

Board for Actuarial Standards

Consultation Paper: TM1: Statutory Illustrations of Money Purchase Benefits

Response from The Pensions Management Institute



PMI's response to the consultation from BAS on proposed changes to Technical Memorandum 1 (TM1)

Introduction

The Pensions Management Institute (PMI) is the professional body for people working in the pensions sector. The PMI's members (currently over 4,200) work as pensions managers, consultants and technical specialists in consultancies and insurance companies. Many are also actuaries, pensions lawyers or company secretaries. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response.

Background

PMI's membership reflects a range of different career streams active within the pensions industry. Our members include pensions managers, trustees and consultants. We are acutely aware of the importance to communicate complicated information to members in a format that is meaningful and accessible and so enables members to make informed decisions with confidence.

The PMI's response

- 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.*

SMPs are intended to help individuals understand if they are saving enough for retirement but, at the same time, appreciate that the very illustrations they are reading are, by their nature, uncertain. They are a great objective, but a lot to ask of someone whose understanding of, and interest in, the subject in question is limited.

SMPs strive to be understandable and consistent, and this is important. However, there are other imperatives that, unless met, mean that the illustrations are never absorbed at all. First and foremost, the statements should be concise, relevant and personalised. Without this brevity and context, they will remain unread.

As well as the content of the document being unsuitable, the form is poor too. A move towards more visually appealing formats delivered in a preferred medium would help the understanding of the recipient greatly.

The need to move towards simpler and shorter documents delivered in more compelling ways underpins this whole response. Hopefully, this will be enabled by the DWP draft regulations.

- 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)***

We believe that more should be done. Some sort of stochastic projection should be utilised to ensure that the reader recognises the inherent uncertainty of any projection. In order to overcome the fact that moving away from a deterministic approach means introducing complexity, we would suggest that the illustration is presented in a strong visual format such as the ‘funnel of doubt’ graph.

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

We would suggest a simplification:

“the aim is to provide illustrations to help individuals understand how much more they should save for retirement and to understand the dynamics that will affect that choice.”

- 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)***

All providers consider the production of SMPIs a necessary regulatory process, but one that they do not believe adds value to the customer. This is because they are not read.

However, to state that providers are comfortable with the requirements is to misperceive the problem. Although they can produce accurate SMPIs, generally they would rather supply a more attractive and compelling document that encourages higher levels of saving. In this respect the objectives of the provider, customer and legislation should be broadly aligned – i.e. to compel the member to make adequate retirement provision. Some providers consider providing an additional personalised document which is intended to add context. However, as adding an additional layer of explanation on top of the SMPI is thought to only increase confusion, most are resigned to adhere to the statutory obligations and rely on other means to increase savings rates.

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

Although TM1 is a lengthy document, we welcome the clarity that this level of detail provides. Providers benefit from having complete confidence that they are complying with regulatory requirements as this means they will not fall foul of compliance reviews and any requirement to re-issue statements where they had mis-interpreted what was required.

- 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)***

The requirements of the SMPI are now well understood and, other than new entrants, the market does not need this level of detail.

7. Do respondents agree with our proposal that TMI 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 do not consider this to be appropriate. Most individuals reaching retirement take a level annuity. Even if people understand the influencing factors they have certain income requirements. There is an affordability issue. This, together with the desirability to simplify and make consistent with FSA point of sale illustrations means that a pragmatic approach is appropriate. There is a danger that this will mean that individuals will underestimate their savings requirements, but since only those that have a reasonable understanding wade through the current illustrations anyway, the advantage of increased engagement outweighs the negative.

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)

Based on knowledge of the actual business of major providers we believe that the proportion of retiring members opting to take annuity increases is considerably less than 5%, with about twice as many taking a fixed increase than index-linking. We believe that the pragmatic solution is that the SMPI be based on a level income.

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

Almost everyone takes the tax free cash (and probably should). To be pragmatic, and to simplify and make consistent with FSA illustrations, this should be the assumption within SMPs. It should not have to be an additional illustration.

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 TMI? (paragraphs 6.7 to 6.16)

We would support a move to the mortality tables PCMA00 and PCFA00. Their widespread use by annuity providers confirms that these tables are the most suitable for the purpose here, namely illustrating what level of retirement income members can expect.

We do not support any attempt to align the assumptions in SMPs with the assumptions used by PPF to set levies. PPF have a completely different outlook on life from what SMPI is trying to achieve.

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

We do not favour tailoring the mortality basis in projections to the assumed experience of the workforce in question. This would lead to a spurious degree of apparent accuracy, as

the vagaries of investment performance will have much greater effect than the difference in mortality of different workforces.

It would also add a further burden on providers, who currently do not hold information on the mortality of the current workforce unless they also happen, by chance, to be the provider of the employer's group life contract.

For similar reasons we do not believe the use of Impaired Life Annuity assumptions is appropriate for TM1.

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

We support the proposal to remove the 0.5% deduction referred to in paragraph 6.19 for inflation linked projections.

If TM1 is amended to provide for pensions that do not increase, then we feel that the gilt yield proposed is too low. In practice, many level annuities issued by insurers are backed by good quality corporate bonds that generate rather better yields than gilts, even after making prudent assumptions for defaults. If you wish to amend TM1 to provide for level pensions, then we recommend you undertake further research in this field.

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

We would not support a move to a non-market related rate for younger members. It could lead to problems of over-estimating pensions if the non-market related rate gets out of line with actual rates.

It is perhaps no bad thing for younger members to see that they will be exposed to market risk when they come to buy their annuity.

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 would support a move to BAS publishing the interest rate to be used. This would enable BAS to set a rate that reflects the economic situation rather better than the rate on one arbitrary day, 15 February.

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)

Yes. However, this should be reviewed as the annuity approach for NEST takes shape. The annuitisation issue is one of the most critical for the low to moderately paid and the

pricing assumptions in the illustrations will need to reflect those experienced by the NEST constituency as well as those in traditional private sector arrangements.

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)

One of the stated objectives of SMPIs as it stands is to take into account the ‘significant uncertainties involved’. However, one of the most pervasive of these is not included: the risk associated with investment returns. Any reconsideration of assumed performance needs to consider the volatility associated with it. If the equity premium is to be assumed then the corresponding equity risk should also be illustrated.

One way that this could be achieved is to roll forward the historic performance experienced by the individual member. *‘your savings have grown at x% over the last 1/3/5 years. This has been accompanied by a corresponding level of volatility equivalent to y. If you continue to experience similar risk and return you are likely to enjoy a retirement income of between £a and £b’*. We appreciate that this would involve not inconsiderable effort by the providers but the added context it would give to each individual member would pay dividends in terms of the uplift in engagement levels.

An alternative approach to the issue of risk is to pick up on the excellent work being done by the IMA and ABI on a synthetic risk illustrator. This will ascribe specific levels of volatility to various asset classes. The ability to thus consistently assign a risk signature to any fund based on its objective and philosophy means that as long as it was understood which fund(s) the saver was in then their susceptibility to fluctuations in growth could be described. The planned move to a visualisation of this approach would make it even more effective.

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)

Most assume a lower assumed rate of return. See comments above about the possibility of using actual individual performance histories to provide a personalised approach.

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

Using the same figure for both price and earnings inflation is illogical, as fundamental to the whole idea of saving for a pension is that the economy will grow generating real rates for savers over inflation. And if the economy is growing in real terms then so will wages.

A price inflation assumption of 2.5% may be criticised as being out of line with Government’s target for consumer price inflation of 2%.

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

See question 18 above. We believe something like 3.0%pa for general earnings growth coupled with 2.5%pa for RPI would not be unreasonable long-term assumptions.

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

We do not support the additional complexity that attempting to mirror guarantees will bring. The guarantees may have conditions attached to them, such as no spouse provision, that may make them unattractive to consumers for other reasons.

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

We favour retaining the existing guidance of consistency with TMI and the insurer's bonus policy. The use of un-smoothed asset shares ignores the insurer's ability to use the strength of the life fund or other profits to smooth out market volatility, which would have been a major factor in the customer choosing with-profits in the first place.

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

Yes.

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

Adding extra illustrations as a way to engender consistency with the FSA will not meet the objectives of clarity and brevity. There needs to be a single set of assumptions, common to both documents that means a single, easily understood illustration. It may not be perfect but if its simplicity results in its being understood then it will have succeeded.

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

It is an excellent idea. The simpler the statutory illustration the better, with other information available elsewhere, through media of the respondent's choice. The ability to signpost to other media – telephone helplines, websites, modellers etc. means that further more complex and perhaps more varied options can be taken by those willing and able to engage in this.

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?*

The sooner changes are effected the better, although introducing any improvements in line with the launch of NEST would seem sensible.

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)*

Better to illustrate based on a continuation of historic savings and performance (risk and return) patterns. A truly individualised and contextual statement will drive understanding and engagement.

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 best be achieved? (paragraph 10.3)*

Yes – see previous comments about ‘funnel of doubt’ visuals or reference to previous personal risk/return signatures.

28. *Would the production of a suite of “best practice” SMPIs be of benefit to members and providers?*

Yes.

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