

# MERCER

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28 May 2010

Subject: Consultation Paper: TM1: Statutory Illustrations Of Money Purchase Benefits

Dear Sir / Madam

We welcome the opportunity to respond to the consultation on amendments to TM1, published in March 2010.

Mercer Limited is a global leader for HR and related financial advice and services. In the UK, our client base includes employers and trustees providing occupational pension schemes to employees in all sectors of industry. We provide pensions advice and services to companies in the FTSE100, but we also have a large proportion of clients that are employers classed as "Small to Medium sized Enterprises", or trustees of pension schemes with sponsoring employers in this class. We will comment from this perspective.

Whilst we agree that there are areas of TM1 that need to be kept under review and updated from time to time, we believe that any changes should be minimal and only made if there is a very strong argument for doing so. This is important from both from a member (understanding) perspective and a provider/scheme (cost) perspective. Unfortunately we believe that SMPs are too often just filed away by members who do not fully understand or even read them and therefore any changes made should have the ultimate aim of trying to make them as user-friendly as possible.



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Our responses to the specific questions raised in the consultation are set out in the attached Appendix.

Yours faithfully

(by email)  
Dina McDonald



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## APPENDIX

*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.*

In our view SMPIs have achieved the aim of ensuring a consistency of assumptions across different arrangements, allowing pensions from several schemes to be combined and compared on a like for like basis. This means that, where an IFA is providing financial advice to a member, in theory the annual SMPI removes the need to produce a scheme specific retirement projection at normal retirement age for the member.

Further than this it is difficult to assess whether the aims of adequacy, extent of further provision and uncertainty issues have been met. We do not get many questions from members which suggests that in many instances members may not be reading or understanding much of what is sent to them.

It could be argued that the SMPI is too wordy and caveated at the moment. In terms of changing behaviour, a requirement to illustrate what effect an additional 1% future contribution would make to the member's pension would be useful.

*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)*

The obvious method that could be used to address the significant uncertainties is by providing illustrations on more than one basis, but we believe that extra numbers would simply confuse members even more. The use of graphics, would assist, but that puts too high a burden on providers.

In our view the best option would be a sign-posted link to a website containing a simple modeller. The modeller would enable members to put in a few basic details and broadly reproduce the figures on their SMPI. From there they could play around with some simple scenarios e.g. increasing/decreasing future contributions, changing the financial assumptions, changing the form of annuity taken etc. Obviously there are questions around the right body to develop and maintain this modeller. More pragmatically, catering for the



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detail of every contribution design (age and service related, matching, salary caps etc) would make it complex to create and, more importantly, difficult for users.

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

We do not believe the stated aims require modification.

*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? (paragraphs 4.2 and 4.3)*

We consider that the primary purpose of TM1 is to assist providers to produce the required illustrations and we have generally found TM1 to be thorough and complete when seeking explanations and assistance on specific issues, when programming calculations and when checking if any changes to calculations are needed.

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

We do not think this is necessary as users of TM1 are now familiar with how it is set out and changing the structure would be counter-productive.

*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)*

Omitting detail will inevitably cause divergence and lack of consistency in what different providers assume which would go against one of the stated aims. It may also be considered unhelpful to any providers that are producing SMPs for the first time - given the new auto-enrolment duties on employers it is likely that a number of new qualifying DC schemes will be set up over the next few years for which SMPs will need to be produced. It would limit the principal source of information and guidance on SMPs which would make it more difficult to answer queries.

We feel that it is more important that TM1 clearly sets out the calculation basis to avoid ambiguity than to reduce the level of detail.

*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)*

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We agree with this proposal and do not agree that the rationale given for the change is sufficiently strong.

There would be a risk in switching from only illustrating a single, RPI-escalating figure to only illustrating a non-escalating figure, since it would cause a significant increase in the pension illustrated. As schemes have been issuing statements on the current basis for a number of years, any change in practice could confuse members and mislead them as to their expected future income, particularly if they then chose an escalating annuity. Schemes would have to manage members' expectations on this and would need to explain the change carefully.

If a non-escalating pension were to be shown, we think this should continue to be an additional option rather than a requirement for schemes, as at present, despite most trustees not wanting to incur the cost of providing additional illustrations.

*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)*

We do not have any detailed statistics on this, but we have carried out an ad hoc analysis of members' decisions in the past which showed that approximately 75% of members choose a level annuity rather than an annuity that increases in payment.

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

Some scheme members and clients have suggested that a cash option could be shown on statements so this does indicate some demand for this.

However, many schemes would face significant challenges if this became a requirement, as it would add additional complexity to SMPI calculations and involve significant reprogramming with associated costs. In effect, the SMPI would become more scheme-specific rather than a generic illustration.

Some schemes would find it difficult to calculate the required cash figure (e.g. for a member who is entitled under HMRC transitional rules to a protected cash sum in relation to their

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service before 6 April 2006), and for these schemes the costs would be greater, particularly if manual calculations were involved.

Furthermore, in some cases there will be a minimum annuity purchase price and this may mean cash has to be restricted to ensure there are sufficient funds to meet this minimum price. It would therefore be necessary to add a further check within the calculations to ensure that the cash is restricted where necessary.

One possibility might be to automatically show a 25% cash sum and then add caveats to the effect that the cash might need restricting or could in certain cases be larger. However, such an approach might be misleading for the member.

Some members, on triviality grounds at least, may be able to take their full fund as cash, not necessarily tax free.

The other approach is to require schemes to include a broad statement explaining that a percentage of their fund could be taken as a cash lump sum and that the effect of this would be to reduce the pension illustrated by the same percentage. However, given the adequacy objective, just quoting pension is simplest and most important.

*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)*

We agree that the mortality basis should be updated as PMA92 and PFA92 are clearly out of date. However the assumption should be set with reference to what bases insurers are using for their pricing.

In relation to the first approach insurance company FSA returns for 2008 indicated that the majority already used the 00 tables as their base table. However they were already making adjustments to these tables e.g. Legal & General was using 90% of PCMA00 and 94% PCFA00, Canada Life 95% of PNMA00 and 84% of PNFA00. Similarly the suggestion of a 1.25% floor for males and 1% floor for females may already be out of date, with Prudential using 100% MC - min 2.25% (below the age of 90) for males and 75% MC - min 1.25% (below the age of 90) for females and Legal and General using 100% MC - min 2% (below the age of 90) for males and 75% MC - min 1.5% (below the age of 90) for females.



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The alternative option of using the CMI's mortality projection model would therefore be preferable in terms of the long term picture, with TM1 specifying the long term improvement rates to be adopted from time to time (or perhaps annually at the same time as specifying the annuity rate for the coming year). However this approach should ideally be informed by what insurance companies are doing as it makes sense for SMPs to have some kind of consistency with actual market practice.

Obviously it should be recognised that any change will involve programming changes and the consequential need for testing for providers.

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

This would be much more complex to program than just having a standard mortality table, and would make illustrations more scheme-specific than generic. Currently we could not follow this approach without amending the way our calculation functions work.

Additionally, we believe that this would be more of a hindrance than a help to members. In our experience the differences in mortality between individual members within a scheme far outweigh the differences in average mortality between different schemes. A standard table that all illustrations use will at least provide some consistency, as compared to illustrations that are not consistent as regards to mortality assumptions but that are also not directly relevant to each member (e.g. by being postcode/health related).

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

We do not have any strong views on this change.

*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)*

As for Q10, this would be more difficult to handle and would involve more programming changes.

We do not think the volatility in figures shown at younger ages should be viewed as a problem, since they reflect what actually happens in practice. Trying to remove the volatility

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might have the effect of lulling members into a false sense of security. Instead an explanation of the reason for the volatility is more important.

In addition trying to blend a fixed approach with a market approach would not only make the calculations more complex, but would also make the associated explanation to members much more challenging. If this change is made, will you be happy for SMPI wording to just say "in line with requirements"?

*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 agree that changing the 15 February fixed annuity date to some kind of smoothed market yield (e.g. last 6 months of calendar year) would reduce the volatility in the assumptions. However, given that we do not think that volatility in the illustrations is necessarily a bad thing, we have no strong views on whether the change should be made.

If this results in more frequent updates, there will be an additional programming and testing requirement for providers.

*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 do not have the necessary information to answer this question but if anything the charge should reflect market practice, especially for smaller schemes.

*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)*

Although this does look high in the current environment, TM1 makes it clear that this is a **maximum** figure.

Recent research conducted by colleagues working in the investment area regarding the performance of the typical lifestyle default over the last 5 years indicates that a 5 year lifestyle fund (50:50 Global Equity to 75:25 Fixed:Cash) would have provided a return of just over 7% p.a. gross, compared to the return on equities of over 8% p.a. for someone still in the growth phase.

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*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)*

Our standard programs can deal with any specific rate of return.

Where we act as adviser to trustees and member funds are invested in assets other than equities, the trustees are asked to consider their approach and whether a lower assumption should be used for SMPs. Once an approach has been agreed, it would generally be used year-on-year but reviewed if any material changes to the investment of member funds, or the economic environment, have occurred. We have a view that the 7% is too widely adopted in practice (and for all members of a scheme regardless of their investment choice), but varying the interest rate by fund for each member would be difficult to provide and may also be inappropriately adopted by members as a indicator of where to invest.

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

We have no specific comments on this assumption other than that the real investment return assumed should remain consistent.

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

Despite evidence that earnings growth exceeds inflation in the long term, we agree that having different long term earnings and inflation assumptions would make the explanation to members far too complex.

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

If guarantees apply it would make sense for the projections to allow for them. However it is likely that they would significantly complicate the calculations and we believe that it should therefore not be made mandatory.

We believe that schemes should be allowed to choose their own approach subject to adequate explanation being given i.e. the word "consider" should be dropped from the TM1 statement that "providers should consider giving a description of any guarantees" to make it into a stronger "providers should give a description of any guarantees".

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

We do not feel qualified to answer this question. However the bigger issue for SMPIs in respect of with profits projections is the continued use by providers of 7% interest, even though their underlying investments range from virtually zero equity content to 80% or so.

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

We think that achieving consistency between FSA and SMPI assumptions is important. Given that the aim of SMPIs is to provide consistency between the illustrations in respect of different products/schemes, it makes sense for there to be consistency in relation to the projections provided for the **same** product.

However, as the consultation acknowledges, it is the net rate that matters and section 7.6 is silent on the FSA inflation rate and the FSA central annuity rate, which perhaps need to be brought into the equation.

There is actually limited usage of FSA projections now, having been largely superseded by SMPIs. The main purpose of FSA projections is more focused on the impact of charges. It would be preferable for the FSA to focus on this, and accept the SMPI basis of pension projections.

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

Suggestions a) and b) seem reasonable for the time being, pending the further reviews discussed in the consultation.

However as already discussed c) should not be a requirement but an option. See 7 above.

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

We agree with the proposal to allow signposting. There are two approaches that could be taken – one is to allow it as an option, which would be our preferred approach; the other is to make it a requirement, which would require changes to SMPI statements and systems.



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Paragraph 9.2 of the consultation paper advises that any changes will be effective from 6 April 2011 and we assume this means that signposting would not be allowed until then. However, the revised disclosure regulations recently circulated by the Department for Work and Pensions permit signposting of information required under disclosure from 1 October 2010. More clarity would be required in relation to timing for schemes wishing to introduce signposting.

*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?*

Making changes by 6/4/11 will be difficult. We think that no changes should be required until 2012, when changes will be needed to reflect the abolition of protected rights. At that time, all changes could be made together. This would save both time and costs (as it would avoid doubling up of testing new programming/statement wording, potential resourcing issues etc). It should be noted that SMPIs were only changed as recently as last year and those changes were quite costly to make.

More importantly, deferring to 2012 would help to avoid confusing members as they would not receive changed SMPIs in two consecutive years (three years in some cases because of the changes announced in 2009). Rather, members could be given a covering note with their 2012 or 2013 SMPIs summarising all the changes which have been made.

Another point to consider is that in some cases the SMPI is not a standalone document but instead is built into the body of the annual benefit statement for the scheme. Therefore any changes to the SMPI will not just involve reprogramming or additional programming, but benefit statement templates may also have to be amended which will also have cost implications.

*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? (paragraph 10.2)*



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We have not had any feedback from clients or members on whether this would be helpful, but we believe there are clear advantages to what is suggested.

In particular, it would make it clearer for members as to what their existing contributions would buy and what pension could be bought by future contributions. In turn, this would help to demonstrate to members the impact on their pension of leaving the scheme or changing the level of contributions. It seems unrealistic to provide the sole statutory illustration based on "job for life" and "no benefit changes for life".

However we also need to remember that the projection is "hypothetical" as the projected illustration will still be based on the member's current contribution rate (and therefore providing a figure showing the pension from a future 1% contribution might be more helpful). There are also other underlying assumptions that have a major impact on the resulting pension and these could change as well, so that the rate or level of future contributions will not be the sole factor determining the eventual pension.

Although this change would add some complexity, we do not think the resulting amendments to the existing calculation methodology should be too onerous. The additional explanation required would hopefully be offset by the signposting referred to above.

*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)*

Mercer's standard is already to show two illustrations to reflect the uncertainty. We have not had any feedback from clients or members requesting any further illustrations, but we would make the comment that if too many illustrations are provided, or they become too detailed and involved, this is likely to be confusing for members and make it less likely that they will read and understand the contents.

*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 think it would be a good idea to make available a series of best practice statements at the time providers are having to make changes, so long as they were not compulsory and

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schemes could decide whether or not to use them. However, “best practice” catering for the needs of different schemes can easily mean longer.

If any standards were to become compulsory, we think they should only cover the minimum necessary to ensure compliance, making it clear that providers should tailor them beyond just meeting these requirements, and that there would need to be realistic timescales for introducing them.