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Re invitation to consult on revisions to TM1

Introduction

Capita Hartshead is the largest third party administrator of occupational pension schemes in the UK and also act as consultants and actuaries to a significant number of schemes in all sectors. With over 30 years experience in the field of administration and specialist professional services, and 3.4 million members under management, this gives us a wealth of industry expertise. We have over 500 occupational pension scheme clients covering all types of arrangements. In addition we administer contract based solutions for a number of providers

We welcome the opportunity to respond to this consultation. Our comments on the questions set out within the consultation have been included below.

11.1

The BAS invites the views of those stakeholders and other parties interested in TM1. In particular the BAS would welcome views on the following issues:

1. How effective have SMPs 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 SMPs, with examples if possible, or provide suggestions for enabling SMPs to better meet the stated aim.

Generally speaking the first part of the statement – "...to provide illustrations of pension benefits on a broadly consistent basis across various types of money purchase pension provision" is being met.

However, the success of the second part – assisting "...individuals to assess in broad terms...the adequacy of their pension arrangements...the extent to which they need to make further provision...the significant uncertainties involved in using illustrations of benefits" – is perhaps more questionable.

If the measure of success is deemed to be that the guidance facilitates provision of illustrations which give individuals the means to make such assessment, then yes broadly speaking we would say that the stated aim has been met. However, we would qualify this by stating that there are some areas in which the guidance is quite vulnerable in this respect, or has the potential to be:

- In certain areas the guidance is less prescriptive than others – for example, very little room for provider discretion is allowed for in terms of SMPI annuity rate calculation, whilst on the other hand what the guidance has to say around assumed gross investment returns is very much a loose framework within which there is significant scope for provider variation. In our experience we have seen significant provider variation in what assumptions are made around gross investment returns, and arguably this scope to employ a significantly different assumption basis in response to a broadly similar underlying situation is detrimental to the stated aim, because the lack of consistency across providers can obscure the overall position for a given individual. This is particularly true of individuals who may have periods of service in different schemes, and will therefore be receiving illustrations from more than one provider, and who therefore need to collate everything in order to make an assessment regarding their overall pension provision.
- For similar reasons we have some reservations around the impending DWP changes which will remove the requirement for providers to make certain express statements in conjunction with the illustration. By allowing the information which enables the individual to make a proper assessment of their illustration to be sourced remotely, we believe that this could well have an adverse impact on the effectiveness of SMPs in meeting the stated aim: the standard of information offered through "signposting" will inevitably vary from provider to provider, information held on websites can be amended or removed retrospectively, and whilst information held remotely (such as on a scheme

website) may be readily accessible to the individual this may not be true of an IFA or other third-party adviser whose help they may enlist in reviewing their pension provision. All of which has the potential to combine in making it difficult to make a considered assessment of an individual illustration, and still more so to collate details of multiple illustrations in order to make an assessment of an individual's overall pension provision.

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)

Perhaps, but not to the point of providing multiple comparative illustrations to demonstrate the projected effects of A versus B, because the danger there is that we will provide so much detail that the recipient will not be able to see the wood for the trees – clearly this would be entirely counter-productive.

Offering comparative projections to illustrate the comparative effect of variation in one specific area, as some providers do at present, might be of some use in this area – for example, to illustrate the projected effects of variation in assumed return, or in contribution rate, or in assumed retirement date, or to show the projected effects of taking a lump sum and residual pension rather than assuming that all of the projected fund will be used to purchase an annuity – but we do not believe it would be materially beneficial to try and illustrate the projected effects of all areas of uncertainty in combination, because the recipient would not be able to tell which if any of the individual variables is the dominant factor influencing the difference between two comparative projections.

Clearly there is only so much that a provider can do to anticipate the effect of “significant uncertainty” and deal with this in the illustration in such a way as to ensure that they have made “...reasonable efforts to ensure that any assumptions or approximations produce appropriate results for each Member “ (per Para 6.2.1 of TM1.3). With this in mind we think that Para 4.8.1 of TM1.3 is very important here: “The objective is to keep to a minimum the information provided and make it as easy as possible for most Members to understand, leaving those who require more information to request it. Providers can provide further information automatically if they wish; however, too much detail may have the effect of reducing the impact and/or intelligibility of the basic information.”

Generally speaking we would tend to favour retention of the current approach, using a single illustration using a specified assumption basis that is documented in the accompanying assumption notes.

One possible alternative might be to issue a separate standard pre-printed enclosure with the member's illustration, showing in simple tabular form the illustrative real terms effect of variation in certain key areas. Assumptions such as investment returns and contribution rates would need to be universal and standardised but, as we would only be talking about a supplement to show the illustrative effect of certain key variables where all other factors are assumed to remain even, without attempting to reflect this in a bespoke member illustration, this would not present a problem. Issuing such a supplement could be a possibility whether caveat notes were being retained in the main member statement, or not, as the case may be. Examples of the tabular examples that might be included in such a universal enclosure are as follows:

- Opening hypothetical fund value of £5K, projected at 3% pa, 5% pa, and 7% pa over fixed terms of 1, 5, 10, and 20 years, with no projected contributions. This would help to illustrate the projected effect on the eventual retirement fund of a +/- 2% pa variation in investment return over the short, medium, and long term (all other factors assumed to remain even);
- Opening hypothetical fund value of £5K, projected to scheme NRA, scheme NRA – 5 years, and scheme NRA + 5 years, (a) on a deferred basis, (b) with projected contributions of 1% pa, and (c) with projected contributions of 5% pa, same assumed investment return in each case. This would help to illustrate the projected effect on the eventual retirement fund of a + 1% pa and a + 5% pa increase in contributions on the same projection term, the projected effects of early or late retirement given the same contribution rate, or a combination of the two, again all without trying to build this into the member's bespoke illustration;
- Hypothetical fund value at retirement of £25K, projected annuity assuming (a) that whole fund is used to purchase annuity, and (b) assuming that 25% of the fund is used to purchase a lump sum at

retirement. Retirement date assumed to be scheme NRA, annuity rate to assume RPI escalation in all cases. Table to show figures using 3 illustrative annuity rates: (a) for member currently aged NPA – 5 years, (b) for member currently aged NPA – 15 years, and (c) for member aged NPA – 25 years, so that illustrative results can be gauged over a cross-section of member ages;

- Hypothetical fund value at retirement of £25K, projected annuity assuming (a) RPI escalation, and (b) nil escalation. Retirement date assumed to be scheme NRA, projection to assume that whole fund is used to purchase annuity. Table to show figures using 3 illustrative annuity rates for each basis, per the previous point.

Of course there are other examples that might be considered, but this should hopefully serve as an example of what might possibly be achieved here.

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

We do not believe that the essence of this statement should be materially altered.

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)

On the whole we have found the explanations and assistance in TM1 to be very useful, not just in terms of initial reference but also in order to assist with ongoing queries.

TM1 is a long document, but on the whole it is well structured and it is not necessary to trawl through the whole document exhaustively in order to find what you are looking for. It is well-indexed so that it is relatively straightforward to locate the specific part of the document that relates to the issue that you are looking at, in addition to which there is a glossary of terms which has proved a very useful supplement on occasion, and we would caution against any radical reduction in the size and scope of TM1.

We agree that certain elements e.g. TM1.3 Para 6.6 are now superfluous and can be removed without adverse effect. However, in certain other aspects, the guidance appears incomplete.

Leading into the second part of your question, we think TM1 therefore needs to recognise that its intended users at different stages may variously be actuarial, pensions administration, and IT professionals, and it would be helpful if one of the purposes of TM1 was to assist providers who produce SMPIs. Failing that it would be helpful if there was a recognised BAS helpline or other contact to which questions of guidance, interpretation, and clarification could be referred. Two areas which we have come across relatively frequently, but to which the guidance makes no express reference, may serve as cases in point:

- A significant number of members pay regular AVCs as fixed monetary amounts rather than as a percentage of salary and in practice therefore the contribution level does not automatically change with each increase / decrease in salary. How to project? On the one hand, we could assume increases in line with earnings in order to ensure that the AVC contribution amount is projected to maintain its current value in real terms, but if this is not happening in practice then that may conceivably give the member a false sense of security and would appear contradictory to the stated aim of TM1 to assist members in reviewing "...the adequacy of their pension arrangements". It would therefore seem more appropriate to project such contributions on a level (i.e. non-increasing) basis, which effectively means that the value of the contribution is projected to decrease in real terms. This is an accurate reflection of what will happen if the member does not review the contribution level on a regular basis. This approach would appear more in keeping with TM1 and is the one that we generally favour, although we would recommend that an explanatory note be included in the statement to explain the basis of the projection;
- The other scenario concerns annual charges, particularly deferred administration charges, which are expressed as a fixed monetary amount. If we project these on a level (non-increasing) basis, the charging level will progressively reduce in real terms, which in turn could mean that the member's projection would be inflated. It seems reasonable to assume that schemes will take steps to periodically review the charging level of the scheme in order to ensure that it remains effective. We tend to take the approach of assuming annual increases to the charge amount in line with RPI in

order to ensure that the charging level is projected to maintain its current value in real terms. Again though, we would recommend inclusion of an explanatory note in the statement.

Whilst we feel that we can justify taking a different approach with each scenario for the reasons outlined, and that the result is reasonable and appropriate in each case, we believe that it would have been helpful to have had some guidance either within TM1.

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

Broadly speaking we think the structure of TM1 is satisfactory as was stated in our responses to earlier questions, it is well-indexed and the user can zero straight in on the pertinent section of the document without any difficulty.

If we have a criticism it is that the document comments exhaustively on some aspects (e.g. the calculation of SMPI annuity rates) whilst being much lighter on others (e.g. assumed gross investment returns).

If there is a lack of consistency in the approach that providers are taking with assumed gross investment returns, this will result in significant variances in the projected retirement funds this reduces the value of the fine detail that goes into calculation of SMPI annuity rates (and by extension the projected annuity). All the more so when consideration is given to TM1.3 Para 6.3 which cautions specifically against giving "...the appearance of spurious precision".

We feel strongly that the disparity in assumed returns is something that should be addressed within the guidance, and have commented on this specifically in my responses to Questions 6 & 17.

In terms of restructuring, therefore, we would like to see retention of the basic layout of TM1. However, we feel that the structure should be reviewed so that equal focus is applied to all factors involved in the projection, and if the purpose of TM1 is to be reviewed in order to assist providers who produce SMPIs perhaps this could be achieved as part of that process.

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)

Whilst we agree that the example that you cite in Para 4.4 of the consultancy document (regarding the methodology for calculating the difference between two dates) is superfluous and can be removed without detriment to the guidance, we should be very careful here and do not seek to remove detail simply because it is detailed. Some detail is not necessary, as with the example cited, but other detail is very necessary and should be retained – and in one or two areas, as noted in the previous point, we believe that detail is required where this is not currently provided.

We are concerned here because we feel that this proposal is grounded to some considerable extent on a false premise. This is illustrated quite markedly in Paras 3.5 and 3.6 of the consultancy paper:

TM1 – METHOD

3.5 TM1 sets out in detail how calculations for SMPIs should be carried out. The level of detail means that in most cases different providers should produce the same figure for the same pension arrangement.

3.6 This approach also benefits those who receive SMPIs from a number of different pension providers, enabling them to build up a complete and consistent picture of their pension provisions.

We disagree with the assumptions that are implicit in these two statements.

TM1 sets out the calculation detail in a great number of areas, most notably calculation of SMPI annuity rates, and in these areas it is indeed the case that there is little or no variation between providers. Given the same projected annuity purchase sum, providers will arrive at a consistent projected annuity. But therein lays the problem. A difference in the assumed annual investment return of just 1% pa compound over the medium to longer term will have much more impact on variances in calculation of the projected annuity than will any refinements that you put into place around calculation of SMPI annuity rate itself. To have consistency with

calculation of the projected annuity, equal focus needs to be given to how the originating annuity purchase sum is calculated as on calculation of the SMPI annuity rate that is then used to calculate the projected annuity.

In certain areas, and in particular with calculation of gross investment returns, the guidance provides little detail. TM1.3 Appendix D3.1 sets a cap of 7% pa compound on the maximum gross investment return that can be assumed, and then directs the user to Para 15.1.2 “for the circumstances in which a lower rate should be used”, which states that “Where the Provider expects the rate in paragraph D3.1 to overstate the investment potential of the Member’s contract or arrangement, the Provider must use an appropriately reduced annual monetary (nominal) accumulation rate, consistently from year to year.”. This para goes on to state quite categorically that “...it will definitely be appropriate to consider the use of a reduced rate in cases where the Current fund is invested in cash or deposit funds and either there is no discretion for a change to an alternative investment medium or there is no intention to change to another investment medium.”.

However, whilst the guidance states that “it will definitely be appropriate to consider the use of a reduced rate” it stops short of mandating such an approach.

So we have a broad framework within which there is much scope for provider discretion around what assumption basis to employ, and in our experience this potential is borne out in practice and we see a significant degree of client-specific variation in these areas.

In view of the degree of variation in practise we have strong reservations around any proposal to remove explanatory detail – whether from TM1 itself, as we are considering here, or from illustrations themselves in favour of “signposting”, if these proposals are premised on the assumption that the statements set out in Paras 3.5 and 3.6 of the consultancy paper are a reflection of actual practice.

If the intention is that given a similar set of circumstances there should be consistency in approach between providers, thereby supporting the statements made at Paras 3.5 and 3.6 of the consultancy paper, then TM1 should be more explicit in order to eliminate the disparity in approach that we see in practice – perhaps by mandating separate gross investment returns for each asset type, for example. If the feeling is that provider discretion (and variation) in these areas is legitimate even given a similar set of circumstances, and that nothing should be mandated in this area, then the assumptions implicit in Paras 3.5 and 3.6 are invalidated and any proposals made on the strength of those two paragraphs will be based on a false premise and therefore undermined.

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 with the provisional conclusion in Para 5.4 of the consultancy paper “...that it is not necessary to alter the requirement that the pension calculated in accordance with TM1 is linked to inflation.”

We do not think there would be any material benefit in providing comparative projections to demonstrate the illustrative effects of one annuity assumption basis versus another (although individual providers are of course free to do so if they wish), and nor would we like to see members being able to select their own individual annuity rate assumption basis for illustration purposes. At the end of the day, of what practical benefit would it be for a 21-year-old to select an illustrative escalation basis for their projected annuity? We feel that members at the younger end of the age spectrum will generally be more interested in the growth of their retirement fund than in what pension that might purchase 40+ years hence. Members who are nearer their assumed retirement date will generally have more interest in the income potential of their retirement provision, but more forward thinking providers are already allowing member access to on line modelling tools which consider the impact of different annuity formats.

One possible compromise might be to go with the separate enclosure idea where providers could incorporate tabular examples to try and quantify the illustrative effects of certain variables based on hypothetical figures without trying to incorporate this level of detail into the bespoke member illustration.

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

It is our experience that a material portion of members currently opt for non escalating pensions. However this position needs to be treated with some caution as the DC market is still immature and the DC benefits taken to date will typically represent just one part of wider retirement provision. Also non increasing pensions may be the symptom of under provision rather than an indicator of the desired benefit format.

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

We think the arguments here are more persuasive regarding illustrating benefits with allowance for pre commutation cash lump sum payments..

In your documents you say, within Para 5.6, that: “We consider that amending TM1 in this way would not be consistent with the intention of legislation”. However, in the preceding Para 5.5, you state that: “The legislation requires SMPIs to show the expected pension at retirement”. If the overwhelming majority of members are taking the maximum permissible lump sum at retirement then would the realistic expected pension at retirement be the residual pension that remains after 25% of the projected fund is assumed to be taken as lump sum?

Whilst we are not promoting that a “dual illustration” SMPI basis is necessarily the way to go, the arguments for going down this route would be much more compelling than those for illustrating the comparative effects of any other variation simply because a large proportion of members do take lump sums at retirement and this has been an established trend for many years.

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 we believe that both the base table and the projections applied are out of date and should be updated.

On the assumption that PA92 tables are obsolete, the PA00 tables are clearly a more suitable than the SAPS tables, being based on insurance company data, and therefore in theory provide a good match for the experience of a set of (non-self-insured) DC scheme annuitants.

However, our understanding is that insurers will invariably apply a percentage adjustment to the PA00 tables, thus reducing mortality levels and increasing annuity rates. This seems logical, as they will need to build in a margin for adverse experience, even if the base PA00 table, after appropriate projection, does reflect the baseline expected mortality rates of a population of potential annuitants.

With regards to projections, the CMI have stated that they consider the cohort improvement tables have become increasingly out of date, and have provided a replacement. We feel that these new projections will therefore inevitably be adopted as an industry standard, and it seems sensible to adopt them at this stage rather than have to make further changes to SMPI methodology in a year or two's time.

In terms of setting a long term rate, the underpin rates set by the PPF may at first glance seem a sensible starting point, assuming that the PPF set this rate to reflect typical rates in use by the insurance industry. However, if the new CMI projections are to be adopted, then overlaying 1.25% / 1% long term rates will give considerably lower life expectancies / annuity rates than medium cohort projections with the same underpin, particularly for females. Therefore, a higher long term rate will be required to achieve parity with the PPF assumptions.

What we are ultimately trying to achieve is a proxy for an insurer's annuity rates. Therefore it would seem that any input from the insurance industry would be useful to BAS when setting the assumptions. Piggybacking onto the research done by the PPF, whilst providing a useful comparison, would seem insufficient given the very different purposes that the two valuations are used for – there are valid reasons why the PPF might want to undershoot an actual buyout basis, i.e. to reduce the possibility of schemes entering the PPF when they could have secured the benefits outside.

Therefore we would not find it unreasonable for BAS to adopt more prudent assumptions than those adopted by the PPF, both for the base table and future projections. These assumptions would need to be based on input provided by the main annuity providers in the market.

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

We do not believe this will enable the “broadly consistent” requirement to be met. As stated in the consultation, there is a serious risk of inconsistencies between similar members in similar schemes with different providers.

The use of one annuity rate per saver across his various SMPI statements seems logical and will facilitate easier assessment of a user’s aggregate holdings.

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

Ultimately, any attempt to set a fixed adjustment to gilt yields to reflect current market practise will be an exercise in tail-chasing. Increased competition and innovation in the annuity market has diminished the usefulness of the straight deduction to gilt yields approach which has been adopted in the past.

If the aim is to replicate market rates at a certain point in time, then surely it would be more straightforward to publish annual tables of market-derived annuity rates for use in SMPIs. For members within a year of retirement, these will be directly based on market annuity rates, either at a point in time or averaged over the previous year. For members further from retirement, these will be blended into the long-term rates, as discussed subsequently.

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)

A non-market annuity rate for members further away from retirement has some appeal, although it will take quite a brave soul to nail his colours to the mast on what the appropriate long-term yield should be, and we note that no proposal has been made in the consultation document.

If such an approach was to be adopted, we feel it is essential that a blended approach is taken rather than a step up at say age 55. We do not anticipate that this would add too much complexity to the calculation.

Further, if market rates were published for those close to retirement, this would enable the publication of 2D table giving SMPI immediate annuity rates for all ages. This would ensure consistency across different providers, and save a lot of programming costs in terms of 2D annuity generators which are not a core specialism of most administration teams.

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)

We do not see any benefit in using a blended yield rather than at a particular date. Whilst a figure at 15 February may be considered high or low with the benefit of hindsight, it is nevertheless the most recent snapshot of the market’s view of future interest rates and can therefore be considered more accurate than an averaged amount, which might not reflect changes in bank base rates, inflation forecasts, etc.

On balance, we would suggest that the current 6-week gap between 15 Feb and 6 Apr is about right.

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)

4% is, as is said in the document, very broad brush. It takes no account of the economies of scale available to a large pension pot and risks overstating the annuity available from a small pot. However it is administratively easy to apply.

The alternative might be to assume that a fixed amount will be deducted from the retirement pot, which, based on our experience of modelling annuity rates available from different purchase prices, might prove a better fit. For instance the PPF assumes £500 per deferred member in its valuations.

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)

The more fundamental question, given that pre-retirement inflation (and salary increases) is fixed at 2.5% pa, is whether a long term real rate of return on equities of 4.5% reasonable?

Historically, 4.5% pa does seem reasonable, although this has certainly not been achieved in the last decade. There is a balance to be achieved here between encouraging adequate pension saving and making a worthwhile retirement outcome seem unachievable. Certainly we would consider an assumption of over 4.5% pa to be overly ambitious and would be comfortable with a reduction to say 4% pa, both to manage savers' expectations and to make a broad brush allowance for the likelihood and advisability of lifestyling as members approach retirement.

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)

TM1.3 Para 15.1.1 notes that the "maximum annual accumulation rate" of 7% pa as stipulated in Appendix D3.1 "...implicitly assumes that assets are invested before retirement in a mix of investments, predominantly equity-type investments." Within the narrow scope of this statement, we have no opinion on the appropriateness of the 7% pa figure as a cap on the rate that can be assumed here.

A large number of members will be investing in accordance with scheme lifestyling strategies, which are indeed predominantly equity-based until the active profiling period commences, when we see a proportionate reduction in the equity holding in favour of gilts and cash based investments.

However, some lifestyling matrices are based on a 5-year active profiling period whilst others work on a 10-year basis – both are relatively commonplace - and in exceptional cases we have come across longer active profiling periods. In addition, the rate at which equity holdings are reduced proportionately year-on-year will vary even between lifestyling strategies with the same profiling cycle: so the point at which equity investments cease to be the dominant asset type will be different in each case. So even given the same overall projection term, the period during which investments can be assumed to remain invested in "predominantly equity-type investments" will not be consistent across all schemes.

The problem is compounded by the fact that the approach taken by providers in their approach here is very inconsistent. A relatively minor number of providers continue to assume universal gross investment returns (generally 7% pa) across the whole membership regardless of investment strategy, even where the majority of members within those schemes are investing in accordance with lifestyling strategies. Others will assume fund- or asset-type specific returns with lower gross investment returns being assumed on cash and gilt / bond holdings, but even here the approach varies widely: some base the assumption on the apportionment of the member's fund value at the illustration date without regard to future changes, whilst others will routinely require that we take account of pre-determined changes in the asset allocation mix (and by extension in the aggregate annual investment return) as set out in the lifestyling profile.

Others will require that we assume different rates of return for holdings secured by each contribution type to reflect scenarios where different contribution types in accordance with different investment strategies – for example, a member may have only joined the pension scheme recently and will have made only a few months' regular contributions by the time of the illustration date, but may have transferred in a large one-off sum from a previous scheme which is invested in the cash fund for example. Over time the fund that is accumulated through investment of regular contributions will come to represent an increasingly greater proportion of the overall fund value, but at the illustration date the transferred-in (cash fund) will be the dominant component of the overall fund value, hence the request that we assume different rates of return on holdings secured by regular contributions and transfers-in respectively.

For similar reasons, some providers will require that we calculate separate returns on the accumulated fund and on projected contributions to take account of situations where members have built up a fund based on one

investment strategy but have recently instructed that future contributions be invested in line with a different investment strategy.

Throughout all these scenarios, even where lower returns are being assumed on non-equity asset types, the rate of gross return that is assumed in each case will vary from provider to provider. The same is true of what allowance is made for AMCs on holdings in each asset type, which will impact still further on what net investment return is eventually arrived at.

In our responses to earlier questions we have already detailed our concerns over the disparity between providers in what assumptions are made around investment returns.

In addition, the statement within Para 15.1.2 that "...it will definitely be appropriate to consider the use of a reduced rate in cases where the Current fund is invested in cash or deposit funds" only concerns itself with asset allocation of the "current fund". As noted above, a large number of members will be investing in accordance with lifestyle strategies, but the point at which active profiling commences and the rate of change from equity to non-equity asset types year-on-year within the active profiling period (and therefore the length of time over which holdings will remain invested in "predominantly equity-type investments") can and does vary markedly from scheme to scheme. So to consider two members in two different schemes, each currently investing in accordance with the scheme lifestyling strategy and each with a projected 20 years to go until retirement: Member A is investing in a lifestyling strategy with a 5-year active profiling period, whilst Member B is investing in a lifestyling strategy with a 10-year lifestyling strategy, so the proportion of the 20-year projection term during which the fund value will be invested in "predominantly equity-type investments" will be different in each case. So even though both members would potentially be investing in wholly equity-based funds at the illustration date, are we saying that it would be appropriate to assume a 7% pa gross investment return in each case when the respective circumstances are so different? Member B in particular will only be investing in "predominantly equity-type investments" for a little over 50% of the projection term, whilst with Member A equity will remain the dominant asset type in the member's fund value for just over 75% of the projection term.

So the framework is certainly there to assume a higher rate of initial return followed by a period of diminishing investment returns, with the term in each case being geared to each member's circumstances. However, whilst many providers do make explicit allowance in the returns that they assume for lifestyling members to take account of pre-determined movement in the investment spread, a significant number still do not. The catch perhaps is in the fact that the statement referred to in Para 15.1.2 states that providers MUST "use an appropriately reduced...rate" in certain circumstances, this is only where the provider "expects" the maximum accumulation rate to lead to an overstating of the member's projection. Different providers will adopt different conclusions here, so again this is contributing to inconsistency in approach.

In summary, we would suggest that:

- Given that the majority of members across schemes will almost certainly be investing in lifestyling strategies, but that the nature of such strategies can vary markedly between schemes, we would suggest that the concept of the "maximum accumulation rate" as currently defined within TM1.3 should be overhauled altogether. Implicit in this thinking here is that the circumstances in which the "maximum accumulation rate" as currently specified in Appendix D3.1 is deemed not to be appropriate should not be restricted simply to those scenarios where the "...Current fund is invested in cash or deposit funds", or "Where the Provider expects the rate in paragraph D3.1 to overstate the investment potential of the Member's contract or arrangement";
- We dispense altogether with the "maximum accumulation rate" in Appendix D3.1, and with all the various caveats and qualifying statements around when a lower rate "must" or "should" be assumed, and instead mandate gross investment returns for each asset type within TM1. As the gross investment return mandated for equity (and possibly property) would be expected to be greater than those for other asset types, this will effectively replace the current "maximum accumulation rate" in setting a cap on the returns that can be assumed for holdings in those particular asset types, but will eliminate the scope for unreasonably excessive returns to be assumed on other asset types and ensure consistency in approach between providers here;
- Where members are investing in lifestyling strategies, with pre-determined changes in the asset allocation mix, the projection must reflect this for each member as a pre-determined diminishing investment return throughout the projected active profiling period;

- You could possibly look to address scenarios where members have accumulated a current fund value based on one strategy but have recently redirected contributions in line with a different strategy or where different contribution types are being invested in accordance with different investment strategies. However, we think there is much less of an imperative here, and that this is something that can safely be left to provider discretion depending on how significant an issue these scenarios represent within the membership of their scheme. The need to ensure consistency in the approach that providers take towards investment returns on different asset types, and with lifestyling in particular, is we feel much more important because we are considering what in many cases will be default investment strategies covering the bulk of the membership.

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

See comments for 16 – the nominal return and inflation assumption need to be considered in tandem.

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

The risk here is underestimating members' future contributions and thus their accumulated pot. This could lead either to members contributing more than they would realistically be required to meet their ultimate needs, or to fail to contribute a sufficient and ultimately affordable amount because their savings goal seemed unachievable. However, given that SMPIs are produced on an annual basis, and that people's salaries do not generally increase smoothly, we think there is more risk associated with savers taking advance credit for a level of salary increase that might not be achieved. Any salary increases in excess of inflation achieved by a member will be built into subsequent SMPIs and taken into account in the member's retirement planning.

Therefore the implicit assumption that salaries increase with RPI seems the most pragmatic approach.

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

According to Para 6.37 of the consultancy paper: whilst "...Paragraph A2.13 of Appendix A of TM1 states that providers should consider giving a description of any guarantees which may apply...there is no requirement, in either TM1 or the governing legislation, for the calculations to take account of any such guarantees."

This statement is potentially misleading in that, by stating that "there is no requirement" for guarantees to be taken into account within SMPI illustrations, it implies that providers may still allow for guarantees if they choose to do so.

In actual fact, TM1 specifically prohibits making any allowance for guarantees where these exist in practice, even should the provider wish to do so (at least insofar as use of guaranteed annuity rates is concerned). TM1.3 Para 11.2.3 states that: "In some cases, the Scheme will contain a guarantee of annuity terms which produces...a higher amount of initial pension as at the Retirement date...and/or...a higher amount of pension in a subsequent year...than would otherwise be produced by the use of the assumptions in this Technical Memorandum...In these cases, Providers must provide an Illustration based on the assumptions in this Technical Memorandum, taking no account of the guarantee."

Whilst we have no strong opinion in favour of any proposal to update SMPI to permit the use of guarantees in assumptions, we would have no objection to allowing such an option at the discretion of the provider. However, if such a proposal is approved, we think that the guidance should mandate that – where guaranteed annuity rates are used in the illustration – this should be clearly stated in the accompanying notes; with a cautionary note around the implications should the guaranteed rates be subject to revision or removal at some future date.

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

n/a

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

In our experience, many members have a tendency to compare projections and frequently query discrepancies, even where they are not comparing like-for-like in terms of illustration date or assumption basis.

We agree entirely that there should be more consistency between TM1 (SMPI illustrations) and the FSA Handbook (point of sale illustrations), because the finer points of why there should be so much variance between the two – and in particular why one illustration should be expressed in real terms and another in absolute terms – will be lost on the majority of members. However, at the same time, we appreciate your comments at Para 7.7 of the consultancy paper and the concluding comment that “The expected timetable of the PRIPs review means that it may not be possible to harmonise the TM1 basis and the FSA rules in the short term.”

Given that providers will at one time or another be required to produce point of sale illustrations and SMPI illustrations in what is a single retirement fund, there can be no logic from the member's perspective in receiving two illustrations that have been prepared on radically different assumption bases. Two conflicting sets of regulatory guidance add up to a recipe for confusion, and in the interests of “Treating Customers Fairly” the two need to be harmonised at the earliest opportunity.

Similarly, it is not something that is directly referred to within the scope of this consultancy paper, we think it is worth considering web illustrations in the same context. Web illustrations are not currently subject to the requirements of TM1 and TM1.3 Para 1.3.1 points out that “...the term Illustration means an illustration for the purposes of Section 113 of the Pension Schemes Act 1993” and that “...the question of the provision of Illustrations by alternative methods (such as electronically, or by posting on a website) is a matter for the relevant legislation.”

Nevertheless, members inevitably compare illustrations that they have produced on the scheme website with their most recent SMPI, and they will query any apparent anomalies. Web illustrations produced by Capita Hartshead are based on the same assumption basis as the annual SMPs and indeed utilise the same underlying calculation program, and we voluntarily apply the requirements of TM1 (as used in the annual SMPs that we produce for each scheme that we administer) to our web illustrations in order to ensure that the two are consistent.

Over the past couple of years in particular, we have seen a significant increase in the number of schemes which are providing members with the means to produce illustrations via scheme websites, and feel very strongly that some attempt should be made to formally bring web illustrations within the scope of TM1 to ensure that they are broadly consistent with SMPI. Web projection routines should provide members with the facility to override certain factors in order to gauge the illustrative effect of changes in certain variables (such as contribution rate or investment return), but there is still a “core” illustration that is based on the model scheme basis. The principle involved here is very similar to that on SMPI where some providers may choose to issue additional comparative illustrations. Just as SMPs are required to meet the requirements of TM1 but it is not compulsory for comparative illustrations to do so, it would surely be possible for core web projections to be subject to TM1 but for any bespoke illustrations produced by members in relation to “what if?” scenarios where they have overridden certain variables to fall outside the scope of TM1.

We believe that the proposal to remove the mandatory requirement for certain express statements to be included in the notes which accompany the SMPI, in favour of optional “signposting” towards other sources of information such as scheme websites, provides an added imperative around the need to look at web illustrations more closely alongside SMPI.

[23. Do respondents have any views on the approach set out in paragraph 7.8?](#)

We think (a) and (b) are eminently sensible proposals for ensuring that providers attempt to minimise any confusion and misunderstanding that might arise from comparison of the two sets of illustrations, pending a longer-term solution. With regard to (b), by the same token SMPI providers might also opt to show an absolute terms equivalent of the SMPI and any comparative illustrations that they are already issuing alongside that, but we would urge caution. We think the decision to illustrate projections in real terms has been one of the biggest single positives around SMPI, and would suggest that it is the FSA approach that needs to be reconsidered here rather than the reverse.

However, whilst such significant differences between the two exist in how the projected retirement fund is calculated, we are not sure that (c) would offer anything meaningful in terms of clarification. If the respective annuity purchase sums in the SMPI and point of sale illustrations have been projected assuming significantly investment returns, then even assuming proposal (b) is adopted and members have a real terms point of sale illustration available for comparison, they will in many cases conceivably be looking at annuity purchase sums with a variance in the order of thousands of pounds.

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

We would urge caution here – responses to Questions 1, 2, 6 & 22 have all touched on the proposal to allow “signposting” and have highlighted the risks and attending concerns that we see around this.

It is not disputed that the DWP changes “...will enable the production of shorter, simpler SMPs”, but our real concern is that this could well be at the expense of transparency and standards.

Consequently, any proposals made off the back of such an assumption would be inherently flawed, and we feel that the removal of mandated requirements around what statements “must” accompany the SMPI in favour of optional “signposting” to alternative sources of information risks undermining the stated aims of TM1. It is the accompanying statements that currently allow the information provided in that statement to be put into context, and meaningful assessment to be made in conjunction with illustrations received from other providers.

All of that having been said, you have proposed “...that TM1 should continue to require providers to consider stating each of the important assumptions used and the key data (including fund value and contributions made)” and that “signposting” should only be allowed “For most of the other statements which TM1 currently states providers should consider giving”.

If the proposal is adopted on this basis, then we would suggest that the definition of what constitutes “important assumptions and...key data” as opposed to “most of the other statements” is something that needs to be mandated within TM1. If this is left to provider discretion then different providers will inevitably have different ideas in some areas around what constitutes an “important assumption” and what by implication is not important. In addition, when producing SMPs the concern of each provider will quite naturally be restricted to the individual pension scheme or arrangement, but as recognised in Para 3.6 of the consultancy paper we need to recognise that some members will be receiving illustrations from more than one provider in relation to different pension schemes and they will need to pull everything together and make sense of it in order to assess the adequacy of their overall pension provision. For that reason again, there needs to be standardisation around what “important assumptions” must continue to be reflected in statements by provider, and where exactly the option for “signposting” will be permitted.

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?

If the final version of the revised TM1 is forthcoming in autumn 2010, and we then have a window through to 6 April 2011 to complete development and testing, then we agree that this will represent ample time for the providers to make the relevant changes to their systems.

You have stated in Para 9.3 of the consultancy paper that “...it has also been suggested that it may be better for changes to be staggered”, and we agree wholeheartedly with this assessment. If it is felt that it is important for changes to be made to TM1 in order to meet its stated aim and ensure that SMPs remain fit for purpose, then those changes need to be made sooner rather than later. The changes to SMPI should be made as soon as is reasonably possible following publication of the revised version of TM1.

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)

We think this would be very helpful in helping members to understand their SMPs, because as you point out it will assist active members in understanding the impact of their contributions in isolation and “...how a change to the level of contributions could affect their pension.” This would have value not only in demonstrating the illustrative effect of any variation in the contribution rate but, perhaps more importantly given that statistically

many active members will not remain active members of the scheme through to retirement, the illustrative effect of what would happen should they cease active membership of the scheme (following which no further contributions will of course be paid into the member's retirement fund).

This would potentially create a dilemma for any providers who are currently issuing comparative illustrations alongside the actual SMPI (for example, to demonstrate the illustrative effects of variance in annual investment return), because they would potentially then be faced with doubling the number of comparative illustrations that they issue so each of those are similarly presented on both an "active" and a "deferred" basis. However, as the issuing of comparative illustrations is not a TM1 requirement but rather is something that providers may opt to do outside the scope of TM1, it should not be a consideration here if it is felt that there would be significant benefit in taking the approach under consideration.

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)

Please see response to Question 2.

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)

We have no strong objection to such a proposal.

Standardisation of some of the language around accompanying statements would we think be very beneficial, and would be additionally useful in promoting the furtherance of "plain English" within SMPs. With impending changes in what statements "must" continue to accompany illustrations and what statements may be dispensed with in favour of "signposting" towards alternative sources of information, it would also help to ensure consistency around what "important" statements are retained, although as noted above we would prefer to see this mandated explicitly within TM1 itself. So clearly there would be potential benefits to be had for members around consistency of format, and particularly for members who need to collate illustrations from different providers in assessing the adequacy of their overall retirement provision.

If this proposal is taken forward, we think that the suite of "best practice" SMPs is something that needs to be developed by a body that encompasses a cross-section of the industry, including both small and large providers, so that all the varying needs are taken into account.

11.2

In addition to the specific questions listed above, the BAS invites respondents' views on any other aspects of TM1.

Please see supplementary comments around web illustrations – provisionally included as part of our response to Question 22 for context.

We hope that our comments are of use to your consultation process.

Yours sincerely

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