30 May 2022

The Director of Actuarial Policy
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Dear Sir

Proposed revision to AS TM1: Statutory Money Purchase Illustrations (SMPIs) – consultation

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation.

Thank you for the opportunity to respond to this consultation. We have prepared this response on behalf of WTW (formerly Willis Towers Watson), a global firm with a substantial presence in UK pensions. We provide consultancy, administration and investment services and solutions to trustees and sponsors of work-based pension schemes. In relation to this consultation, WTW's advice to trustees of trust-based occupational DC schemes and administration of clients' DC arrangements provide us with insights into the work needed to make these changes effective and an understanding of how they would be received by the wider public.

We support the general principle of amending AS TM1 to provide greater consistency for recipients of SMPIs where individuals have several different pension policies, particularly in the context of information to be provided on pension dashboards. However, we have concerns about some of the proposals, which we set out in the answers to the questions, including the proposals on accumulation rates, the form of benefits at retirement, and annuity rates at retirement.

The proposals on accumulation rates are radical, and we think that they can create problems in understanding for individuals and significant additional work for fund managers and providers in many cases. The proposals can also create anomalies when, for example, bond fund prices are volatile. On balance, recognising that the SMPI will be indicative only, we would prefer an asset-class based approach, which is the approach most schemes adopt currently. We give further comments on this in the response to the questions.

Spencer Bowman

51 Lime Street
London
EC3M 7DQ

T +44 203 124 6000
D [redacted]
F
E [redacted]
W wtwco.com

We note that most individuals do not take annuities at retirement, and further thought should therefore be given to the form of benefits used in the illustration so that they better match what individuals would typically do when taking benefits. We appreciate that this may take some time, and that the annuity approach may need to be maintained for a period.

Given the Government's proposal that all DC projections for the Dashboard are covered by AS TM1, we believe AS TM1 should refer to and give guidance on any additional projections for the Dashboard not currently referred to in AS TM1, such as projections based on the accrued fund (See question 13). However, this should reflect the final Dashboard Regulations on this matter.

Our responses to your specific questions are set out in the appendix to this letter.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me at [redacted].

Yours faithfully

[redacted]

Spencer Bowman
Director

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 support consistency across projections from different providers, and we agree with the FRC specifying accumulation rate assumptions will assist this.

We also agree that specifying the form of annuitisation will assist consistency. We believe that most SMPIs are carried out currently assuming no cash, index-linked increases and 50% spouse's pension. Given this, the easiest form of annuitisation to achieve consistency would therefore be on this basis. We do think that the approach adopted should be realistic in terms of what individuals do in practice, however, so we accept that if the annuitisation approach is retained it would be reasonable to change to level pensions and single life. However, further thought should be given to how best to reflect that individuals frequently opt for a combination of drawdown and taking cash and do not opt for annuities initially on retirement. We provide further comments on this below.

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

We support 1 October 2023, provided that the final version of the revised AS TM1 is in place by 1 October 2022 as planned. It is imperative that this happens so that administrators are able to provide figures consistent with the Dashboard requirements from the Dashboard data available point. Also, an implementation date after the Dashboard data available point may cause confusion for members if the outputs changed significantly between two illustrations calculated on different bases.

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

While this is an interesting proposal and appears to address certain disadvantages of alternative approaches, we think there are significant problems with this approach, based on the information provided for the consultation.

The FRC has indicated that it has a number of objectives for the approach, and while we agree that these are reasonable, in practice balancing them will prove difficult. As you outline in paragraph 3.4, these are:

- Realistic
- Take some account of additional returns that can be expected from higher-risk funds
- Consistent across funds
- Understandable
- Do not place an undue burden on providers
- Avoid unintended incentives

We recognise that the FRC has carried out a great deal of research on the proposed volatilities approach, some of which has been shared. On balance, we do not find the volatilities approach set out easy to

understand, and we suspect this will be even more the case for individuals particularly when funds change bands and they see material changes in projections.
The FRC has indicated that money-market funds will go into volatility group 1, lower volatility fixed interest funds into group 2 with other fixed interest funds in group 3 and equity funds mainly in group 4 with some of the less volatile equity funds in group 3. We suspect multi-asset funds and property funds are expected to mainly fall in group 3. These expectations broadly align with our expectations on which asset classes would fall into each group, however we have observed differences in outcomes against expectations when applying the 5-year historical volatility based approach to sample funds and market indices (used as a proxy for funds).

- Money market indices – 5 year historical volatility falls within 0-5%
- Fixed interest indices – 5 year historical volatility falls within 5-15% largely dependent on the duration of the bonds. Short term duration bonds fall within 5-10% and long-term duration bonds fall within 10-15%.
- Equity market indices – 5 year historical volatility overwhelmingly falls within 10-15% which reflects the lower volatility equity market environment we had experienced for many years.
- Multi-asset *funds – 5 year historical volatility falls within 5-10%*

These observations have potentially significant implications for projections as passive index tracker funds are likely to have a lower 5 year historical volatility and therefore fall into group 3. Passive equity index tracker funds are most commonly used within the growth phase of default lifestyle options, which themselves are the most popular investment option for occupational scheme members, and so this could impact the majority of occupational scheme members by reducing their projected returns[?].

Multi-asset funds also tend to form an important part of default option design in the consolidation phase and so lifestyle strategy projections will be subject to depressed accumulation return assumptions (relative to expectations) for the majority of their investment horizon as a result of the low volatility market environment we have experienced over the past few years.

The backward looking calculation can present other difficulties. For example, taking the property fund example where the percentage in cash can vary, this might have had 25% cash in the past but now have only 5% affecting the volatility calculation and future expected return. Bond funds also represent particular peculiarities as alluded to above. The volatilities approach would put a greater burden on providers in relation to non-standard funds than the asset-class based approach, albeit the FRC has tried to address this for some funds – we are not convinced unquoted assets should assume a nil real return when the whole premise for investing in unquoted assets is to capture the illiquidity premium. The volatilities approach would therefore need to have significant advantages in other areas to offset these disadvantages, and we are not currently convinced that it does.

On balance, we would prefer the asset-class based approach. We note the points in 3.18 to 3.20 highlighting issues with this approach. The abiding principle here is that perfection will never be possible or desirable – being overly precise and using a whole range of assumptions for different "types" within an asset class (e.g. standard equity vs sustainable equity vs low volatility equity etc) imply a level of accuracy to members that can be misleading and are more likely to make members feel they are "prediction". Using an approach based on the asset class might lead to the following categories, which is how the majority of schemes currently set their assumptions:

- Cash
- Gilts

- Corporate bonds
- Equities
- Property*
- Multi-Asset funds*

**Funds where the underlying allocation or style may vary (e.g. property with different percentages to cash and Multi-asset funds):*

- The FRC could adopt an approach aligned to the benchmark objective of the fund as a representation of the exposure it seeks to deliver long term (e.g. a property fund with a property benchmark should be classed as property even if it has 15% in cash… as the cash may be temporary while the fund searches for new property assets and the fund's long term goal is to deliver a property like return)
- For funds with very broad underlying assets e.g. Diversified Growth Funds (DGFs), most *schemes currently use an assumption slightly below equities as a broad brush assumption for this type of fund rather than doing a "look through" assumption. While there are many different DGF styles and types, they generally aim for cash + 3 -5% p.a. again (like property) the long term objective can be used as a guide for the assumption.*

The FRC identifies having to make regular updates to deal with "new and emerging" asset classes. We think this is equally likely to be an issue for the volatilities approach. Innovation in this area is coming from increased use of and developments in Environmental, Social and Governance (ESG) funds, and the lack of historical statistics on these funds or equivalent alternative funds will cause issues for the volatilities approach which may not be adequately addressed by the mitigations referenced in the consultation.

4 Based on an assumed CPI of 2.5% do you find the accumulation rates proposed for the various volatility indicators to be reasonable and suitably prudent?

We agree that the proposed resulting accumulation rates would currently be in the reasonable range for assumptions at August 2021 for the main asset classes.

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

We support this proposal and believe that most schemes already adopt this approach. If administration is incapable of allowing for this, then we think best endeavours should be allowed.

6 What are you *(sic)* views on the proposals that the recalculation of volatility indicator should be annually as at 31 December with a 0.5% corridor?

If this approach is adopted, we think this is reasonable to provide consistency year to year and to ensure only occasional changes to the allocation to band. Changes will cause communication issues, both in terms of changing assumptions for the volatility bands and when funds move between volatility bands, *particularly when dropping a band as there would likely be a significant impact on the projection for the individual without any change in fund.*

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

We have little experience of DC benefits operating with-profit funds, but the proposal seems reasonable to us in the overall context of the proposal.

8 Do you have experience of unquoted assets held in pension portfolios and what are you (sic) 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 have little experience of the use of unquoted assets in occupational DC funds at present.

There are similar issues with illiquid assets, which are typically quoted less frequently. These funds may appear to be less volatile than daily quoted assets simply due to the longer periods between valuations, whereas in reality they could well be investments in riskier assets. Furthermore, as mentioned earlier, the investment case for investing in illiquid assets is to earn additional returns by capturing the long term illiquidity premium which is at odds with setting a zero real rate of growth for projection purposes.

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

Assuming the overall proposal is adopted, we are comfortable with this specific proposal.

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?

Longer term, since most people opt for cash and drawdown rather than an annuity, cash and drawdown would seem to be the appropriate approach to model in these statements. This becomes even more important as the prescribed information is used for the dashboard where there will be less opportunity for trustees to add content and information to the prescribed figures. Clearly a move to a drawdown projection approach would need further consideration and a consultation on the details. We would encourage this to be taken forward as soon as possible.

In the meantime, while we continue to use an annuity-based approach, a non-increasing annuity is probably the best option, as it is likely to be closer to the level of drawdown income achievable than an annuity with increases. Having said that, illustrating a level pension versus an index-linked pension would currently more than double the illustrated amount, and this may encourage people not to think adequately about the impact of inflation on their income. If a level pension is used for illustrations as proposed, then very careful communications would be required to explain to members why their projected income in retirement has more than doubled (all other things being equal) compared with an index-linked pension.

We are less concerned about not showing a joint life pension, provided it is made very clear that the annuities illustrated would cease completely on the member's death. This approach also assists those schemes that wish to provide gender neutral statements as single life annuities are already gender neutral.

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?

a) *The fixed interest gilt yield is more appropriate when considering level annuities, and we support dropping the alternative based on real yields and adding a margin, an option available currently when illustrating level pensions.*

b) *It is unclear what is being proposed for those within two years of retirement. C3.4 indicates the illustration should be no better than using the '**provider's** own **annuity rate** and must be consistent with those annuity rates available in the market place**….**'. First, for occupational DC schemes, the trustees do not have their own annuity rates. Second, it would represent a very significant administrative burden to use a different approach for annuities for those members within two years of retirement than for those members over two years from retirement. As the consultation notes individual market rates depend on many and general market annuity rates would only be indicative. In our experience schemes generally provide SMPIs within two years of retirement on the current basis, despite not being required to under the legislation. The revised AS TM1 should allow this approach to continue – it is particularly disproportionate to require schemes to assess possible annuity rates with greater accuracy, given that in practice the majority of members do not purchase an annuity.*

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?

This seems reasonable. As noted in the consultation document, actual annuities would reflect a host of individual factors, such as impaired lives and postcode, which make relating the SMPI pension to what would actually result if a pension is secured on retirement with an annuity no more than indicative.

13 Do you have any other comments on our proposals?

AS TM1 does not refer to some of the requirements of the Dashboard Regulations proposed currently, which are to be covered by AS TM1 under those Regulations. For example, there is a proposal in the Dashboard Regulations to provide an illustration based on the current fund without investment returns and future contributions – the 'annualised accrued value' referred to in schedule 3 of the draft Pensions Dashboards Regulations 2022. If this is retained, or a variation of it, in the final Regulations, then AS TM1 should provide guidance on it. It is important AS TM1 covers all the guidance requirements of the Disclosure Regulations as amended by the Dashboard Regulations once finalised.

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

We suspect there will be increased costs, particularly for fund managers, in measuring the volatility under the volatilities approach. The proposals on annuity rates for those within two years of retirement could also represent significant additional costs. There could also be significant transitional costs related to calculations and communications explaining the changes to individuals, particularly where this leads to large changes in the illustrations compared with previous projections.