

Response to consultation paper: TM1: Statutory Illustrations of Money Purchase Benefits

This response has been prepared on behalf of the retirement benefits practice area of Towers Watson, a global firm with a substantial presence in the actuarial consultancy market. The firm provides advice to around one-half of the top 100 pension funds in the UK and overall employs over 300 actuaries in the UK.

This response is primarily based on our experience of larger, employer-sponsored pension schemes (trust-based or contract-based).

The main issues or themes we would highlight are:

- The scope or purpose of SMPIs/TM1 needs to be clearly and carefully stated, and the aims and content of TM1 kept proportionate to this scope or purpose. The scope or purpose should address the decisions that members might make on the basis of the SMPI alone, or that they might make on the basis of further information or advice. There are many aspects of the calculations and disclosures (such as the form of benefits taken at retirement, or the way in which uncertainty is highlighted or illustrated) where, depending on exactly how the purpose of SMPIs or TM1 is stated, quite different approaches might be justifiable.
- As a general principle, we do not believe that there should be mandatory additional figures or illustrations (especially where some kind of description might suffice), which might only act to discourage the member from reading or acting on the SMPI. Providers should retain the flexibility to tailor their communications for their audience.
- Members need to understand the purpose of SMPIs, and understand what decisions they might need to make on the basis of the SMPI. Without this background or context, there is a danger that the SMPI will have no meaning for the member, regardless of its actual content.
- TM1 should give guidance that is sufficiently detailed to enable someone who is not an actuary to calculate an SMPI figure. In practice, this may mean changing prescribed methods to recommendations or suggestions, rather than removing them completely. For mortality assumptions, TM1 may need to refer to tables that have already been (or will need to be) calculated and published, rather than leaving the actual projection of mortality tables to providers.
- Signposting may allow providers to keep the SMPI document short, but must be done in a way that is clear to members and ensures information is readily accessible to all members. There may be a role for a generic guide on pension illustrations or reviewing pension arrangements, which providers could then signpost.

Our responses to the specific questions asked in the consultation paper are set out in the appendix.

Towers Watson Limited
3 June 2010

Responses to questions in the consultation paper on TM1

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.

We are not convinced that SMPIs have been successful in meeting the stated aims, but believe that the reasons for this may go beyond the content of the SMPI itself.

In particular, members themselves may not understand the purpose of the SMPI, or what decisions they might need to take on the basis of the SMPI. Where providers have treated the SMPI purely as a compliance requirement, it may be introduced with words to the effect that “we are legally required to give you this figure” and “you shouldn’t use this as the basis for any decisions”; there is no actual requirement in TM1 to explain the purpose of the SMPI, and this may restrict their impact.

We believe SMPIs will be most effective when introduced in the right way, so that members understand the need to look at the “big picture” of their overall retirement provision (which may span several pension arrangements, including the State scheme), the need to review their provision periodically and the decisions they might need to make. Without this background or context, there is a danger that the SMPI will have no meaning for the member (regardless of its actual content), and that it will go unread and the member will take no action at all.

We therefore suggest that providers should be required to state the purpose of the SMPI and the decisions the member might consider taking (the exact wording of the purpose and the decisions would need to be agreed, as explained in our response question 3).

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 have seen a variety of different approaches taken to highlight the uncertainty associated with illustrating money purchase benefits.

At a basic level, SMPIs have made a statement based on the existing legislative requirement, but emphasising the uncertainty. In other words, a statement that the amount of pension eventually received will depend on the actual levels of future contributions, the actual performance of investments and the actual cost of buying an annuity at the time of retirement, all of which might be quite different from the assumptions used for the SMPI, and that as a result the actual amount of pension received could be significantly higher or lower than the illustration.

We are also aware of some pension schemes which supplement the basic SMPI with additional illustrations to demonstrate the sensitivity of the SMPI result to different outcomes (for example, if investment returns before retirement are 1% pa lower than assumed for the SMPI).

More generally, since SMPIs were introduced we have seen significant growth in the use of web-based interactive pension modellers, which allow members to freely vary future contributions or assumptions about future investment returns, and demonstrate uncertainty in a way that could not be simply achieved by a conventional paper benefit statement or illustration.

However, we are not convinced that it would be appropriate to require providers to go any further than a qualitative warning highlighting uncertainty, as any additional information provided with the SMPI risks discouraging members and should therefore be left as optional. We believe that the approach taken on uncertainty is connected to question 3, on the actual aims of SMPIs/TM1 and the decisions that members are expected to make on the basis of the SMPI alone.

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

It will be important to carefully state (or rephrase) the aims of SMPIs and/or TM1, so that the content of TM1 can be proportionate to these aims. Indeed, we suspect that many of the questions raised in the consultation could be answered by reference to these aims.

The aims mentioned in the consultation document may reflect the broad policy intention behind the introduction of SMPIs, but we suggest there are more specific, narrower aims for TM1 itself:

- To provide the “guidance” referred to in the SMPI legislation (as stated in paragraph 2.3 of the current version of TM1)
- To give guidance in sufficient detail to allow providers to implement SMPIs without the need to obtain detailed actuarial advice or input
- To set out mandatory requirements proportionate to the decision(s) members might make on the basis of the SMPI alone

On this last point, we suggest that the stated aims should include a focus on member decisions, and in particular which decisions might be made on the basis of the SMPI alone and which might require further information or advice. This should help keep the content of TM1 proportionate to its aims.

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)

TM1 should continue to include explanation and assistance on areas where providers might otherwise require actuarial input.

As noted in the consultation document, explanation and assistance were probably most helpful when SMPIs were first introduced, but may still be helpful to new entrants into the market – or indeed to anyone rewriting their software routines (for example, moving legacy systems onto a common platform). Our own experience was that TM1 contained a suitable level of detail for those implementing SMPI calculations, even if in some places it is prescriptive where it need only give guidance.

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

We believe the document is reasonably clear as it stands, given its aim of providing technical information to non-actuaries implementing SMPIs.

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)

As stated above, TM1 should give guidance in sufficient detail to allow providers to implement SMPIs without the need to obtain detailed actuarial input, and that this guidance should include explanation and assistance. There are many aspects of the calculations where providers may still need (or wish) to have guidance, even if TM1 does not prescribe how to carry out the calculations. Where the exact approach used is unlikely to have a material effect on the result, TM1 should not be prescriptive but may still offer guidance.

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)

On balance we agree with this proposal, on the grounds that this approach gives a single figure which summarises the overall purchasing power of the projected pension. Other approaches such as illustrating a non-increasing pension would need further explanation of how inflation in retirement might erode purchasing power. Providers have always had the option to produce additional illustrations alongside the SMPI, if they choose.

However, there is a disconnect between the form of pension currently taken when members retire and the form of pension used for SMPs. We believe the form of pension used for SMPs should be justified by reference to a clearly-stated purpose for SMPs as a whole.

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 understand that in practice many members currently opt for a cash lump sum and a pension that either does not increase or increases at a fixed rate.

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

We agree that the SMP should assume that all funds are used to purchase (an inflation-linked) pension at retirement, with providers having the option to illustrate other combinations of benefits if they wish.

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 annuity basis should be updated, so that SMP annuity rates are consistent with the rates that insurers might currently typically expect to offer.

Each of the approaches proposed in the consultation document would require some kind of calculation (projection) to produce the specified generational mortality tables. Where providers already use an actuary to supply annuity factors each year, neither approach should present any problem for the provider. However, in other cases providers may find that they need a greater degree of actuarial input than before. This would be especially so in the case of the CMI model, where the model and accompanying software was intended for use by experts (actuaries), and where the required mortality tables may have to be updated every year to reflect the latest population experience.

We therefore suggest that, whichever approach is adopted, the BAS consider publishing the resulting mortality tables, unless the full details of the required tables have already been published elsewhere. This would retain consistency with the current approach, which refers to published tables of base mortality rates and improvements.

We also note that the suggested changes to the annuity rate assumptions (mortality rates and the interest rate) have been justified in the consultation document by reference to the way insurers currently calculate annuity rates. In due course, UK insurers will be subject to the EU's Solvency II capital requirements, and this may have an effect on the pricing of annuities, potentially requiring a further revision to the TM1 annuity basis.

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

An "appropriate" mortality table would presumably mean one that gives a reasonable approximation to the annuity pricing terms expected when the member is due to retire. We are not convinced that many providers would be prepared to make such an estimate in practice, especially given the growing sophistication of annuity pricing and the increased relevance of underwriting at retirement.

We also note that providers have always been free to give additional illustrations alongside the SMP, and could do so if they felt that the standard SMP annuity terms are not appropriate.

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

As noted in our response to question 10, we agree that the annuity basis should be updated if this brings the annuity rates more into line with the rates that insurers might typically expect to offer, but note that further amendments may be required in due course to reflect any changes in annuity pricing from the EU's Solvency II capital requirements.

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)

If the annuity rates used for younger members had no connection to market conditions, members may not then see the “true” cost of purchasing pension until it is too late to amend their retirement plans. Any alternative approach for younger members should keep some form of market link, and should not be allowed to move too far from the market-related rates used for older members. This might be achieved by using market yields that have been averaged over a period, or by restricting any specified non-market rate to be within a “corridor” around the market-related rate.

However, as the use of different annuity rates for different groups of members would add complexity to the SMPI calculation, any alternative approach should be optional rather than mandatory and should be kept as simple as possible.

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)

The current fixed-date approach has the advantage that annuity rates do not need to be updated more than once a year. For organisations (pension schemes or providers of administration services) that issue SMPIs at several different dates over the course of the year, this helps keep down the cost of producing SMPIs.

However, one weakness of the current fixed-date approach is that the SMPI calculation uses fund values measured at one date and annuity rates based on market conditions measured at another date, which in the case of 31 March or 5 April Illustration Dates is over a year earlier. This mismatch between the measurement of fund values and annuity rates is potentially important for members who have built up significant funds, especially if these are invested in index-linked bonds or “annuity protection” funds.

We suggest that providers could be given the option of:

- Using gilt yields as at the same effective date as the member’s current fund value
- Using gilt yields as at some earlier date (to allow time to set up the required annuity rates), fixed by reference to the Illustration Date (for example, the start of the calendar month preceding the Illustration Date)
- Using gilt yields as at a specific date in the calendar (as per the current version of TM1, allowing the use of a standard set of annuity rates for all SMPIs produced over a given year)

By making the exact choice of approach optional, third party administrators could continue to offer a low-cost standard approach to schemes.

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 believe that the current expense assumptions are reasonable in the context of an SMPI intended as a broad-brush illustration.

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)

This rather depends on the original aim of having a maximum accumulation rate. If the aim was to achieve consistency with the FSA’s mid-point investment return assumption, the maximum would remain appropriate until the FSA’s mid-point assumption changes. If the aim was to ensure that SMPIs were not based on very subjective views of potential future returns, it may be appropriate to reduce the maximum, pitching it at the lower end of the current range of views on future returns for assets such as equities.

However, we would argue that the requirement not to overstate the potential investment growth of the member's funds is more important than the long-term maximum rate of accumulation itself. The consultation document notes that, in current market conditions, providers should consider the accumulation rate carefully, particularly for funds invested in cash or bonds; we believe that providers should keep the accumulation rates for all asset classes (including equities) under regular review.

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)

An approach that we have seen used by actuaries advising pension schemes is to review accumulation rates each year, based on market yields and/or views on expected future returns. For each asset class or fund, an expected real return is combined with the 2.5% pa inflation assumption underlying the SMPI calculation, and the 7% pa maximum applied, before deducting expenses. This basic approach is adapted, or the outcomes simplified, to suit the exact circumstances of the pension arrangement such as the capabilities of the provider's administration system or the range of available investment funds, including the structure of any "lifestyle" funds.

More generally, providers also have to decide how to apply accumulation rates, where the member's current funds are spread across a range of investments and/or where there are future contributions. We have seen a variety of different approaches to this, such as using a single, average accumulation rate for the whole SMPI calculation, or using separate rates for separate investment funds.

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

We agree that, in most circumstances, it is the interaction of the inflation assumption and the accumulation rate which most affects the outcome of the SMPI calculation. In this context, the level of the maximum accumulation rate relative to the inflation assumption is also important; we have made further comments on this maximum accumulation rate above.

We also note that the SMPI result is presented in current money terms, which has the effect of reducing the apparent value of fixed elements such as contributions or expenses. The inflation assumption determines the exact extent of this reduction, with (for example) a higher inflation assumption making fixed contributions appear less valuable.

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

We believe that assuming earnings growth in line with inflation is a simple and pragmatic approach, and should be retained.

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

Under the current version of TM1, there is no requirement for providers to allow for guarantees in the calculation of the SMPI figure itself, and disclosure of details of guarantees is optional.

Depending on the terms of the pension arrangement in question, guaranteed annuity rates may only apply where the member purchases a specific form of pension (such as a single life non-increasing pension), which may not match the form required for the SMPI calculation. If the pension figure quoted in an SMPI were based on a guaranteed annuity rate, the accompanying disclosures might need to explain quite carefully the terms of the guaranteed annuity, so that the member does not misinterpret the quoted figure.

We therefore suggest that any new requirement in relation to guaranteed annuity rates is limited to disclosure of information, such as:

- A statement that there is a guaranteed annuity rate, which has not been allowed for in the calculation of the SMPI, and that the terms of the guarantee may be more attractive to the member than the terms used to calculate the SMPI

- A pointer to where the member can obtain further information on the guarantee

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

The most important requirement for with-profits funds is that the asset value and the accumulation rate used in the SMPI calculation, when taken together, produce a reasonable projection of the maturity value that might be available for the member to purchase an annuity. We believe that the current overall approach (including the requirements for accumulation rates and other aspects of the calculation) reflects this requirement in a way that is proportionate. Where providers use a value other than an unsmoothed asset share as the asset value for the SMPI calculation, they would presumably use an accumulation rate that reflects the nature of the chosen asset value and the potential growth or transition from this chosen value to a projected maturity value available to the member.

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

We agree that pension scheme members would benefit from a harmonised approach to pension projections, but note the comments made in the consultation document that this may not be achievable in the short term.

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

Additional information risks drawing attention away from the SMPI or causing confusion, whether this information is provided alongside the annual SMPI itself or at the point of sale. This risk is greatest where the member does not have access to someone who could help them understand the material.

Under the current version of TM1, providers have the option to supply additional illustrations alongside the SMPI, subject to appropriate disclosures or explanations. We are not convinced that what is already an optional additional illustration should be made into a mandatory one.

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

We agree that signposting should help achieve shorter, simpler SMPs that are more likely to be read by the member. However, signposting should be prominent enough that the member understands there is important information, and it must be easy for the member to access this information.

We suggest that, where providers are allowed to use signposting, they should be required to offer the same information in a different format (such as a booklet or a helpline) on request, and state that this information is available.

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 suitability of the timetable depends on the scale of the changes made to TM1. The more significant the changes, the more difficult it would be to implement changes for April 2011 Illustration Dates, especially for providers that use online modellers to supplement the SMPI shown in the annual benefit statement.

If there are further changes expected in the near future, there would seem to be little benefit in making two sets of changes within a short period of time. However, given the different views expressed in the consultation, the pragmatic solution may be to choose a later effective date for the changes but allow early adoption. This approach would allow providers the flexibility to implement changes at the time that best suits them.

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)

In many cases it would be helpful to show the amount of the SMPI pension that is attributable to contributions already paid.

However, providing extra figures or illustrations may not be the best approach in all cases, and the additional information may actually discourage a section of the population at which SMPIs are targeted. We suggest that any such extra information is treated as a recommended practice, rather than being made mandatory, leaving providers with the flexibility to tailor their communications.

The mandatory rounding required for the SMPI figure has sometimes led to practical problems when giving any kind of breakdown or further analysis, such as identifying the amount of pension attributable to contributions already made. As an example, for a member close to retirement and still contributing, there is a danger that the implied amount of pension from future contributions may appear very low, or even disappear completely, as a consequence of the rounding used. We suggest that providers should be allowed some element of flexibility in the rounding that they use.

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)

As mentioned above, additional information may actually discourage a section of the population at which SMPIs are targeted, and must be kept proportionate to the purpose of the SMPI.

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? (paragraph 10.7)

There may be a role for a generic guide for members on pension illustrations and reviewing pension arrangements, analogous to the Pensions Regulator’s guides on choosing investments or making choices at the point of retirement. Such a guide could cover much of the (generic) material that might appear in “best practice” SMPIs, and providers would then have the option of either signposting it or enclosing it with their SMPIs, helping to keep the SMPI document short and simple.

We believe that, as well as streamlining the content of the SMPI, this type of document would also help members understand the purpose of the SMPI and the decisions they may need to make on the basis of the SMPI, so that the SMPI is more relevant to them (as mentioned in our response to question 1).