

**AEGON's Response to the DWP's consultation:
'The use of Default Options in Workplace Personal
Pensions and the use of Group Self Invested
personal pensions for Automatic Enrolment'**



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AEGON's Response to: 'The use of Default Options in Workplace Personal Pensions and the use of Group Self Invested Personal pensions for Automatic Enrolment

AEGON strongly supports the Government's workplace pensions reform agenda, the concept of automatic enrolment and the use of default investment options in workplace personal pensions.

We welcome the DWP's guidance on default investment funds, which will help to raise minimum standards in workplace personal pensions. We believe this should be extended to occupational pension schemes. However, we would welcome a more 'principles-based' approach rather than the prescription suggested in some parts of the guidance, in particular the introduction of the 'stakeholder-like' price cap.

The workplace market is competitively priced, as evidenced by the DWP's recent research, and this is unlikely to change. A price cap could stifle innovation, preventing operators from developing suitable default fund investment solutions to best meet the changing needs of their customers. And this in turn could lead to poorer retirement outcomes.

Further, we believe a price cap is unworkable in a post RDR world, where the provider will set the manufacturing charge, but will have no involvement in determining the level of the Adviser or Consultancy Charge.

We therefore urge the DWP to reconsider introducing a price cap due to the effect this may have on employees' retirement outcomes.

1. Introduction

AEGON welcomes the opportunity to comment on the recent consultation on draft guidance for the use of default investment options in workplace personal pensions and the use of Group Self Invested Personal Pensions (GSIPP) for Automatic Enrolment.

AEGON UK is part of the AEGON Group, one of the largest life insurance and pension companies in the world. In the UK we have pensions, life insurance, asset management and advice businesses. AEGON UK has assets under management of £47.6 billion, including revenue generating investments and employs over 4,900 staff. The AEGON Group has assets of around Euro 351bn (£277 billion).

2. General Comments on the Default Options Guidance

2.1 'Stakeholder-like' price cap

The guidance sets a stakeholder-like price cap for all charges members will face, including adviser or consultancy charges, should they be in the default fund. We have various concerns with this:

2.1.1 Competitively priced market

The market is currently working well and is competitively priced. DWP research¹ showed the typical mid-range annual management charge (amc) where the provider paid the intermediary for its services via commission was 0.9%, falling to 0.5% where services were paid by fees. There is no evidence that a charge cap is needed.

2.1.3 Stifle innovation

Price caps will stifle innovation. From 2012 the pension landscape will be a very different place from what it looks like today. All qualifying schemes will have to offer a default fund and it's likely that initially the majority of employees will invest their pension contributions into a default fund. Providers will take the opportunity to develop default fund strategies which meet their customers' changing needs. And this may mean the use of guarantees and active management techniques. But these come at a cost. Introducing a price cap may prevent providers from developing the best possible solutions for their customers.

Maintaining confidence in pensions is key to encouraging persistency of scheme contributions. Research has repeatedly shown members are more concerned about loss of their money than achieving returns. And the use of guarantees can play an important role in building confidence in pensions.

¹ Current practices in the Work Place Pensions Market: Quantitative Research with Pension Providers and Intermediaries' 2009

The table below sets out common types of guarantee, all of which will be difficult for the trustee corporation to adopt due to cost restraints, apart from in limited circumstances.

Full guarantee – the fund guarantees to provide a certain income, such as a deferred annuity or guaranteed annuity rates. For guarantees to work, the individual needs to continue to pay contributions for the duration of the contract.

The cost depends on the guarantee, but is likely to be in the region of 0.5% to 1% above the fund cost while greater exposure to equities increases the cost. The cost of full guarantees is likely to be prohibitive for the personal accounts scheme.

With-profits – old-style traditional with-profits had the benefit of consistent returns and a guarantee at a certain point, typically normal retirement date for pensions. At the point of taking benefits, investors hope to make further gains through a terminal bonus. However, issues arose with lack of transparency, inflexibility (the guarantee only applied in certain circumstances) and market value reductions.

New generation with-profits don't have any guarantees. The objective is to smooth the returns from underlying assets, avoiding volatility from the member perspective. The risk is the smoothing reserve runs out so the benefit of smoothing returns is lost. And the lack of transparency may attract 'bad press'.

Constant Proportion Portfolio Insurance (CPPI) – the fund is designed to provide a defined level of capital protection (such as 80% of the highest price reached). It typically invests in a mix of equities and cash, with different start periods and different asset allocations. When the market falls the equity weighting of the fund is reduced and cash is increased. When the market rises the cash is reduced and equities increased. The change in the asset allocation is driven by an algorithm, so there is no human intervention.

The risk is if the market falls for a long time, or if there is a sharp fall, it becomes difficult to regain a meaningful exposure to equities, so the fund becomes a 'cash fund'. The additional cost comes from the crash (gap) insurance underpinning the fund, which is designed to pay out should the market collapse and the protected price be breached. Typically the additional cost is around 0.6 to 0.9%, again incompatible with an extremely low-cost scheme.

Ratchet funds – are designed to lock in growth. The guarantee given is a proportion of the index return if it has risen over a certain period. The additional costs are around 0.5% to 1%.

2.1.4. Interaction with the RDR

A price cap is incompatible in a post RDR world, where the operator will set the manufacturing charge, but will have no involvement in determining the level of the Adviser Charge (AC) (or the Consultancy Charge where the advice is to the employer).

The price cap assumes that all charges within a workplace personal pension (WPP) are fund related, amc, but this isn't the case outside of stakeholder pensions. Charges are now frequently a combination of contribution and fund related. Under FSA AC proposals, charges to cover adviser costs are highly unlikely to be fund related. But in theory, they could be. The adviser could set his AC as the difference between the stakeholder cap and the 'factory gate amc' offered by a provider. But this assumes they've already picked the provider, and know the amc, before they set their AC. This is exactly what AC is designed to eliminate – advisers are prohibited from varying their AC between different providers. In practice, AC is much more likely to be fixed monetary amount or a fixed percentage of premium.

The latest FSA consultation paper, 'Delivering the RDR', proposes AC for all contract-based schemes including group stakeholder scheme sold under basic advice. If FSA implements its proposed ban on factoring, there will be an increased frequency of nil or heavily reduced initial allocation periods for regular premium savings (including WPPs). If limited factoring is permitted, we'll see a small contribution charge coming out - say 3% over the first 5 years. We're supportive of limiting factoring to five years. But neither of these options is consistent with a price cap on total charges which is linked to a percentage of fund.

Providers will not be required to offer AC. So one outcome of the DWP proposal might be that WPPs used in future for auto-enrolment could not offer the AC facility. This would mean employers who put in place a WPP would have to be prepared to pay for advice on a fee basis. Equally, if employees were offered advice, they would have to pay for this on a fee basis. This would severely limit the use of WPPs and would create regulatory arbitrage towards other forms of pension that were not subject to equivalent rules.

The FSA is considering extending the commission ban to investment products linked to trust-based schemes sold as an alternative to GPPs, to prevent regulatory arbitrage. The FSA proposals would not create an equivalent ban for third party administrators, creating another 'anomaly'. But AC principles are likely to be partially extended to insurance based trust-based schemes. This is likely to make the price cap unworkable there too.

Faced with fee-based advice in both WPPs and occupational defined contribution schemes, many employers would simply not take advice and would be more likely to opt for personal accounts, contributing the bare minimum. This would be a bad result for members and for pension provision more generally. Without the involvement of an adviser, fewer members join, contributions are typically lower, and more individuals fail to maintain contributions. Outcomes will be poorer with lower retirement income.

AEGON believes price caps on overall charges are simply not consistent with the introduction of AC. We support AC and consultancy charging as a positive development for consumers and employers. It creates transparency of what advice is costing and makes it clear who is paying for this increasing engagement. We also believe providers should be allowed to offer limited factoring on regular premium business (over 5 years) so that advice costs can be recouped through a modest deduction from the first 5 years of contributions, making it less likely members will refuse to join.

With AC or consultancy charging, provided there is appropriate disclosure, there is no need for customer protection over how much they may be charged for advice. On this basis, we believe that if price caps are still to play a role in future, they should only – and indeed can only sensibly – be applied to manufacturing costs. Any charge for advice, specifically agreed with the employer and / or member under AC arrangements should not be subject to the price cap and should be able to be deducted in addition.

2.1.5 Personal accounts charge

We believe that the right structure for personal accounts is a dual charge, combining a modest contribution charge with an amc, not a stakeholder-like cap. This will give much greater financial stability than an amc, significantly reducing the borrowing the scheme would otherwise have to undertake. Research carried out by AEGON demonstrates such a structure would not impact on opt-out rates.

The pre-budget report clearly demonstrated the importance the Government is placing on shorter term cashflow. There is a huge political imperative to reduce our nation's borrowing. One consequence of this for pensions was the decision to lengthen the introduction of auto-enrolment into workplace pensions, saving tax relief. The financial services industry and the FSA are placing much greater emphasis on making the best use of limited capital and on fully understanding managing financial and prudential risks. Organisations should not take risks unless they have the capital to do so.

2.1 Suitability and governance of default funds

The guidance assumes providers deal direct with employers and will be in a position to help them assess the suitability of default funds for their employees. This does not reflect current practice as in the majority of cases the operator's relationship is with advisers, not employers. Suitability has to be set by employers, with their advisers, and employers (often with the help from their advisers) must be responsible for making sure the default fund remains suitable for their employees. Governance of the default fund will be the responsibility of the operator.

The guidance suggests that default funds are set at the employer level. This is unlike the current situation for stakeholder default funds, which operate at operators' level. Operating at each employer's level means additional decisions for employers, more need for advice and therefore increased costs. It also means the need for operators to potentially develop multiple default funds and to track these at individual scheme level. This means additional information has to be stored, maintained and reported on, which increases set up and maintenance costs and increases the operator's governance.

However, to differentiate themselves, operators should have the choice to operate multiple default funds, following the guidance, which means employers will need to make a suitability choice. This works well if employers have an appropriate adviser to help them to make this choice. But many employers don't have investment advisers and may find making a choice difficult. And many advisers will not want to give advice on the selection of the default fund. If there is an overall price cap on default funds, advice will be further squeezed out, exacerbating this issue.

An alternative is for operators to establish a range of 'generic-style' default funds, from which employers could choose, without needing an adviser. These funds should follow the guidance set out by the DWP. This allows more flexibility to respond to worksite concerns. Governance of both types of default fund would be the responsibility of the operator, with non-advised funds operating at operator level in the same way as stakeholder default funds currently work. Part of this governance should be the ability for operators to make streamlined changes in default strategies without member consent.

Providing high quality generic information, including risk ratings, will help employers to select a non-advised default fund for their employees. But the risk is this could drive employers to low risk funds giving poorer retirement outcomes for members. Giving employers 'safe harbour' protection will help to mitigate this (see 2.5).

2.2 De-risking strategy

The guidance states that default funds should have a de-risking mechanism in place and this should take account of the retirement profile of the members. De-risking processes typically start five to ten years prior to the member's selected retirement date. Members choose their selected retirement date when they join the pension scheme, but this is often not the date they actually start to take their retirement income. Many members will not necessarily know in advance whether they are going to purchase an annuity, go into unsecured pension or into phased retirement.

Matching de-risking mechanisms to individuals' retirement profiles increases costs. Operators will have to communicate regularly with customers to check on their retirement intentions, fielding the enquiries this would generate and making the requested changes. These increased costs would have to be factored into the price the customer pays.

We believe that the de-risking mechanism should reflect the position of the typical member.

We also believe the guidance shouldn't limit the choice of de-risking strategies which currently exist, but should allow for scope for future developments in the market.

2.4 Asset Allocation

The guidance suggest that shares of the company scheme should not make up more than 5% of the default option. Where a large quoted company uses an equity fund as its default, more than 5% of the fund may invest in the company simply due to its index weighting. To restrict this holding to 5% restricts the investment freedom for the fund, when making changes to investment funds operators would need to consider the impact on employers and market movements, which may lead to a forced sale.

A perceived 'bias' for a particular company shouldn't exist where the operator decides the asset mix, rather than the employer or trustees, as the fund is at 'arms-length' from the scheme, unlike a defined benefit arrangement.

As an alternative, we suggest the guidance states that shares of the company scheme shouldn't make up more than 5% of the default option, unless the market capitalisation

of the company is such that a pooled investment fund might hold more than 5% of the shares.

2.3 Safe Harbours

Auto-enrolment will bring millions of people into pension arrangements from 2012, changing the pension landscape significantly. Employers, many for the first time will have to select default funds for their employees, with or without advice. As such, employers, advisers and operators face heightened performance risk.

We strongly believe employers, and their advisers, must be given safe harbour protection in connection with selecting default funds for their employees, provided they follow the guidance and the FSA's Treating Customers' fairly principles. This will give protection against performance risk litigation.

And we believe safe harbour protection should be extended to provider-designated funds as long as they are within the guidelines. We suggest the DWP works with the FSA to establish how this could work in practice.

3. Specific Consultation Questions on the Default Funds Guidance

Q.1 Does the use of 'operator' provide enough clarity on who falls under the remit of this guidance?

We believe the term 'operator' does give enough clarity for the purpose of the guidance.

However the guidance is contradictory in places as it implies that the operator is responsible for setting the default fund but later makes the employer responsible for this (paragraph 26).

Q.2 Do you think the Government should issue separate guidance on the design of default options in occupational schemes as well?

We believe it would be appropriate to issue separate guidance for occupational pensions schemes. The purpose of the guidance should be to ensure minimum standards across all work place pension schemes.

If the DWP considers that it is appropriate to have some sort of 'stakeholder price cap' this should also apply to occupational pensions schemes to mitigate the risk of regulatory arbitrage.

Q.3 Would it be helpful to set out in guidance how many options we feel should be offered to the employer? If so, we would welcome views on what is manageable number of options.

No. We believe there should be no requirement for operators to offer a range of default funds to employers. Although providers will want to differentiate themselves by developing different styles and numbers of default funds to meet

their target market. Operators should be allowed to develop as few or as many default funds as they feel fit.

Offering a choice of default funds means employers will need advice to help them to make this choice. Small to medium sized companies will not have the expertise to select an appropriate default fund and many won't want to spend their money on advice. As an operator, we can't give them advice and in the majority of cases we don't have direct relationships with employers. In addition many advisers will be cautious of giving investment advice.

Employers should be encouraged to take investment advice on the selection of an appropriate default fund to best meet their employees' needs and risk appetite. Operators should not and cannot be involved in the selection of the most appropriate default option, other than providing clear and transparent generic information.

The DWP needs to recognise that not all employers will get investment advice. A solution is for operators to operate 'generic' type default funds alongside advised or bespoke default funds.

Q.4 Would it be useful to define 'common industry benchmarks' more closely?

No, as these will change from time to time.

Q.5 Are there any other cases which should trigger a review?

Reviews should be triggered by employer driven reasons, such as company restructures.

We disagree with the view that operators should carry out reviews to look at the 'ongoing suitability of the default fund option for members'. This is the role of the advisers and employers. We don't have close enough contact that would enable us to make an informed decision about the suitability of default funds.

In terms of reviewing suitability of charges, we believe providers should only have to review this in terms of deciding whether the charge is the right price for the fund. It is for employers and adviser to decide whether the manufacturing charge is suitable for the default fund

Q.6 What else should the review of the default option look at?

We believe an adviser, provider and employer (or provider and employer, if no adviser) should together be able to review and change the default fund without member consent, providing they demonstrate they are acting in the members' best interests with safe harbour protection, as long as guidance was followed.

Q.7 We are considering recommending that operators should make information on the review of their default fund available on their website. How feasible is this?

We agree that information surrounding the review of default funds should be made available to members, providing it is on a generic, non-employer-specific basis. This could include performance of individual fund components, and whether this is consistent with the overall objectives of the default option (but not the ongoing suitability of the fund, as mentioned above,

Operators will need to consider keeping a balance between provision of information about the default fund and various other funds, so that it isn't excessively promoted to the detriment of other funds. Moreover, this will need to be balanced against information overload. Too much information tends to be counter productive.

4. Specific consultation Questions on the use of automatic enrolment into SIPPs

Q.1 Are these definitions helpful and are there any alternative definitions which you could suggest?

We agree with the definitions used.

Q.2 Would it be helpful to provide separate sections on the use of insured and non-insured group SIPPs given their different structures?

Yes. We agree that this would be helpful.

Q.3 Do you view non-insured group SIPPs as a suitable product for auto-enrolment, given their non-tiered structure?

If group SIPPs meet the automatic-enrolment requirements, they should be suitable products.