unfortunate consequence of creating a bias in favour of surrendering safeguarded benefits by understating their value and obscuring the risk that a consumer is taking on transferring.

EValue would like to propose the following revisions to the FCA's proposals:

- A "risk free" market related discount rate should be used to discount safeguarded benefits for the purposes of the TVC;
- The "risk free" market related discount rate should be based on a suitable government bond at the time of the analysis;
- The TVC should be presented as the % which the transfer value bears to the "amount you would need to buy the same income on the open market" (FCA's words); and
- The subsequent product illustration is produced in conformity with COBS 13 reflecting the benefits expected for the amount of investment risk that it is suitable for the consumer to take.

The advantage of this approach is that there would be an objective comparison between the safeguarded benefits and the transfer value i.e. the TVC. The TVC would be consistent between all advisers and not influenced by the consumer's assessed attitude to risk which may not be consistently measured by different advisers. In addition, the expected rates of return believed to be achievable at a given level of risk may differ between advisers. The COBS 13 product illustration would show the consumer the reward for taking risk and it would be for the adviser to make sure that the consumer has the capacity to take the risk, understands the risk and is comfortable with any potential downside.

EValue has a further comment on the proposed calculation of the TVC. The FCA is proposing that safeguarded benefits be projected to Normal Retirement Age (NRA) before the discount rate is applied. We are generally in agreement with this proposal although we would point out that NRA is an anachronism since compulsory retirement at an employer determined age is no longer legal. Nevertheless, it is appropriate for calculating the TVC for a DB scheme when the consumer's retirement age is unknown and NRA is the earliest age at which a consumer is entitled to unreduced DB benefits. However, for consumers who are actually considering retiring from a DB scheme, the retirement age is known and their benefits are calculated by reference to that age. EValue would therefore like to suggest that, for consumers who are retiring i.e. leaving employment, the TVC should be calculated based on their actual early retirement benefit rather than one projected to NRA. For a consumer who is retiring, the benefit that would be received if retirement were to have occurred at NRA, is irrelevant. It should therefore not be used in the TVC calculation which should aim to be as realistic as possible.

Q9: Do you agree with the proposed changes to the assumptions for the rolling annuity interest rate, non-annuity mortality, the growth rate and the inclusion of charges?

Annuity interest rate: Yes, we agree with this proposed change.

Non-annuity mortality: Yes, we agree with this change.

Growth rate: As explained in our answer to Question 8, EValue thinks that, while the two principles set out in section 4.24 are sensible i.e.

- consistency with the assumptions in COBS 13, where relevant, so that the financial analysis can be explained in the context of any illustrations the client may also receive; and
- consistency from practitioner to practitioner, when undertaking the financial analysis (currently the TVA);

these aims could be better achieved.

The rate used to discount safeguarded benefits is not **relevant** to the assumptions in COBS 13 and should be based, as explained in our answer to Question 8, on a "risk free" rate of return. This will ensure consistency from practitioner to practitioner and avoid the comparison being influenced by the consumer's attitude to risk which may be assessed differently by different practitioners. Furthermore, a product illustration in accordance to COBS 13 will show the potential reward for the risk being taken when safeguarded benefits are given up. It is, of course, important that this risk is fully explained to consumers so that they are not led to the conclusion that there is "a free lunch" available on transfer i.e. no loss of prospective benefits and the flexibility of the pension freedoms available in a DC pension plan. In this context, as discussed in our answer to Question 10, stochastic forecasts have an important role to play.

Charges: An allowance for charges should be included in the illustrations of the proposed DC receiving plan. We do not think that it is appropriate to include charges in the TVC as this is showing the discounted value of the safeguarded benefits and should be done using a "risk free" return. As stated above, EValue thinks that the TVC should be calculated on an objective basis (which would not vary between adviser firms) free from conflation with a consumer's attitude to risk and the charges on a potential product once the transfer has taken place.

Q10: What are your views on the use of stochastic tools within appropriate pension transfer analysis? How could the outcomes be presented in a way which results in good consumer understanding, given the format and outcomes presented in other mandated documents?

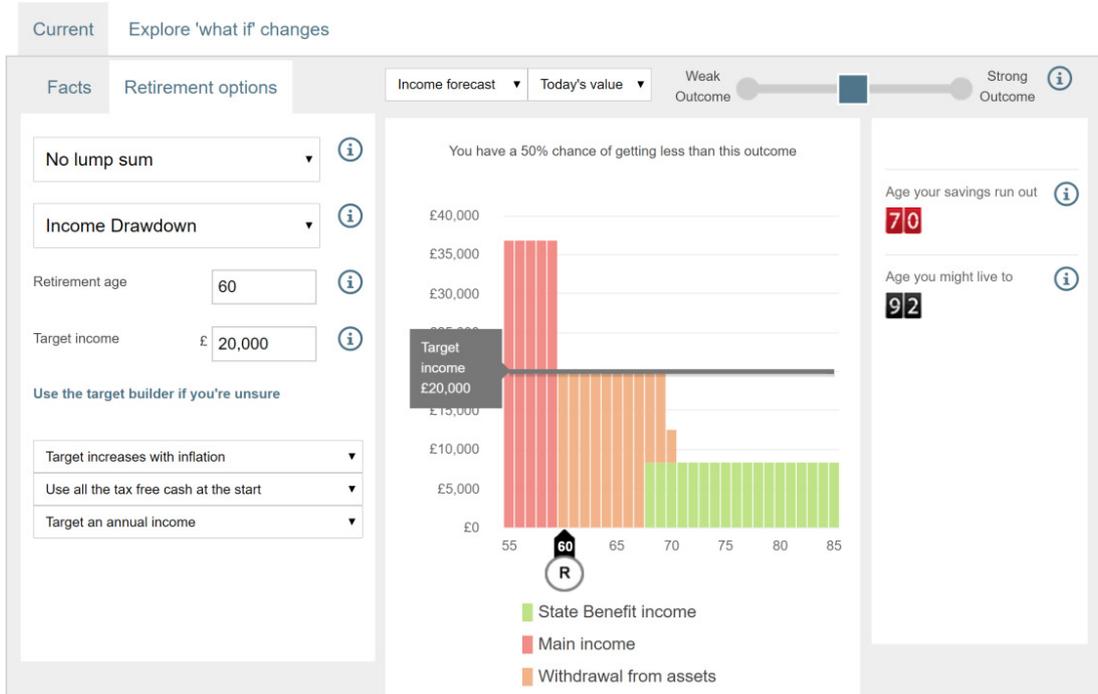
EValue (and in its preceding existence within Willis Towers Watson) has been using stochastic forecasts to explain risk to employees in company pension plans since 1993. We started doing this in response to the emerging practice, in the early 1990s, of employers closing their DB pension schemes and replacing them with DC plans. We did this for the following reasons:

- to enable employees to make a fair comparison between old and new benefits by using realistically determined forward forecasts of returns from a robust independently developed asset model (by "independently" we mean that the asset model was built and used for multiple purposes which were independent of making comparisons between DB and DC pensions but for which the model was nevertheless suitable);
- to illustrate graphically the transfer of risk from employer to employee when moving from DB to DC pension provision; and
- to help employees who transferred to decide how best to invest their DC accounts to achieve satisfactory outcomes i.e. to understand the risk and reward characteristics of the investment options available within a DC plan.

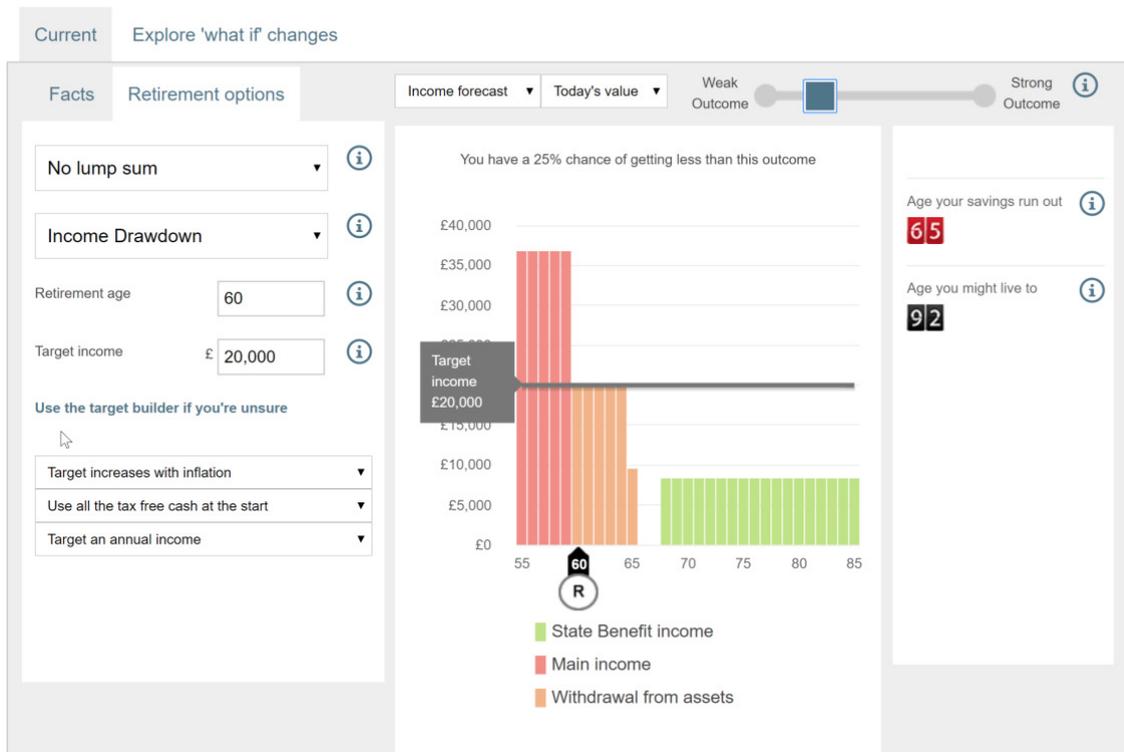
Since 1993, EValue has continuously sought feedback on its products from consumers and made improvements in the light of this input. Today the number of employees in DC plans with access to stochastic retirement modellers is well over one million (EValue's stochastic retirement modellers alone are made available to approaching one million employees).

For employees nearing retirement, the following type of stochastic display is used. For income drawdown forecasts, the age at which money runs out is shown depending on the income drawn, investment market conditions and the employee's attitude to risk. The pension fund is £150,000 and is invested in a moderately adventurous multi-asset passive fund. The user can change the target income, retirement age and investment market performance to see the changes in the projected results.

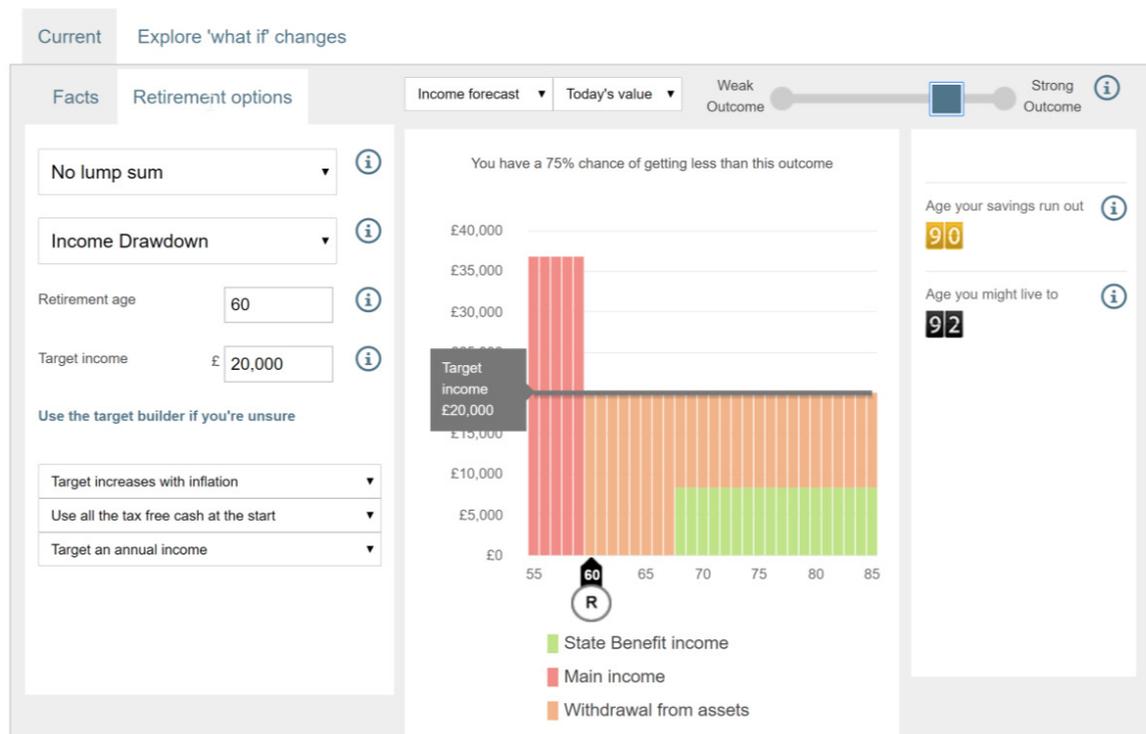
This screenshot provides a "best estimate" forecast.



The next screenshot shows an example of the downside if there is a poor return on investments.

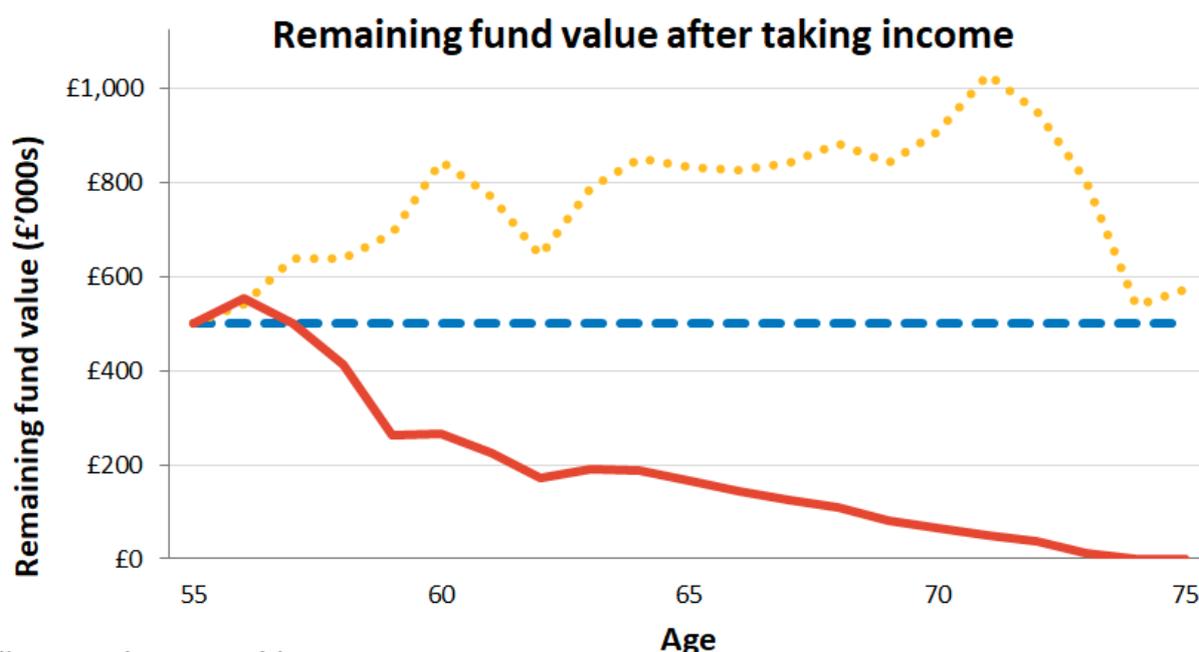


To provide balance the upside is also shown.



Stochastic modelling (using an economic scenario generator) produces thousands of different forecasts starting from current market conditions. This has the advantage of being able to show for income drawdown the risk of getting a run of bad investment returns in the early years. The forecast above, showing money running out at age 65, is an example of precisely this risk and this is one of the key risks faced by retirees using income drawdown. This risk cannot be illustrated with deterministic projections which assume the same level of return for every year of the forecast. For the same average rate of return over the whole period of a projection, deterministic projections will systematically understate the downside risk. The use of deterministic illustrations with drawdown is another inherent bias in favour of transferring away from safeguarded benefits.

The diagram below shows a simple example where the earned investment income of 5% a year after charges is taken from a fund of £500,000 over a 20 year period. The dotted blue line is the deterministic projection with a steady 5% a year investment return over the period – equal to the income taken. The red line shows the “returns sequencing” risk associated with an early run of low returns which are not compensated for by high returns in the later years.



All 3 scenarios start with £500,000 and have an average of 5% pa return after charges with £25,000 taken each year as income

- Scenario 1 - Evenly spread returns
- Scenario 2 - End with bad years
- Scenario 3 - Start with bad years

EValue, as a longstanding supplier of stochastic modelling tools, monitors the usage of these tools to see whether and where consumers have difficulties resulting in a “drop off” of usage. From the management information (MI), which we monitor closely, we can identify areas where improvements in usability need to be made. There is no evidence from this MI that consumers struggle to understand stochastic forecasts. Consumers understand that market returns vary – sometimes dramatically. As can be seen from the screenshots above, EValue’s presentation of stochastic returns could be mistaken for three deterministic projections: weak, mid and strong performance. The critical difference is that the sequencing of returns is taken into account with the stochastic forecast so that the risk of a run of poor returns is reflected in the projections.

EValue believes that there is no difficulty in presenting stochastic returns in a manner which is at least as easy for the consumer to understand as deterministic projections under the COBS rules and furthermore do not systematically understate the downside risk by ignoring the "returns sequencing" risk.

The Consultation Paper poses the question about ensuring consistency between the intermediate deterministic COBS projection and the median stochastic forecast for 70% equity/30% government bond asset allocation as applied under previous FSA rules. EValue resets its stochastic forecasts quarterly. For well over a decade, EValue would not have had to apply the FSA's restriction to its stochastic forecasts because the deterministic COBS projection was consistently more optimistic. We would tentatively suggest that the COBS 13 assumptions should be reviewed more frequently and, unless they are, no adjustment to stochastic forecasts would be appropriate.

EValue believes that the deterministic projections under the COBS rules have a very important role to play and ensure consistency between product projections. We do not, however, think that they are suited to helping consumers understand downside risks particularly when they are considering giving up safeguarded benefits and using income drawdown to provide themselves with a retirement income.

Q11: Do you have any comments on our explanation of the responsibilities of advice firms in relation to software?

The responsibility for ensuring that software tools are appropriate to their advice needs clearly should rest with adviser firms. However, adviser firms' ability to undertake their due diligence is, on occasion, hampered by a lack of disclosure of the computations undertaken and assumptions inherent within software tools and models. EValue believes that a FCA suggested minimum disclosure for providers of software tools and models, would encourage more consistent disclosure and greatly facilitate adviser firms in carrying out their due diligence.

Q12: Do you have any views on the assumptions for CPI and for benefits with caps and collars?

Our own analysis for the purpose of our stochastic asset model suggests that the combination of the formula and the constituents leads to an anticipated gap on average over the next 10 years of 1%.

However, reducing the CPI rate assumed below the Bank of England target rate at a time when all indications seem to be that this is more likely to be overshoot will lead to poor consumer outcomes where the DB pension scheme has revaluation in deferment or increases in payment linked to CPI.

As the RPI rate is a central foundation of the expected returns that rate should not be adjusted outside of a major review.

On average, it seems that a 1% gap might be appropriate; however, you might find that it is better achieved by increasing the RPI rate rather than decreasing the CPI rate. Given that, then perhaps the FCA would be better off waiting for the next review of the economic assumptions.

SECTION 5

Q13: Do you agree with our proposal for the application of the additional requirements for pension opt-outs to be restricted to opt-outs where there are potential safeguarded benefits available?

Yes

Q14: Do you agree with our proposal that the new TVC analysis should not be required for any pension opt-outs?

Yes

Q15: Do you have any thoughts on the impact of these proposals on overseas transfers?

No

Q16: Do you have any comments on our expectations for the provision of streamlined advice when advising on safeguarded benefits?

No, we agree with the FCA's expectations. As stated in our answer to Question 2, EValue thinks that, when providing streamlined advice, it is important that consumers' wider circumstances and objectives are taken full account of in so far as they might affect the suitability of transferring safeguarded benefits.



Powering financial insight

EValue

Benyon House

Newbury Business Park

Newbury

Berkshire

RG14 2PZ

Tel: 01635 881180

Email: contact@ev.uk