

BOARD OF ACTUARIAL STANDARDS: CONSULTATION PAPER ON TM1 (STATUTORY ILLUSTRATIONS OF MONEY PURCHASE BENEFITS)

HYMANS ROBERTSON'S RESPONSE TO BAS' CONSULTATION ON TM1

In March 2010 the Board of Actuarial Standards (BAS) published a consultation paper on TM1: Statutory Illustrations for Money Purchase Benefits. This is Hymans Robertson LLP's response to that consultation.

HYMANS ROBERTSON'S VIEWS

We welcome the publication of this consultation paper and support the aims it sets out to achieve. However, we feel that the paper is looking at too many aspects in order to solve the concerns over TM1. We believe that the solution is that TM1 should be withdrawn and replaced by a directive to schemes and providers to ensure that members have the correct information in order to make educated decisions about their pension. We appreciate that this is outside the remit of the Board. However, we are of the view that TM1 does not provide the information individuals need to make informed decisions and making adjustments to it will not resolve these problems. We, therefore, urge the Board to liaise with the Department of Work and Pensions ("DWP") so that we are able to work towards an approach that meets users' needs better. We elaborate on this further below. We have also answered your questions in the appendix recognising that at least in the short term TM1 will need to be amended to reflect changing market conditions.

We continue to support the stated intentions for providing Statutory Money Purchase Illustrations ("SMPI") as stated in paragraph 1.1.1 of TM1, but share BAS' view that "significant uncertainties" in illustrations are not addressed by SMPs. We would also say that it has failed on the intention to assist individuals understand the "extent to which they need to make further provisions".

We believe that in simply adjusting the assumptions provided under TM1, SMPs will continue to fail. The problem is more fundamental than this. We believe that a radical change is required, one which TM1 is unlikely to be best-placed to deliver.

The question here is actually about how to educate members so that they have the knowledge and understanding to make choices and decisions about their pension. Effective communication is the key to this and our research has the same findings as that of the DWP. The annual benefit statement is the document which members are most likely to read and take action on.

Finding a set of assumptions to suit everyone in a DC pension is impossible. Including too many scenarios will confuse members. The answer is to raise the level of understanding so that members can understand for themselves how well prepared they are for retirement.

A lot of time and money is currently invested by schemes and providers to issue SMPI statements annually to members. We do not feel that this time and money is well spent and that it should be redirected towards a more effective communication strategy. This would probably need to begin with raising awareness so that members are encouraged to engage with their pension. We would recommend continuing with a personalised communication because we know that it is more likely to be read by a member. But the communication messages need to be clearer and more direct so that members are encouraged to take action.

We recently commissioned a survey, similar to that undertaken by the DWP which supports its findings. However, producing a one-size-fits-all format limits the information which can be provided to members. For

example, providing an inflation-linked pension may be the type of benefit which is attractive to one member but not another. Additionally, telling members that there are investment risks and showing a series of potential outcomes may confuse them and prevents them from making an informed decision.

We believe that education is the key to success.

The emphasis is on the provider to decide the type of information and the format in which it is supplied to members once they have done some research into the audience. Clearly, some ground rules will be required, but providing legislation in the format of principles rather than strict methodology is a better way for providers to supply members with information.

If SMPIs are to remain then we agree that interaction is required with the Financial Services Authority ("FSA") Handbook to achieve consistency between projections provided at the point of sale of certain products and SMPI projections. It simply does not make sense to deliver ongoing projections that differ from those given at point of sale. Not only is this confusing, but it could have the effect of making them irrelevant to members.

We appreciate that our suggested approach would take time to develop but it is a more realistic approach to achieving the objective.

In the interim we feel that in its present format TM1 requires some adjustments to the assumptions used and we have answered the specific questions in the appendix attached to this response.

ENQUIRIES

If you have any comments on this response, please address them to Stuart Vincent, whose contact details are below.

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For and on behalf of Hymans Robertson LLP

APPENDIX

This appendix gives Hymans Robertson LLP's direct responses to BAS' questions highlighted in its consultation paper on TM1. As noted we have answered the questions on the basis that TM1 will need to remain in force at least in the short term in its current form and hence needs to be updated. However, we believe that in its current form, TM1 does not meet its objectives or the needs of individuals.

- 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 aims.**

Please refer to our main response for the answer to this question.

- 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.**

Please refer to our main response for the answer to this question. In addition, there is a trail of thought that providing stochastic projections would be the best way to educate members on the uncertainties inherent in their projection. However, it may be the case that some providers are ill-equipped to offer this and there would also be cost implications in some cases. We would also be concerned that many members may be currently ill-equipped to understand stochastic projections correctly.

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

We agree with the stated aim in paragraph 2.4.

- 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 SMPs?**

We have no issues regarding the contents of TM1.

- 5 Could any changes be made to the structure of TM1 to improve its clarity?**

We have no issues regarding the structure of TM1.

- 6 What views do respondents have on our proposal to reduce the level of detail in which TM1 sets out the calculation methodology?**

We are comfortable with the current level of detail. If the level of detail in TM1 is reduced we feel that new providers may struggle to comply with the regulations.

- 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?**

We understand that by showing the level of pension at retirement which would increase in line with inflation illustrates to individuals what they will get if they want to protect their income in retirement. In practice, though, the vast majority of individuals opt to purchase a level pension on retirement. As such, the SMP does not illustrate the level of pension most individuals will actually opt for on retirement. We are reluctant to suggest that both options be included in a statement as the more scenarios illustrated, the more confusing a statement will be. Which option to include in TM1 will depend on what the Board wishes TM1 to achieve; either to illustrate the pension a member will get on retirement or to illustrate how much more an individual needs to save to inflation link their pension.

8 In respondent's experience what proportion of members on retirement opt to take annuities with index-linking, fixed increases or no increases?

In our experience, the vast majority of individuals opt to purchase a level pension.

9 Do respondents have any comments concerning the option to take a cash sum at retirement?

Similarly to question 7, it should be noted that the majority of individuals opt to take a cash sum at retirement and if the aim is to illustrate what they are likely to receive on retirement, then there is an argument for including a cash sum in the illustration. However, there is a rationale, as with pension increases, for not showing the cash option not least as there is no guarantee that this option will be available in the future.

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?

We support a review of these assumptions. We would encourage BAS to create an assumptions discussion group who, based on experience of insurance companies, confirm the mortality assumptions to be used each year.

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

We would not recommend any changes. Whilst insurers are purporting to be using more information at the individual level to set their longevity assumption, this is far too complex an approach to be replicated in TM1. We also believe that there is little to be gained from permitting the longevity table to be set reflecting in general terms the characteristics of the members of an arrangement; at the individual level this is likely to be as inaccurate as the use of a standard table as we currently have in TM1. An approach to allow arrangement specific longevity would create inconsistency between projections received by an individual who is a member of two different money purchase arrangements.

12 Do respondents agree with the proposal to change the yield used for annuity calculations?

We support a review of these assumptions. We would encourage BAS to create an assumptions discussion group who, based on experience of insurance companies, confirm the net annuity yield to be used each year. We note, though, that the suggestion made in the consultation seems more in line with the yields being used in the bulk annuity market. The yields in the individual annuity market are far lower; generally with a significant margin below gilt yields. As such, the proposal will lead to overly optimistic projections.

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?

We would not recommend any changes. The use of such an approach would mean that the non-market rate would need to be blended into the market rate over a number of years. This would add a level of unwarranted complexity and subjectivity.

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?

The current approach has significant merits as it helps keep the statements as simple to produce as possible and for those more than a few years away from retirement, the fact that the yield is out of date is not overly relevant in terms of what the statement is trying to achieve. But for those closer to retirement, fixing the rate in this way will lead to the statement giving an inaccurate illustration of the likely level of pension on retirement and

may be a hindrance to retirement planning. As such, there seems to merit in using a more up to date yield for those closer to retirement though to do so would add a level of complexity.

15 Are the expenses assumptions currently specified in TM1, reasonable, in particular, the assumption of 4% of the value of the annuity at retirement?

We support a review of these assumptions. We would encourage BAS to create an assumptions discussion group who, based on experience of insurance companies, confirm the expense assumptions (though continue to encourage scheme-specific assumptions should they be known). We would encourage that the assumptions continue in a similar broad-brush format (e.g. fixed percentage for annuity expense loading).

16 Do respondents have any comments on the appropriateness of the long term maximum rate of accumulation of 7% pa?

We would not recommend any changes as we consider this to be a reasonable assumption. We would encourage that this is regularly reviewed by our suggested assumption discussion group.

We have concerns as to how this cap is being applied in practice by some providers. We believe that some providers use 7% as the default return for the illustration irrespective of the underlying investments. Even where thought is being given to the underlying investments held by an individual, we think that the cap is being applied inconsistently. For example, consider an individual with two investments (50% of assets in each) that might conceivably return 8% p.a. and 6% p.a. respectively. Some providers are applying a cap to the 8% return, which when averaged with the second fund gives a total return of 6.5% p.a.. Other providers average first to get 7% p.a. and then apply the cap.

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?

We apply a lower level of investment return based on the investment choice of each member. However, as noted above, we suspect that this approach is rarely used by other providers. Should it be agreed that SMPIs continue in its current format, we support a strengthening of the wording in TM1 as the current format allows providers to apply 7% pa for all pre-retirement investment returns (which, for example, is unrealistic as a return on cash).

18 Do respondents have any comments on the long term inflation assumption of 2.5% pa?

We would not recommend any changes as we consider this to be a reasonable long term assumption albeit that the use of a fixed assumption in this way is inconsistent with the use of current yields being used for investment return assumptions. We would encourage that this is regularly reviewed by our suggested assumption discussion group.

19 Do respondents have any comments on the long term earnings inflation assumption of 2.5% pa?

Clearly the assumption that earnings will not grow faster than inflation is not backed by long term experience. However, it is a sensible approach as it avoids the risk that the projection 'pre-books' higher contributions that might be paid if pay does grow faster than inflation. We would not recommend any changes.

20 Should TM1 require SMPI projections to allow for guarantees?

We would encourage TM1 to be changed to allow for scheme-specific guarantees which may be in place. To not reflect guarantees, the statement is not reflecting what an individual might receive on retirement.

21 Is the approach for with-profit funds set out in section 6.7 of TM1 appropriate?

We do not have a specific view on this question. However, we feel that BAS should take guidance from responses provided by life insurers and we would encourage that this is reviewed by our suggested assumption discussion group.

22 Would pension scheme members' benefit from the FSA and TM1 bases being harmonised?

We agree that individuals will benefit from the FSA and TM1 bases being harmonised and would encourage that these bases are harmonised as soon as possible. We would not want to see the harmonisation being carried out, however, at the expense of providing something useful to individuals. In short, we believe that a harmonised approach would be closer to the SMPI approach than to the current FSA requirements in terms of financial assumptions.

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

We do not believe that (a) would be factually correct. For a mixed fund (mainly in equities with some bonds for instance) an SMPI is likely to use a return figure of less than 7% p.a. We don't think that (b) or (c) will prove to be overly helpful as they would mean several figures being presented at the same time on different bases which can only lead to confusion. As such, we feel that the Board and the FSA need to reach agreement on what is a 'right' standard approach to take.

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

We are supportive of any measure to make information provided to individuals easier to understand. For many, the detail underlying the assumptions is not something that they wish to see but for others and advisers, this detail is clearly important.

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

Based on the intention to provide a revised TM1 in autumn 2010, this is likely to leave a period of 6 months or less for systems to be changed and tested. The difficulties of making these changes in time will be dependent on the changes to be made, but we would expect this to be a tight deadline. We encourage BAS to consider the expectation of trustees and members about prompt provision of illustrations after the illustration date and not the statutory deadline for furnishing members with those illustrations.

26 Would an illustration of the pension attributable to contributions already made help recipients of SMPIs and if so, should there be a requirement for this to be shown on SMPIs?

We agree that this could be a useful addition. The split for members would provide useful information and this should not be too complex for providers to produce.

27 Do respondents believe that recipients of SMPIs would benefit from additional information illustrating the uncertainty in the amount of the illustrated pension? If so, how would this be best achieved?

Please refer to our main response for the answer to this question. Our view is that it is important to illustrate the level of risk being run by individuals and this can be seen to lead to an element of stochastic projections being brought into the process. The key, then, is how to communicate effectively with individuals and the education provided to them. Whilst the introduction of stochastic projections may be a sea-change for many providers, we are seeing that they are being introduced as a matter of good practice by some. We would be more than happy to discuss with the Board how such seemingly complex calculations can be communicated effectively and simply to individuals.

**28 Would the production of a suite of “best practice” SMPIs be of benefit to members and providers?
If a suite of “best practice” SMPIs is developed who should maintain it?**

We do not support the use of such a suite. It should be left to each provider to decide how best to communicate with their members. This is particularly important if we are to move to a more complex approach such as a stochastic projection of outcomes.