



## Financial Reporting Council - Consultation on draft TAS 310

This paper sets out First Actuarial's response to the FRC's consultation on its draft TAS 310: Collective Money Purchase Pensions.

First Actuarial is an actuarial consultancy providing pension scheme administration, actuarial, investment and consultancy services to a wide range of clients across the UK. Our clients' pension schemes range in size from £0.5 million to nearly £2 billion in assets and cover a number of sectors including manufacturing, financial services, not for profit organisations and those providing services previously in the public sector.

We consider ourselves to be experts on CDC. A number of our employees have a longstanding interest in CDC. First Actuarial LLP advised the Communication Workers Union on the development of the CDC pension for the Royal Mail. We are a supporter of CDC pensions and expect they will be prove to be a successful means of providing pensions in the UK.

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### TAS 310: CMP pensions

**10. Do you have any comments on our intention to have an effective date for TAS 310 of within one year of the first CMP scheme being in operation? Is there an alternative timing that would be more appropriate? Please provide any supporting evidence for alternative timings.**

We expect that actuaries as highly trained and experienced professional people will advise well in relation to CDC, paying attention to TAS 100, with or without TAS 310.

### Assumptions

**11. Do the proposed provisions provide sufficient clarity of requirements for practitioners to set central estimate assumptions? Please set out any areas of setting CE assumptions you believe require further provisions, including reasons for these.**

P2.3 of draft TAS 310 read in conjunction with 3.9 of the consultation paper indicates that actuaries should consider the term structure of market implied inflation and gilt yields.

#### *Market implied inflation*

"Market implied inflation" is derived from the gilt market, by comparison of the nominal yield on fixed interest gilts and the real yield on index linked gilts. The assumptions of this method are:

- There is the same supply demand balance between fixed interest and index linked gilt markets.
- The same investors invest in both markets.

- These investors are indifferent between fixed interest and index linked gilts.

One only has to write down these assumptions to see that they are implausible. Index linked gilts are relatively scarce. Index linked gilts are tightly held by UK insurers and pension funds. Overseas investors prefer fixed interest, they have little need for UK inflation protection. Investors are not indifferent between fixed interest and index linked.

Given that the assumptions of the method do not work, it is unlikely that the difference between fixed interest and index linked gilt yields can form a good indicator of future inflation.

Granted that comparing fixed and index linked gilt yields is a popular method, but that is not sufficient reason for the FRC to require or promote the method. If this is the main reason, then the FRC is participating in group think. We do not think that the FRC should promote (albeit it does not compel) the use of a method which has such weak foundations.

#### *The relevance of gilt yields*

The only thing that the term structure of gilt yields tells us is the pattern of returns over time on gilts. This does not inform the pattern of returns expected from non-gilt asset classes, especially where those asset classes have little or no correlation with the gilts market.

Gilts are not much needed in a CDC scheme while it is growing and maturing. While cash flow coming in from contributions and asset income exceed benefit payments, there is no need to hold bonds for the purpose of mitigating disinvestment risk.

Gilts and other bonds will have their place in a diversified portfolio at times when the yield on them is sufficient to merit their place in a real return-seeking diversified portfolio. This depends upon market conditions. Gilts have been on negative real yields for a few years until recently and would have been an unlikely choice of investment for a new CDC scheme, were one to have been opened in the recent past.

In commending the consideration of the term structure of gilt yields, TAS 310 is promoting a method of low or no relevance.

#### *The wording of TAS 310*

In P2.2 and P2.3 we think that “advising on” is better wording than “setting”.

In P2.3, “practitioners should consider whether and how to make allowance for the term structure of each assumption” would be better wording, in order to capture the possibility allowed for in 3.9 of the consultation document that actuaries may choose not to use a term structure, while equally allowing actuaries to use a term structure if they wish.

In P2.4, the requirement is to derive central estimate assumptions using as much information as is “sufficient”. It is conceivable in relation to some investments that sufficient information to fully understand the expected return is not available. The standard cannot have a “must” requirement attached to a task which may often be impossible to comply with.

We thought about whether there is a connection between the use of the word “sufficient” in P2.4 and the use of “sufficient” in the TAS Proportionality Guidance 2.13 – 2.16 and TAS 100 Principle 6. FRC could consider whether to add wording to either make this connection (or not) depending on what is intended.

Using third parties where necessary to support the task of obtaining the expected return is sensible. We agree the need to test this input for reasonableness. There may be occasions when the supporting evidence is limited or not made available – perhaps for commercial reasons and would suggest using the phrase “available supporting evidence”.

Although the expected return assumption is important, it also important not to over-complicate its derivation. Consistency of approach from one valuation to the next is also important: members experience a change of mind about an assumption as a change to their expected benefits. It may be difficult to maintain consistency if many third parties are involved (most of whom will not be actuaries working to the standards of the TASs).

Central estimate is defined in legislation. The FRC needs to use this definition in TAS 310, FRC’s alternative definition needs to be removed.

## Modelling

### **12. What are your views on the proposed provisions in relation to CMP modelling? Do you expect the proposed requirements on communication to support intended users in making relevant decisions based on modelling? Do you believe there are further items where additional requirements would be appropriate?**

Section 3 seems to be mainly or wholly about stochastic modelling. P3.3 and P3.4 explicitly use the word stochastic and P3.2 requires the provision of probabilities which implies the use of stochastic modelling. P3.1 requires a “demonstration of the level of uncertainty” which may or may not be an allusion to stochastic modelling.

We think that the main annual task of carrying out the valuation and deciding the benefit adjustment is best done by making a deterministic central estimate. Deterministic modelling is also modelling. Section 3 might be better headed “Stochastic modelling”.

In P3.1, it is not clear who the standard has in mind as the recipients of the demonstration of the “level of uncertainty in relation to future benefit adjustments” nor why the standard thinks this is needed. The purpose of actuarial work needs to be clear if the work is to be well designed and carried out.

The sequence of benefit adjustments declared over a number of years will tell its own story of how well the scheme is doing and the uncertainty of outcome from one year to the next. Possibly nothing needs to be done to demonstrate benefit adjustment uncertainty than to let time pass and observe the outcomes. We note with approval that the recent history of benefit adjustments is required to be given in a valuation report (Appendix A item d).

Referring to the consultation document 3.14, we like the balance in the first sentence, which describes the importance of the *trustees* understanding risk and uncertainty, and the importance of *appropriately communicating* risk and uncertainty to members. In the second sentence, we would not put members and trustees together in their “need to fully understand the possibility and severity of downside risks”. We think the trustees should have the greater understanding of risk and uncertainty, which they then apply when thinking about how to appropriately communicate with members. Therefore where 3.14 goes on to say that “stochastic modelling would be required to achieve the level of understanding required” we think this refers to the level of understanding required *by the trustees*, but not necessarily by the members.

The key objective of CDC management is inter-generational fairness, hence the use of central estimates. Very high upside outcomes may also be problematic for inter-generational fairness but are not covered by P3.2 which considers only downside risk. We would prefer P3.2 to consider potential ranges of outcomes.

P3.1 and P3.2 refer to the live running tests. The live running tests are calculations to be done annually as part of the viability report. The requirement is to calculate whether the tests are met as at the date of the viability report. It is not a requirement of the live running tests to forecast whether the tests will be met in future. Stochastic modelling is not needed to carry out the tests. There is no need for the live running tests to be mentioned in a section on the stochastic modelling of a CDC scheme.

In 3.17 of the consultation document, there is no need for the FRC to be alarmist about the consequences of failing a live running test (the withdrawal of authorisation by TPR is suggested). If this happens, the balance between contributions and benefit accrual can be altered in a way designed by the actuary to be fair to members, under the critical appraisal of the trustees and as authorised by TPR. It is not obvious what help stochastic modelling will give to seeing this coming. It may be that all stochastic modelling will show some risk of failure many years hence, which is not informative if all modelling shows some failures. Rather, if an actual failure of live running tests emerges, it will be in response to recent adverse movements in the investment markets. We do not need stochastic modelling (which may only be done at intervals of a few years) to see this coming, only a watchful eye on the present state of the markets.

Of P3.1 to P 3.4 which cover stochastic modelling, P3.3 which directs the use of stochastic modelling to test soundness is useful. As noted above, P3.1 and P3.2 need not mention live running tests in the context of stochastic modelling. P3.2 would be better framed to give an indication of the range of outcomes covering both upside and downside risk. We are unclear of the meaning of P3.1 – is the reference to complexity meant to cross refer to the dependence of benefits on uncertain future events? P3.4 seems to be covered implicitly by P3.5 which requires the communication of the same uncertainties so is perhaps unnecessary.

The viability report (in which the soundness of a CDC scheme is evaluated) is an annual requirement. But the actuary could reasonably conclude that it is not necessary to carry out (potentially highly expensive) stochastic modelling annually to provide the viability report. P3.3 needs to be amplified to say that annual stochastic modelling is not required. Repeat stochastic modelling should only be carried out if the actuary concludes it is necessary.

#### *Communicating stochastic modelling*

It tends to be that different consulting firms construct their models in different ways, in particular in the construction of the discount rate. For example, one might use a “gilts plus” discount rate, another “CPI plus” and another internal rate of return on the assets. In each case, we think that CDC can be shown to work over time. But each organisation is committed to its own discount rate approach and may not be able to model alternative approaches without considerable model rebuilding.

The long run outcome of CDC is determined by the contributions paid and the returns achieved by the investment strategy. The actuarial model is a device to spread the scheme’s resources to provide benefits to the members. While the actuarial model can affect the spread, it does not affect the amount of money available to be spread among members. Provided that the discount rate is a reasonable estimate of the expected return on the assets, it is not crucially important how that discount rate is derived.

We think that there is scope to think about the nuances of P3.5. We think it best to avoid an implication that extensive additional modelling might be needed to fulfil it. We also wonder whether an unintended consequence of presenting trustees with multiple methods and assumptions could be that they become tempted to switch methods and assumptions occasionally to get a different answer? CDC ideally is valued consistently at each valuation, which suggests that, once a model and assumption set is carefully chosen (from a variety of methods), there should be less need to consider alternatives at future valuations.

P3.10 is biased in its focus on down side scenarios and this is unhelpful. It is also important that extreme upside scenarios are managed fairly in CDC. It is important that CDC modelling is unbiased and a one sided view of things risks encouraging bias.

Items P3.5 to P3.10 are comprehensive and suited to an exercise carried out rather less frequently than annually.

### **Scheme design**

**13. What are your views on the proposed provisions in relation to Scheme design? Do you envisage any difficulties in meeting the requirements of these provisions. Please provide details to accompany your response.**

It is not obvious what the distinction is between developing a scheme design prior to preparing an application for authorisation and developing a scheme design as part of the preparation of the application for authorisation.

Data should be collected to suit the purpose in hand. Sometimes, data which it would be desirable to have does not exist to collect. Or desirable data does exist, but is in the possession of a body unable or unwilling to share it. The injunction to collect data “as comprehensive as possible” can be read two ways: 1) it can be read as acknowledging the potential for some data not being available, 2) it can also be read as requiring the collection of as much data as is available to collect whether it is truly needed or not. Hopefully (1) is the intended interpretation and a reword could help clarify that.

## ■ Viability assessments

### **14. What are your views on the proposed provisions on completing assessments of scheme viability and certifying soundness? Do you consider it is appropriate to require practitioners to consider areas beyond those outlined in legislation when certifying soundness? Please give reasons for your response.**

Referring to the consultation document 3.33, we agree that FRC (and TPR) should not attempt to define soundness, given that “sound” is not defined in legislation. If “sound” needs a definition, then legislation is the place for that definition.

In P5.1, “all relevant matters” could be too high a hurdle . The “main material matters” allows scope for judgement to leave out smaller matters.

Stochastic modelling is central to the FRC’s view of the examination of soundness. Stochastic modelling does not test “all relevant matters” but one or two key metrics which are tested very many times (e.g. 30 years of projection in 5,000 scenarios equals 150,000 tests of one metric).

In P5.1b, it is not useful to compare present benefit adjustments with the expectations at the outset of the scheme. The initial expected benefit increases/decreases are superseded by the increase/decrease decision following the first valuation. The revised rate of increase/decrease from the first valuation is superseded by the decision arising from the second valuation. The point of CDC is there is no guarantee, there is and must not be any anchoring to a superseded expectation – this would discourage appropriate reactions to a changed situation. The world has moved on, the scheme has done better or worse than originally expected, there is a new expectation of what will come from the future.

It is helpful to see in P5.3 that annual stochastic modelling is not necessary, although perhaps the wording could be made stronger on this point by stating explicitly that annual modelling is not expected. P5.4a is clear that reliance can be placed on previous modelling.

In P5.4e, given that soundness is to be tested by stochastic modelling, then there may be 50 (1%) to 250 (5%) out of 5,000 generated scenarios where the stochastic modelling indicates a problem in the future. The usual output of stochastic modelling is not a description of scenarios of failure but an illustrated range of outcomes with probabilities attached. Digging into individual scenarios of failure to see what happened in each one, to seek out some common scenarios in the reasons for a failure of soundness could be a very time consuming exercise. We wonder what proportionate activity FRC envisages in fulfilment of P5.4e?

In 5.4f, we think that the legislated live running tests are a test of the present situation only. It is not required by legislation that forecasts of future possible failures of the live running tests are made.

P5.4f could be better worded. Presumably “negative real or nominal increases” is meant to refer to “negative ... nominal increases” i.e. nominal decreases. Why not more simply to refer to “real terms decrease” and “nominal decrease”? Of course, there is not necessarily anything wrong with a nominal decrease if it is in a scenario of deflation of prices.

In P5.4f, there needs to be symmetric reference to excessive increases as well as to decreases in real terms and nominal terms.

A lot of stress is being placed on stochastic modelling. It must be remembered that stochastic modelling of investment performance is difficult to do well. Stochastic modelling is least reliable at the extremes of probabilities, yet it is extreme events which are of most interest. If a stochastic model gives a problematic result, it should first be considered whether what is being highlighted is a problem inherent to the model, as distinct from a problem in the real world which needs addressing. While it is fine for FRC to encourage the use of stochastic modelling, it is also important not to place more stress on it than it can bear.

**15. Do you agree that the considerations for a practitioner certifying scheme soundness via a viability certificate are the same as those a practitioner should communicate to trustees in their own consideration as to whether the design of the scheme is sound for their viability report?**

An actuarial certificate must cover only those matters specified for it in legislation. The actuary’s considerations should only be actuarial considerations, being what the actuary is qualified in.

The trustees’ considerations of viability are likely to be wider than narrow actuarial ones.

**16. Are there any other areas in relation to soundness (including practitioners’ communications of their work on soundness) which require further standards? Please provide as much detail as possible.**

No.

**Actuarial valuations**

**17. What are your views on the proposed provisions on actuarial valuations for CMP schemes? Are there other key areas of judgement beyond the central estimate assumptions? Are there further areas you would expect to be included? Please give reasons for your response.**

In P6.1a, actuaries are required to consider “the consistency of assumptions with those adopted for ... the first gateway test.” The first gateway test is the scheme must plan for CPI increases at the outset. The assumptions for calculating this cease to have any relevance the moment markets move on. They will certainly be superseded by the assumptions of the first actuarial valuation, and the assumptions of the first actuarial valuation will be superseded by

the assumptions of the second actuarial valuation, and so on. The point of CDC is that benefits are adjusted to adapt to changing conditions as the scheme develops.

It is important that actuarial assumptions are derived consistently from one valuation to the next, with any variations from apparent consistency justified and documented (for approval by trustees, review by TPR and publication). But consultation document 3.39 and P6.1a go too far in seeking consistency with the assumptions at the scheme's opening, which with the passage of time will become decades ago.

3.39 says "The benefit adjustments which results from actuarial valuations are expected to be measured against the original aspirations of the benefit design communicated to members." This misunderstands the operation of CDC. The initial aspirations are replaced by the new expectations calculated in the first actuarial valuation, and in turn those expectations are recalculated and replaced at the next valuation, and so on.

What is the scope of P6.1b? Alternative central estimate discount rate only? Or alternatives to each and every actuarial assumption? The former seems appropriate.

Also, is the intention here to show sensitivity to assumption(s) (specifically the discount rate)? If so, P6.1b could be rewritten to clearly say so. If the outcome of P6.1b is that trustees are presented with results on alternative sets of assumptions that the trustees pick and choose between, that does not seem appropriate.

The legislation requires annual valuations of a CDC scheme. Given annual valuations, it is excessive to require the consideration of post valuation experience in 6.1c. There will be a continuous annual cycle in which no sooner is one valuation (and viability report) prepared, considered, signed off and benefit adjustment communicated, than the next annual cycle starts. The next annual cycle captures the post valuation experience since the previous valuation. In the defined benefit world of three yearly valuations, there is sense in considering post valuation experience before signing off a schedule of contributions expected to last 3 years. But in the CDC world of annual valuations it is unnecessary to mandate it.

**18. Do you agree the required content of the valuation report set out in Appendix A is reasonable for CMP schemes? Is there further content which should be included?**

The wording of item h seems odd to us. Adjusting the benefits upwards or downwards is the principal means of equating the benefit payments to the assets and contributions. The word "risk" has connotations of "something which shouldn't happen or hopefully won't happen but might". In a CMP scheme, it is not a risk that the benefit increases/decreases are changed from one valuation to the next (in the sense of something undesirable which hopefully won't happen), it is a certainty that changes from the previous expectation will be made, because this is the normal functioning of the CDC scheme. It is also entirely normal that outcomes will deviate from the actuarial assumptions, in the short and long term, without this being a failure of modelling.

Deviation from modelling carried out on central estimate assumptions is as likely to be above prior expectations as below. In item h we have another example of drafting unhelpfully focussed on the down side.

We think it best for item h to be deleted.



## Factors for individual calculations

**19. What are your views on the proposed provisions in relation to factors for CMP schemes? Do you envisage any issues complying with provision P7.4 regarding selection risk? Are there certain groups of members you believe this may disadvantage? Please provide reasons for your response.**

We note that P7.2 is written with a “should” not a “must”, so it is not the case that factors must be cost neutral on a central estimate basis, and P7.5 recognises the possibility that factors might not be cost neutral.

Considering P7.4, in defined benefit schemes, it is not common to allow for selection risk in the setting of factors in a quantified, evidence based way. We doubt that there will be much evidence available to support adjustments for selection in the calculation of factors. The possibility of underwriting the conversion of a transfer in of a DC pot to a CDC scheme on retirement in a “decumulation only” CDC scheme falls outside the scope of these remarks.

## Impact assessment

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

We have made many remarks ranging over the whole draft. We note there are simplifications which can be made to sections 2, 3, 5 and 6 in particular of draft TAS 310.

We recommend simplifying TAS 310 wherever possible. Over-complication consumes additional time and money in the running of CDC. Of course, the impact assessment does not capture the additional consumption of time and money from over-complication.