

30 August 2012

The Director of Actuarial Policy
The Financial Reporting Council
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Dear Sir / Madam

Responses to Chapter 5 of CP12/10: Assumptions for Statutory Money Purchase Illustrations

Thank you for the opportunity to comment on this consultation paper. This response has been prepared on behalf of the retirement benefits practice area of Towers Watson, a global firm with a substantial presence in the actuarial consultancy market. The firm provides advice to around one-half of the top 100 pension funds in the UK and overall employs over 300 actuaries in the UK.

Our responses to the questions set out in chapter 5 of the above consultation paper are in the Appendix. We have also posed in the Appendix one further question to the FRC.

The view of Towers Watson is that we welcome consistency between FSA point of sale and SMPi assumptions within limitations set out by their different purposes. We do not believe that it is necessary to retain a maximum accumulation rate for SMPi's, but if a maximum is retained, it needs to be credible and not less than the current maximum accumulation rate.

Yours faithfully



Spencer Bowman

Appendix - Responses to Chapter 5 of CP12/10: Assumptions for Statutory Money Purchase Illustrations**Q1: Do you agree that the assumptions in AS TM1 should be consistent as far as possible with those specified in COBS 13 Annex 2 of the FSA Handbook?**

We agree that consistency of assumptions used for SMPs that are produced under TM1 and FSA projections under COBS 13 would be desirable, particularly where individuals will be provided with illustrations provided under both requirements. Having said that, as the consultation points out, these projections are produced for different purposes. In particular point of sale illustrations give a range of outcomes at the outset, helping an individual decide how much to contribute, and may assist in his choice of fund, although this is not their primary aim. In contrast, SMPs are produced each year until close to retirement to give an indication of the likely outcome of benefits that might be secured on a specified benefits basis at retirement, having specified the level of contributions.

In relation to accumulation rates, please see our response to Q2.

In terms of other assumptions included in TM1, we note that these were considered in detail in the SMP consultation leading to v2.0 of TM1 issued in December 2011.

Future reviews of assumptions should be carried out simultaneously by the FSA (and its successor) in conjunction with the FRC, so long as this does not delay necessary changes

Q2: a) Should AS TM1 continue to specify a maximum accumulation rate?

We are not convinced that it is necessary to specify a maximum accumulation rate for SMPs prepared under TM1. TM1 already requires providers to take into account the investment potential of the investments members make, including future investment strategy. This has been reinforced by the BAS's FAQ 5.6 stating that actuarial advice to providers on accumulation rates for SMPs is covered by the Pensions Technical Actuarial Standard.

In our experience advising trustee clients, there is no evidence of deliberate use of excessive investment returns for SMPs, as there is no commercial incentive for trustees, or the scheme sponsor, to overstate projections. In a minority of cases, some more prudent investment funds may have been projected on the 7% pa default accumulation rate under TM1 v1.4 as a consequence of provider system inflexibilities. This we find is being addressed under TM1 v2.0 supported by the FAQ. There has been significant work carried out recently on this matter by many trustees following the changes to TM1 and the FAQ 5.6 in December 2011, and in light of challenging current market conditions. A further significant change, such as reducing the maximum accumulation rate, would not be welcomed by most trustees and may well lead to a fall in pensions saving, contrary to government policy, as individuals perceive a declining return on their investment.

We note that version 2.0 of TM1 no longer refers to the 7% maximum being based on the nature of asset mix referred to in the FSA consultation and in earlier versions of TM1.

Applying a maximum in the context of the other guidance on accumulation rates in TM1 has paradoxical effects, which, however, have not been significant when the maximum is set at 7%pa, but which would be significant if set at a lower level:

- it should be explained to members, where it artificially understates the potential investment return that would otherwise be assumed
- a member could well see higher accumulation rates, net of investment charges, from funds with lower investment potential, such as bonds
- clarity would need to be provided by the FRC as to how the maximum rate should be applied. For example, take a lifestyle fund, with investments switching from equities to bonds and cash in a run-up to retirement, and, say, the provider takes a cautious view on equity returns, say 6% pa, with 4% pa for bonds and 2% pa for cash. Should the proposed 5% pa cap apply here to each single year before and during phasing, or would the maximum be based on 5% pa

compounded over the whole period? With 7% pa maximum this would not have been an issue, at least in this example.

In conclusion, we believe that if the FRC retains the current guidance in TM1 and FAQ 5.6 on accumulation rates for SMPIs, we do not see the necessity of specifying a maximum accumulation rate. If a maximum accumulation rate is retained, and it is reduced from 7% pa, greater clarity on how it should be applied will need to be provided by the FRC.

Q2: b) If AS TM1 continues to specify a maximum accumulation rate, should it be the same as the FSA's intermediate projection rate?

If a maximum accumulation rate is retained, it needs to be credible as a maximum. 5% pa would, in our view, be too low for a maximum for all investments over all periods, exacerbating the points made in the bullet points in the answer to Q2 a) above.

We note that a change from 6% pa (if that rate were currently assumed) to 5% pa before investment charges would reduce projected benefits from past contributions by about 17% for a member with 20 years to retirement, and broadly half that for future contributions, all other things being equal. This significant impact would undermine confidence in SMPIs by both trustees, particularly following other recent changes to TM1, and individuals who will see lower projections for arguably no particularly good reason.

Q2: c) If your answer to b) is 'No', what rate should be specified in AS TM1?

We would suggest the maximum, if a maximum is retained, should be based on the higher flanking assumption for FSA projections. However, we would not object to retaining 7% pa.

Q3: Should the wording for the mortality assumption in AS TM1 be changed along the lines of the wording proposed in Chapter 2?

We would have no objection to the relevant wording in TM1 being changed for clarity. The issue of clarity on this aspect of TM1 was noted in BAS's FAQ 5.7, which could then be replaced.

Q4: Given the proposed nature of the changes to AS TM1, do respondents envisage any difficulties with a four-week consultation period for an exposure draft of a revised version of AS TM1?

We would not envisage problems with a short consultation period, although this depends on the answer to Q1.

If a (lower) maximum is retained, additional clarity on how a maximum should be provided, if a maximum is retained, and this may require additional consideration.

More generally, we would suggest that all relevant guidance should be included in TM1, rather than left to further FAQs issued by BAS, and so all material considerations should be made in advance of the issue of any revised TM1, even if this were to lengthen the consultation period, if necessary.

Q5: Do you agree with our proposals for the timing of any changes?

We are comfortable with 6 April 2013 illustrations being covered by revised guidance for SMPIs.

Q6: Do you have any comments on the impact assessment for our proposals?

There could be a material systems cost impact. This is likely to be greater if a significantly reduced maximum accumulation rate of, say, 5% pa is adopted, depending on the FRC's guidance on how the maximum should be applied. Systems may not have been set up to apply caps on a compound basis. Significant communications issues may arise.

Additional question for the FRC:

Please can the FRC ensure consistency with FAS on the reference date in TM1 for gilt yields for determining annuity rates each year.

- TM1 states "C.3.2 The rate of interest must be determined at each 15 February. This rate must be used for all statutory illustrations with illustration dates occurring in the following financial year (6 April to 5 April). If the information on which the rate of interest is to be based is not published on 15 February, providers must use the relevant information for the previous working day on which such information is published."
- COBS13 states (Annex 2 para 3) " 'ILG0' and 'ILG5' are the real yield on the FTSE Actuaries Government Securities Index-linked Real Yields over 5 years, assuming 0% and 5% inflation respectively, updated every 6 April to use the ILG0 and ILG5 which applied on or, if necessary, the business day immediately before, the preceding 15 February"

These differences are unnecessary and can be interpreted to mean yields published for 14 or 15 February.