



**Scottish Widows response to Board for Actuarial Standards Consultation
Paper: TM1: Statutory Illustrations of Money Purchase Benefits**

Scottish Widows, which is part of Lloyds Banking Group, welcomes the opportunity to provide input into this DWP consultation. When combined with the heritage brands of Clerical Medical and Halifax Life we are the UK's largest investment, pensions and savings provider. In particular, we are a leading provider of defined contribution workplace pensions, including group personal pensions. In preparing our response, we have considered the proposals from the viewpoints of product provider, scheme administrator, scheme member and employer.

We are broadly supportive of the need to revisit Statutory Money Purchase Illustrations (SMPs). Since their introduction in 2003 these have become increasingly lengthy through the inclusion of explanations, assumptions and warning statements (often for the benefit of the provider rather than the consumer). The illustrations need to be de-cluttered, with their original purpose reinstated as a wake-up call to consumers.

However, with a lot of mandatory change required in the insurance and investment industry over the next few years, providers will face considerable challenges in terms of resources and costs. Our main concern is therefore that the consumer benefits derived from changing SMPs must be sufficient to justify the cost of introducing change. We would especially wish to see any changes to the calculations - beyond simple parameterised changes - made optional rather than mandatory.

If you wish to discuss any of the contents of this response or any other matters please do not hesitate to contact me.

A handwritten signature in black ink, appearing to read 'John Taylor'.

John Taylor
Market Director, Corporate Pensions
Scottish Widows
69 Morrison Street
Edinburgh
EH3 8YF

Telephone 0131 655 3922
e-mail john.taylor@scottishwidows.co.uk

Q1: 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.

A: SMPIs take into account an assumed rate of inflation to present the illustrative future pension amount in real (today's) terms. We feel that this is likely to assist in promoting consumer understanding – both in terms of the adequacy of their pension arrangements and the extent to which they need to make further provision - since they are able to contextualise the illustration against a set of circumstances that are meaningful to them.

However we feel that SMPIs have been less successful in alerting consumers to the significant uncertainties involved in using illustrations of benefits. Whilst a conscientious recipient may assess this by comparison of their current and previous statements, the natural tendencies of consumers will be to go straight to the single figure detailed in the illustration without referral to previous statements and without reading the accompanying assumptions and warnings. This may to a large extent be due to the fact that, since SMPIs were first introduced in 2003, providers have made the accompanying text increasingly voluminous and defensive, thus diluting the impact of the key messages regarding the uncertainty in the illustration.

Q2: 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.

A: We agree that it is important that the SMPI clearly explains the risks and uncertainties relating to the arrangement and that more does need to be done in this respect.

However we do not favour the use of additional figures to achieve this, since this approach may actually introduce more confusion for consumers than clarity. We would much rather see future developments to TM1 (that are intended to highlight these uncertainties) focussed on improving clarity in the statements that accompany the projected pension figure.

In this respect it would be useful if TM1 stipulated the explanatory/warning messages that must be output and restricted any further provider text on the illustration to signposting where it may be obtained. The desired outcome would be further strengthened by inclusion of a requirement such that providers must state that the illustration will vary from year to year (possibly significantly) and that this reflects the inherent uncertainty in the pension illustrated.

Q3: Should the stated aim in paragraph 2.4 be modified and if so how?

A: We feel that the purpose of the SMPI should be to serve as a wake-up call to consumers, alerting them to the (in)adequacy of their current pension provision whilst making it clear what factors contribute to the uncertainty in this assessment so that they may make informed decisions. We are happy that the aim stated in paragraph 2.4 achieves this.

Q4: 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?

A: If we are to maximise the effectiveness of SMPIs it is essential that providers are given a clearly articulated methodology for their production, calculation and presentation. It is helpful that this is currently supported and enhanced where appropriate by guidance and comment.

Not only is this especially valuable for staff who have not previously been involved with SMPI (and as we move towards final implementation of workplace personal pensions there will be many people who are likely to be reading TM1 for the first time), it will also help ensure that the *intention* of specific paragraphs is clearly brought out.

We would therefore urge BAS to retain (and indeed develop) the use of this facility within TM1.

Q5: Could any changes be made to the structure of TM1 to improve its clarity?

A: The current structure of TM1 is logical and well set-out. It is especially useful to have key assumptions and statements detailed in separate appendices to the main body of the document. However, with this in mind we would suggest that Appendix C (Northern Ireland Legislation) does not readily fit with this approach and perhaps could be better positioned in Section 2 of TM1.

Q6: What views do respondents have on our proposal to reduce the level of detail in which TM1 sets out the calculation methodology?

A: We believe that throughout TM1 it must remain clear through the use of prescriptive rules (rather than principles) as to exactly what calculations are prescribed.

However, we would be happy with a less detailed approach that permitted providers to take sensible decisions in seeking to meet the overall requirement. For example, in our view the detail required within Section 6.6 (calculating the period between two dates) is unnecessary. This could be removed and instead providers would be required to apply the principles of Section 6.2.1 to the calculation – this would let them take a reasonable approach that is aligned to their existing system functionality and result in zero client detriment.

Q7: 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?

A: It is essential that consumers understand the importance of ensuring that they have adequate retirement provision throughout their retirement and not simply at the point of retirement.

Index-linked annuities are expensive in comparison to level annuities and result in lower initial payments, sometimes taking years before the total income paid out matches that under a level annuity. However, whilst they may not be suitable for

poorer consumers and/or those with lower life expectancy, generally they offer protection against periods of higher than expected inflation that would lead to a substantial reduction in the value of a level annuity.

Therefore we agree with the proposal that TM1 should continue to require an index-linked basis for calculation of the annuity. In addition we feel that the relevant statement in Section A2.3.1 of TM1 should be enhanced to require providers to include an explanation of why index-linked annuities are an important consideration.

Q8: In respondents' experience what proportion of members on retirement opt to take annuities with index-linking, fixed pension increases and no increases?

A: Our own experience is that a very high proportion of our pension policyholders take a level annuity, with only a few choosing RPI-linked. As detailed in the response to the previous question, payment levels may be lower for several years than those under a comparable level annuity and this is likely to be a leading factor for this distribution.

Q9: Do respondents have any comments on paragraphs 5.5 to 5.6 concerning the option to take a cash sum at retirement?

A: We feel strongly that mandatory disclosure of cash sum and reduced pension would be inappropriate on several levels:

- we feel that the intention of the Disclosure legislation is that SMPs should communicate an illustration of the full pension that may be expected at retirement
- providers may currently, if they wish, supplement this by providing an illustration of the cash sum and reduced pension. However the complexities of the A Day legislation (and specifically the protections arising from it) mean that it is only feasible to do so assuming 25% of the fund is taken as cash. It is arguable how much value this adds for anyone who is entitled to a protected cash sum and will inevitably generate the need for further statements of assumptions and warnings, thereby potentially pulling against the intentions of this review
- providers who currently fully comply with TM1 and the intention of the Disclosure legislation by only providing an illustration of full pension will need to make potentially costly enhancements to calculation systems and output templates to accommodate such a change, with (as described) very little evidence to suggest there would be benefit for the consumer

Q10: 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?

A: Yes, we agree that the mortality tables should be updated. PCMA00 tables would be appropriate, although we would question the need for a differential between the sexes with regard to the floors on the annual improvements. We do not feel that there is sufficient evidence to warrant this.

Q11: Should TM1 allow providers to choose specific mortality tables which are appropriate for the members of the arrangement in question?

A: No, we believe that the use of a standard prescribed mortality table should continue. Whilst recognising that this is a fairly broad-brush approach, we feel that it is preferable because:

- it gives consumers a consistent assessment of the pension they may expect from year to year. This may be especially valuable for those who move around different employments and/or geographical locations who would otherwise receive SMPs based on different mortality assumptions
- the pension figure illustrated in the SMP is based on a wide range of assumptions both before and after retirement. Using a single prescribed mortality table avoids inclusion of requirements into TM1 that would introduce what would essentially be spurious accuracy

Q12: Do respondents agree with the proposal to change the yield used for annuity calculations?

A: The proposed removal of the 0.5% deduction from the annuity interest rate calculation would (in isolation) increase the annuity interest rate and hence the pension. We would suggest that now is not the right time to be increasing annuity interest rates, given the increasing concerns over longevity risk and Solvency II implications.

Q13: 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?

A: We would prefer to use the same annuity rate basis across all ages. Using a market-related rate gives some impression of the inherent variability in rates.

If there were to be changes here we feel that a blended approach across all ages would be preferable. That said, we do not feel strongly that change is actually warranted in this area: younger recipients will see changes to the pension illustrated year on year and there will likely be several reviews of the annuity interest rate anyway between now and when they are near retirement age. Older recipients will still have their calculation based on market-related rates so will see no difference.

Q14: 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?

A: The fixed reference date brings simplicity and we would be happy for it to remain at 15 February. We also point out that the calculation of this date (in TM1 Section 15.2) is deliberately consistent with the calculation of the Intermediate Rate "Y" in FSA COBS 13 Annex 2 R3.1 for use at point of sale. We strongly recommend that this consistency is maintained and that FSA and BAS work together to ensure that any future change is coordinated so as to minimise the impact on providers' systems and to retain the current consistency for consumers.

Q15: Are the expense assumptions currently specified in TM1 reasonable, in particular the assumption of 4% of the value of the annuity at retirement?

A: We are happy with the 4% assumption for annuities and do not feel there is any convincing argument for more sophistication in this area.

Where charges or expenses are not known and cannot reasonably be obtained or estimated, TM1 Section 16.1.4 requires providers to make an assumption of 1% a of the fund value at the start of each year. We would like to see a requirement such that the assumption on these must be realistic - accepting that it can be difficult to illustrate using actual charges in SIPPs for example, in many cases the actual level of charges could be well above 1% and this should be allowed for.

Q16. Do respondents have any comments on the appropriateness of the long term maximum rate of accumulation of 7% pa?

A: We are happy with this as a standard assumption.

Q17. 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?

A: Lloyds Banking Group is the result of the coming together of two very large organisations which themselves had been through previous mergers and acquisitions. Consequently there is currently some variation in approach among companies that are now part of the Group.

However we are actively working towards a consistent approach across our heritage businesses. This will move us to a point where the growth rates used in projections will always reflect what we believe to be realistic investment return assumptions and will be accompanied by the creation of a robust methodology and governance for setting/reviewing those assumptions.

Q18. Do respondents have any comments on the long term inflation assumption of 2.5% pa?

A: We are happy with this assumption. Whilst we suggest that it seems slightly low (3% would be nearer the mark), any increase to the RPI assumption will decrease the illustrated pension still further, at a time when there is already mismanagement of expectations between point of sale projections and SMPs.

Q19. Do respondents have any comments on the long term earnings inflation assumption of 2.5% pa?

A: Whilst we agree with the expectation that, in the medium to long term, earnings inflation will exceed price inflation, we would prefer to see TM1 retain the single assumption across both earnings and price inflation for simplicity. We feel that divergence of these assumptions within TM1 will introduce complexity for consumers (since it will result in additional assumptions having to be explained on the illustrations) and additional costs for providers (who will need to make systems

changes to calculations and outputs) with, in most cases, little impact on the illustrated pension figure.

Q20. Should TM1 require SMPI projections to allow for guarantees?

A: Guaranteed annuity rates were a feature of several of our legacy products and provide very valuable guarantees to the policyholders, so we do understand that this is a valid area of TM1 to challenge. However there are two main reasons why we feel strongly that any future inclusion of pension guarantees in illustrations should be optional:

- it has to be recognised that guaranteed annuity rates will largely be a historic feature of providers' product sets, with the nature of the guarantees varying considerably across products. In many cases the calculations are likely to be complex and developed well before system-based calculations became the norm. We have, over the years, attempted to automate several of these calculations but they remain manually resourced off-system due to the complexities inherent in doing so. We feel that inclusion of pension guarantees in illustrations will present considerable IT implementation issues for many providers including ourselves
- many guarantees will require the pension to be set-up on a specific profile which is unlikely to include features that are standard within the SMPI pension profile (e.g. RPI-linking and reversionary spouse's benefit). As a result, it will not immediately be clear whether the guaranteed pension presents better value than the standard basis and its inclusion on the illustration will require additional explanatory text and lead to increased complexity for the consumer

Q21. Is the approach for with-profits funds set out in section 6.7 of TM1 appropriate?

A: We believe that this approach is appropriate.

Q22. Would pension scheme members benefit from the FSA and TM1 bases being harmonised?

A: We believe that it is important to convey a consistent message from point of sale through to the SMPI and that this can be achieved through BAS and FSA working together to ensure that future changes to each set of rules are coordinated.

There is of course currently a good deal of alignment between FSA COBS rules (for projections at point of sale) and BAS TM1 (for SMPIs):

- between the projection rate used for SMPIs and the mid FSA prescribed growth assumption used at point of sale
- in the requirements within each set of rules (COBS and TM1) to reduce these where they will overstate the investment potential of the underlying funds
- with regard to the mortality tables and annuity interest rate calculation
- with regard to the annuity expense assumption

If BAS do decide to implement changes to mortality tables, annuity interest rate, expense assumption and interest rate blending for SMPs, we feel that they should also enter into discussion with the FSA regarding their adoption at point of sale.

Q23. Do respondents have any views on the approach set out in paragraph 7.8?

A: We would prefer not to link point of sale projections and SMPs through text on one referencing the basis applied by the other, since to do so would potentially increase maintenance costs (for example, a future change to the SMP calculations may mean that we had to change SMPs and the text on point of sale projections).

We would rather see BAS and FSA taking the lead by working together to achieve consistency across their respective rules.

Q24. Do respondents have any comments on our proposal in 8.4 to allow signposting?

A: As detailed in our response to Q2, we believe that it would be useful if TM1 stipulated the explanatory/warning messages that must be output and restricted any further provider text on the illustration to signposting where it may be obtained.

This would un-clutter the illustration, allowing attention to focus more on the key message and assumptions used and positioning the illustration more strongly towards being a wake-up call (which was, after all, its initial intended purpose).

Q25. 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 insurance and investment industry faces considerable mandatory change over the next few years (e.g. RDR, Solvency II, Pensions Reform). In addition, the current focus on ensuring that growth rates used in projections at point of sale reflect realistic investment return assumptions will create considerable resource constraints for many providers, including ourselves (see our response to Q17).

We therefore feel strongly that the timetable described in Section 9 will be extremely challenging if we are required to implement anything other than straight forward parameter-based changes (e.g. to mortality tables, expense assumptions and/or inflation assumptions) during 2011. We also feel strongly that it would be desirable to delay any changes until their implementation can be coordinated with similar changes to projections given at point of sale. To implement in isolation would reduce the current consistency that exists between BAS and FSA requirements (see our response to Q22), at a time when the industry should be working towards creating a consistent message for consumers across the lifecycle of their policy.

Q26. 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?

The key message conveyed by the SMPI should be the estimate of the amount of pension that the consumer may receive at their selected retirement date, supported by clear messages conveying the uncertainty in the illustration.

If the SMPI were also to include an estimate of the pension derived from the current accumulated fund, this would need to be accompanied by relevant messages explaining the purpose of the figure. We feel that it will be challenging to convey these clearly to consumers without increasing the complexity of the illustration or detracting from its key message.

Q27. 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?

See our response to Q2.

We would prefer to see these messages conveyed through appropriate warning text rather than by means of additional figures.

Q28. 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 feel that a suite of "best practice" documents would add additional complexity for providers and be of little use unless it was robustly maintained. Since the content of the documents would need to be closely coordinated with changes to the requirements in TM1, the maintenance overhead would seem logically to fall to BAS.

We would prefer to see increased usage of guidance commentary alongside specific prescriptive requirements in TM1, in instances where this guidance would help providers to understand and apply the intention of the requirement.