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4th June 2010

Ms L Pryor
Technical Director
Board for Actuarial Standards
5th Floor, Aldwych House
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Dear Louise

Consultation Paper: TM1: Statutory Illustrations of Money Purchase Benefits

I am writing on behalf of the Association of Consulting Actuaries in response to the Consultation Paper issued by the Board for Actuarial Standards in March 2010.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is effectively the "trade association" for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

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

Before dealing with this we would like to make a general point. Practitioners now have often quite complex systems in place to produce the illustrations efficiently. It is also clear that at present many recipients pay limited attention to and have limited understanding of the illustrations they are sent. For this reason, we believe there are two themes running through our responses:

- It will be costly and counterproductive if substantial changes have to be made to existing systems.
- Keep the illustrations as simple as possible bearing in mind the purpose they are serving.

We are also of the view that TM1 serves a very different purpose to actuarial Guidance Notes currently in your care. Whilst we support the principle of replacing these Guidance

Notes with your Technical Actuarial Standards we think that the concepts that underlie the drafting of these Standards have no place within a Technical Memorandum.

We understand that when TM1 was adopted by the BAS, the actuarial profession handed to you a number of known technical issues with TM1 from their "to-do" list. It appears, from the contents of the Consultation Paper, that you are considering at least the more substantive issues as part of your proposed amendments to TM1.

Finally, we ask that when you issue TM1 version 1.4, you do so also in track change form (against version 1.3), so that existing users can rapidly appreciate the changes that are being made.

We hope that you find our comments of assistance.

Yours sincerely

A handwritten signature in black ink that reads "David Everett". The signature is written in a cursive style with a large initial 'D'.

David Everett
Deputy Chairman, Pension Schemes Committee

Enc: Appendix

Copy to: basTM1@frc.org.uk

1. How effective have SMPIs and TM1 been in meeting the stated aim set out in paragraph 2.4? If the aim has not been met, please provide information concerning the effectiveness of SMPIs, with examples if possible, or provide suggestions for enabling SMPIs to better meet the stated aim.

We consider that SMPIs and TM1 have been very effective in meeting the primary aim set out in paragraph 2.4 of providing “illustrations of pension benefits on a broadly consistent basis across various types of money purchase pension”. However that paragraph goes on to say that this is intended to assist individuals to assess the adequacy, need for further provision, and uncertainties in relation to their pension arrangements. We consider that for many recipients, they are not providing the intended assistance.

Your paper makes reference to the DWP research, *Understanding Responses to Pensions Forecasts*, and summarises the findings of this. Our experience would not lead us to disagree with the DWP findings.

The DWP research highlights the general lack of understanding of pensions as a barrier to SMPIs’ effectiveness in assisting individuals as envisaged. We consider addressing this issue to be beyond the scope of this consultation. However, we suggest in passing that the public’s understanding of pensions may have to be improved as part of the “2012 changes”. The research also highlights some ways in which the layout of SMPIs could be changed to increase their effectiveness, and the ideas would seem promising if they can be incorporated without significant system changes. We note in this regard the proposals within the DWP’s draft regulations published this January that give schemes the option to adjust their current arrangements. However, we are firmly of the view that the layout of SMPI is not a matter for the BAS to address in a future version of TM1.

2. Should more be done to highlight the significant uncertainties involved in using illustrations of benefits? Respondents are asked to supplement their responses with examples of how this could be done. (paragraph 2.7)

Again referring to the DWP research, this seems to suggest that there is reasonable appreciation of the uncertainties. We do not consider that there is any need to mandate more than the present statement on the actual amount of any pension payable.

We note your ambition in relation to communicating risk when drafting Technical Actuarial Standards, but we do not see a parallel with TM1 as the illustrations are only intended to assist the recipients in broad terms.

3. Should the stated aim in paragraph 2.4 be modified and if so how?

We see no reason to modify the stated aim. It may simply have to be recognised that the second part is more a statement of overall aspirations than something which can realistically be achieved by SMPIs alone.

4. How helpful do respondents find the explanations and assistance in TM1? Should one of the purposes of TM1 be to assist providers who produce SMPIs? (paragraphs 4.2 and 4.3)

When it was published, providers might have taken the view that the detailed explanations were not always helpful. But after a number of years of operation we would expect that providers have systems in place which produce SMPIs consistent with those detailed explanations. Therefore, we do not consider existing providers either wish or would be assisted by reducing the level of detail in TM1. Indeed we would be concerned that if the level of detail was reduced, the less detailed wording might introduce some inadvertent requirement to change existing systems.

If there are new entrants to the market, the existing level of detail in TM1 is required if the objective of producing consistent illustrations is to be met.

There will be some scope for reduction in length of TM1 as Appendix B that deals with projected contracted-out rebates should be redundant now that the previous Government has announced that money purchase contracting out will cease from 6th April 2012.

5. Could any changes be made to the structure of TM1 to improve its clarity? (paragraphs 4.2 and 4.3)

See above.

6. What views do respondents have on our proposal to reduce the level of detail in which TM1 sets out the calculation methodology? (paragraph 4.4)

As stated above, we would be against any such reduction in the level of detail in TM1.

7. Do respondents agree with our proposal that TM1 should continue to require that the pension a member takes at retirement is assumed to increase in line with inflation? (paragraphs 5.2 and 5.4)

We agree. If the DWP felt it necessary to recognise that most members do not take index-linked pensions, and the implications of this, then this should be done by the regulations, not TM1, extending the requirements for the statement on the index-linked nature of the illustrative pension. Keep it simple.

8. In respondents' experience what proportion of members on retirement opt to take annuities with index-linking, fixed pension increases and no increases? (paragraph 5.4)

Anecdotal evidence is that the majority of members take pensions with no increases. Information from one of our member firms suggests that well over 80% of retirees take level rather than index-linked pensions.

9. Do respondents have any comments on paragraphs 5.5 to 5.6 concerning the option to take a cash sum at retirement?

We advocate the retention of a pension only illustration as the requirement. Keep it simple. Again the situation can best be covered by providing members with an enhanced explanation of the possible variations from the illustrated pension (and governing bodies/providers can always provide a pension/cash illustration if they wish).

10. Do respondents agree that the mortality basis should be updated? If so, what tables and allowance for improvements do they consider should be adopted in TM1? (paragraphs 6.7 to 6.16)

Yes. PCMA00 and PCFA00 base tables. As regards allowing for future mortality improvements, the cohort adjustments are based on increasingly outdated experience, and presumably it is intended that the new TM1 basis should be sustained for some time in the future. Therefore, whilst it is early days yet for the CMI projection model, this would seem the most appropriate approach, and the 1.25% and 1% minimum improvement levels would seem reasonable at this stage.

11. Should TM1 allow providers to choose specific mortality tables which are appropriate for the members of the arrangement in question? (paragraph 6.16)

No. How would they do this in any consistent way? Keep it simple.

12. Do respondents agree with the proposal to change the yield used for annuity calculations? (paragraphs 6.18 to 6.22)

We agree with the continued use of the existing formula but without the 0.5% reduction. However, the more important point is that you should carry out an analysis prior to settling the yield and the mortality tables to test that the annuity rates generated are close to terms being offered by insurance companies and you have some confidence that they should remain close over the period that you intend the basis to be in force.

13. Should a non-market related annuity rate be used for younger members? If so, what rate should be used and how should it transition into a market related rate for individuals close to retirement age? (paragraph 6.24)

We sympathise with the idea behind non-market related annuity rates for younger members and some sort of transition into market related rates for older members. However, it would involve a degree of complication and system change which would be disproportionately large compared to any benefit for the younger members whose SMPIs would be affected. Therefore we advocate no change to the current approach.

- 14. Do respondents have any views on the use of a fixed reference date for setting the interest rate for calculating annuity rates and whether an alternative approach would be preferable? If a fixed reference date is preferred should it be 15 February? (paragraph 6.26)**

Paragraph 6.26 articulates well the potential drawback of a fixed reference date. However these drawbacks exist anyway to the extent that fund values are volatile from year to year. The use of an average yield would not remove the drawbacks, although it might mitigate the most extreme variations. We would be comfortable with either an average yield published by the BAS or the continuation of the status quo.

- 15. Are the expense assumptions currently specified in TM1 reasonable, in particular the assumption of 4% of the value of the annuity at retirement? (paragraphs 6.27 to 6.29)**

We have no evidence to suggest that any other simple allowance would be more reasonable.

- 16. Do respondents have any comments on the appropriateness of the long term maximum rate of accumulation of 7% pa? (paragraphs 6.30 to 6.33)**

In the context of an inflation assumption of 2.5% pa and an assumption of “predominantly” equity based investment strategy (ie maybe assuming a bit of “lifestyling” approaching retirement?), we would not argue for any change from 7% pa.

- 17. What approach do providers take when members’ investments are in funds which are expected to accumulate at less than the maximum rate of 7% pa? (paragraph 6.33)**

We have experience of 5% pa for gilts/bonds funds and 3% pa for projected cash funds.

- 18. Do respondents have any comments on the long term inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)**

At the time of writing, the “break even RPI inflation rate” implied by the difference between fixed interest and index-linked gilt yields is approximately 3.4%. On the other hand the Bank of England is charged with taking action to target an annual 2% pa CPI increase. All sorts of arguments can be put forward for assuming long term inflation rates at various points between these figures, but to cut to the chase, 2.5% pa currently looks low for RPI increases. In isolation, an increase to 3% pa would seem reasonable. However, could this open up arguments that the 7% pa equity return assumption should be increased?

- 19. Do respondents have any comments on the long term earnings inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)**

We are comfortable with the rationale that sets the assumed earnings inflation rate equal to the assumed price inflation rate.

20. Should TM1 require SMPI projections to allow for guarantees? (paragraphs 6.37 to 6.38)

No. Keep it simple.

21. Is the approach for with-profits funds set out in section 6.7 of TM1 appropriate? (paragraph 6.39 to 6.40)

Whilst sympathising with the theory expressed in paragraph 6.40, we would not advocate any change from the current wording of TM1 for With-Profits Funds.

22. Would pension scheme members benefit from the FSA and TM1 bases being harmonised? (paragraphs 7.4 to 7.7)

No comment.

23. Do respondents have any views on the approach set out in paragraph 7.8?

It seems the best which can be aspired to in the current circumstances. We consider it would be inappropriate to require providers to explain the differences between regulatory/legislative requirements.

24. Do respondents have any comments on our proposal in 8.4 to allow signposting?

Consistent with the findings of the DWP research referred to earlier, we consider that “signposting” could help in achieving the aspirations set for SMPI. However, in order to avoid enforcing short term system changes, we would want the change to allow rather than require “signposting” at this stage.

25. Would the timetable outlined in section 9 allow providers sufficient time to make changes from statements with effective dates on or after 6 April 2011? What benefits, if any, would there be if changes were to be effective a year later?

This depends on what the changes are, and whether they require substantive system changes. If system changes are required, then 6 April 2011 may be too soon. The argument that illustrations are normally issued “some time after their effective date” is not compelling where trustees and members are used to receiving 6 April illustrations shortly after this date.

- 26. Would an illustration of the pension attributable to contributions already made help recipients of SMPs and if so, should there be a requirement for this to be shown on SMPs? (paragraph 10.2)**

As commented earlier, more illustrative information is likely to further confuse and overwhelm many recipients, and this would certainly require material systems changes.

- 27. Do respondents believe that recipients of SMPs would benefit from additional information illustrating the uncertainty in the amount of the illustrated pension? If so, how would this best be achieved? (paragraph 10.3)**

See earlier.

- 28. Would the production of a suite of “best practice” SMPs be of benefit to members and providers? If a suite of “best practice” SMPs is developed who should maintain it? (paragraph 10.7)**

It would only be helpful if any changes it encouraged could be easily adopted and were clearly seen to be assisting with the more aspirational aspects of SMP.

Response by:

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