



BOARD FOR ACTUARIAL STANDARDS

**CONSULTATION PAPER:
TM1: STATUTORY ILLUSTRATIONS OF MONEY
PURCHASE BENEFITS**

MARCH 2010

CONTENTS

<i>Section</i>	<i>Page</i>
1 Introduction	2
2 Background	4
3 SMPI legislation and key provisions of TM1	7
4 Content of TM1	9
5 Form of benefits	10
6 Assumptions	12
7 Interaction with FSA Handbook	18
8 Disclosures	20
9 Timing of changes to TM1	21
10 Miscellaneous issues	22
11 Invitation to comment	24
<i>Appendix</i>	<i>Page</i>
A Members of the Board and Working Group	27

1 INTRODUCTION

BACKGROUND

- 1.1 The Board for Actuarial Standards (BAS) is responsible for setting technical actuarial standards in the UK. It is an operating body of the Financial Reporting Council (FRC).¹
- 1.2 Since 6 April 2003 certain money purchase pension arrangements have been required to provide members with Statutory Money Purchase Illustrations (SMPIs). Legislation requires that SMPIs are produced in accordance with guidance prepared by a prescribed body approved by the Secretary of State for Work and Pensions and by the Department for Social Development in Northern Ireland. The BAS was appointed as the prescribed body with effect from 6 April 2007. It fulfils its requirements through the publication of *Technical Memorandum 1: Statutory Money Purchase Illustrations* (TM1).
- 1.3 In accordance with paragraph 2.6 of TM1 we review the memorandum regularly. TM1 was last amended with effect from 6 April 2009 in order to reflect changes to legislation affecting contracted-out money purchase schemes including the proposed abolition of defined contribution contracting out.

AIMS AND AUDIENCE OF THIS DOCUMENT

- 1.4 The aim of this document is to set out the areas that we consider should be the focus of our current review of TM1 and to seek stakeholders' views on possible changes to TM1.
- 1.5 Members of a working group have provided valuable input during the preparation of this document (see Appendix A). We have also consulted extensively with the Department of Work and Pensions, the Financial Services Authority and the Association of British Insurers.
- 1.6 This document has been written for anyone with an interest in SMPIs, including those responsible for providing them (such as insurance companies and pension scheme trustees) and the pension scheme members and policyholders who receive them.
- 1.7 We would welcome views on the matters addressed in this document, and in particular on the questions listed at the end of each section and collated in section 11. The responses will provide valuable input as we develop an exposure draft of the revised TM1.

CONTENTS AND STRUCTURE OF THIS CONSULTATION PAPER

- 1.8 We consider the purpose of TM1 and recent research into the effectiveness of SMPIs in Section 2. Section 3 outlines the provisions in the current legislative framework that governs SMPIs and Section 4 discusses the content and structure of TM1.

¹ The Financial Reporting Council is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance.

- 1.9 In Section 5 we consider the form of the pension members are assumed to take and in section 6 we consider the elements of the actuarial basis used in the calculations underlying SMPs. Section 7 considers the interaction of TM1 with FSA rules for point of sale projections. The various disclosures about matters such as risk are considered in section 8.
- 1.10 In Section 9 we discuss the timing of changes to TM1. Miscellaneous issues are discussed in section 10.

RESPONSES TO THIS CONSULTATION PAPER

- 1.11 Details of how to respond to this paper are set out in section 11. Comments should reach the BAS by **4 June 2010**.

NEXT STEPS

- 1.12 We intend to publish an analysis of the responses to this consultation later this year, together with an exposure draft of the revised version of TM1. The exposure draft will also be subject to consultation.

2 BACKGROUND

INTRODUCTION

- 2.1 Since 2003 there has been a requirement for members of certain money purchase pension arrangements to be provided with Statutory Money Purchase Illustrations (SMPIs). Legislation requires that these statements are produced in accordance with *Technical Memorandum 1: Statutory Money Purchase Illustrations* (TM1).
- 2.2 TM1 has been revised since it was first published. The current version is known as TM1 v1.3. Any references to the content of TM1 in this paper are to TM1 v1.3.

PURPOSE OF TM1 AND SMPIS

- 2.3 SMPIs are intended to provide individuals with illustrations which enable them to understand their likely pension income in retirement.
- 2.4 Paragraph 1.1.1 of TM1 states that “the overall aim is to provide illustrations of pension benefits on a broadly consistent basis across various types of money purchase pension provision. This is intended to assist individuals to assess in broad terms:
- the adequacy of their pension arrangements;
 - the extent to which they need to make further provision;
 - the significant uncertainties involved in using illustrations of benefits.”
- 2.5 However SMPIs have a wider purpose than that: one of the key objectives of their introduction was to make people more aware of the need for retirement planning by highlighting the projected income from their pensions and so help them to establish how far it is likely to meet their needs and expectations in retirement.
- 2.6 We would be interested in hearing whether respondents believe that these aims are being met in practice and if not, why not. If the aims are not being met, comments on respondents’ experience, including examples, would be most helpful. We would also be interested in respondents’ ideas for enabling SMPIs to better meet their aims.
- 2.7 It has been suggested that the “significant uncertainties” in illustrations are generally not well addressed by SMPIs. We would be interested in respondents’ views on whether more should be done to highlight them.
- 2.8 We would also be interested in whether respondents consider the aim quoted in paragraph 2.4 should be modified.

NATIONAL EMPLOYMENT SAVINGS TRUST

- 2.9 The National Employment Savings Trust (NEST), which is due to commence in 2012, will be run as a trust based occupational pension scheme and therefore will have to issue SMPIs to members. NEST Corporation, which will run the scheme, is likely to become by far the biggest issuer of SMPIs. It

is likely that many members of the NEST will be low to moderate earners who currently do not participate in a workplace pension scheme.

STATE PENSION FORECASTS

- 2.10 Individuals are entitled to request and receive a State Pension forecast which gives an estimate of:
- a) the basic State Pension; and
 - b) the additional State Pension, also called the State Second Pension and formerly known as the State Earnings-Related Pension Scheme.
- 2.11 Pension schemes and providers can provide their members with a Combined Pension Forecast which combines a forecast of the scheme pension and a State Pension forecast.

ABI REPORT

- 2.12 In July 2006 the Association of British Insurers (ABI) published a *Review of Yearly Statements* which covered SMPI provision. The ABI's findings and suggestions included:
- providers should be allowed more flexibility on the form of pension (for example the level of pension increases) which is illustrated;
 - for the majority of statements required to accompany SMPIs, providers should be allowed to "signpost" readers to their website or a call centre; and
 - there should be consistency between FSA point of sale illustrations and SMPIs.

DWP RESEARCH

- 2.13 In 2008 the DWP published a research report *Understanding responses to pensions forecasts: Qualitative research*. The research was based on around 80 individual in-depth interviews with people who had recently received either a State Pension forecast or an SMPI forecast. Interviews were conducted between January and June 2007 with people who had been sent forecasts between October 2006 and March 2007.
- 2.14 The research found that most respondents displayed weak knowledge and understanding of how pensions work and this limited their ability to understand, interpret and act on their forecast. Forecasts were not generally seen by respondents as high-impact documents, and were usually received passively rather than acting as a call to action on pensions or retirement planning.

DWP DEREGULATORY REVIEW

- 2.15 Following the publication of its White Paper on *Security in Retirement* the Government initiated a deregulatory review of pensions. The Department of Work and Pensions (DWP) has been carrying out this deregulatory review with the objective of simplifying and reducing the burden of legislation governing private pensions.²
- 2.16 As part of this work, the DWP carried out a review of the Disclosure Regulations (which apply to SMPs), publishing a consultation paper in March 2009. The DWP wishes to simplify the disclosure legislation and reduce the level of prescription within it.
- 2.17 The DWP published draft regulations – *The Occupational, Personal and Stakeholder Pension Schemes (Disclosure of Information) (Amendment) Regulations 2010* – on 6 January 2010. The draft regulations remove the requirements for some statements to appear in SMPs, and allow some statements to be included by reference to other documents or sources of information rather than explicitly (known as “signposting”).
- 2.18 These changes will not require schemes to change their current arrangements, but will allow changes that:
- enable the production of shorter, simpler SMP statements for those schemes wishing to review the information provided to members; and
 - further engage members and help to improve their understanding of the statement.
- 2.19 It is planned that the amendments will come into force on 1 October 2010.

The BAS would welcome responses to the following questions:

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

² <http://www.dwp.gov.uk/policy/pensions-reform/deregulatory-review>.

3 SMPI LEGISLATION AND KEY PROVISIONS OF TM1

INTRODUCTION

3.1 This section summarises the key provisions of the legislation governing SMPs and the key provisions of TM1.

LEGISLATIVE REQUIREMENTS

3.2 The Disclosure Regulations (SI 1996/1655, SI 1987/1110 and SI 2000/1403) require that:

- SMPs must show the amount of pension likely to accrue to a member, on the assumptions that:
 - contributions continue to the member's retirement date;
 - the pension in payment will increase at the "relevant percentage" set out in TM1;
 - there is a spouse's pension of 50% of the members pension; and
 - members are assumed to be married unless records indicate they are not married or it is agreed otherwise with the member.
- SMPs must include a statement that the amount of pension is expressed in today's prices; and
- SMPs must include certain statements relating, for example to investment risk, annuity purchase risk and the real terms nature of the illustration.

3.3 Our understanding is that the underlying intention of the legislation was not to permit the provider to make any allowance for the member to take part of the pension entitlement as a cash sum.

TM1 – ASSUMPTIONS

3.4 TM1 requires the following assumptions to be used in the calculations presented in SMPs:

Mortality after retirement	Standard tables: PMA92 for males and PFA92 for females with medium cohort mortality improvement rates.
Interest rate for annuity	Based on the yield on index-linked gilts assuming 2.5% pa inflation, minus 0.5%.
Pension increases	Pensions effectively assumed to be increased in the line with the Retail Prices Index.
Expenses at retirement	4% of the annuity value at retirement.

Expenses before retirement	Either as set out in terms of contract or, if not known, annually 1% of the projected fund at the start of the year.
Accumulation rate before retirement	7% pa or lower if appropriate.
Rate of increase in Retail Prices Index	2.5% pa.
Rate of increase in earnings	2.5% pa.
Age difference between member and spouse/partner	Men are three years older than female partners. Same sex partners are the same age.

TM1 – METHOD

- 3.5 TM1 sets out in detail how calculations for SMPs should be carried out. The level of detail means that in most cases different providers should produce the same figure for the same pension arrangement.
- 3.6 This approach also benefits those who receive SMPs from a number of different pension providers, enabling them to build up a complete and consistent picture of their pension provisions.

TM1 – DISCLOSURES

- 3.7 Appendix A of TM1 sets out the information to be included with SMPs. Some of the information is required by statute, in which case TM1 uses the word “must”. Some of the information is not required by statute, in which case TM1 generally uses the word “should”.

4 CONTENT OF TM1

INTRODUCTION

- 4.1 TM1 is a long document. It includes a great deal of detailed explanation of how it should be interpreted as well as repeating some of the requirements of the Disclosure Regulations. This section considers the content of TM1 and the extent to which it should be reviewed.

EXPLANATIONS AND ASSISTANCE

- 4.2 TM1 contains numerous references to, and paraphrases of, legislative requirements. It also provides detailed explanations of exactly how calculations should be performed. Much of this information was probably very helpful to those issuing SMPs when they were first introduced, but providers now have significant experience of producing SMPs and may no longer require so much assistance. There may, however, be new entrants into the market who would still welcome such assistance.
- 4.3 We would be interested to know how helpful respondents find the explanations and assistance in the current version of TM1, and whether one of the purposes of TM1 should be to assist providers. In particular we would be interested in respondents' views on the structure of TM1, and whether shortening, or restructuring, the document might add clarity.

DETAIL OF TM1

- 4.4 TM1 sets out the calculation methodology for SMPs in great detail. For example, paragraph 6.6 specifies how the difference between two dates should be calculated. We consider that this level of detail is not necessary and propose that future versions of TM1 should be less detailed.

The BAS would welcome responses to the following questions:

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

5 FORM OF BENEFITS

INTRODUCTION

- 5.1 The Disclosure Regulations require that SMPIs show the amount of pension which is likely to accrue to a member. This section considers the form of the pension which members are assumed to take at retirement.

PENSION INCREASES

- 5.2 The Disclosure Regulations state that the pension illustrated should be assumed to increase as specified in the relevant guidance, which is TM1. TM1 requires that pensions should be assumed to increase in line with the Retail Prices Index. Some providers have noted that most members choose to take a pension which does not increase when in payment. They have suggested that TM1 should reflect this by requiring that the pension is assumed not to increase when in payment. This would increase the amount of pension illustrated in SMPIs.
- 5.3 The value of a pension which does not increase is eroded over time by price inflation. Showing a non-increasing pension could result in members overvaluing their pension, particularly in respect of payments at older ages.
- 5.4 Paragraph 13.2.2 of TM1 states that providers may provide additional illustrations using different assumptions for pension increases if they so wish. We therefore consider that it is not necessary to alter the requirement that the pension calculated in accordance with TM1 is linked to inflation. We would however welcome respondents' views on this. We would also be interested in respondents' experience of the proportion of members choosing to take an inflation-protected pension.

CASH ON RETIREMENT

- 5.5 The legislation requires SMPIs to show the expected pension at retirement. TM1 currently states that in calculating the pension no allowance should be made for any option available for members to take part of their entitlement as a cash sum instead of a pension.
- 5.6 It has been suggested that providers should show a lower pension alongside a cash sum. The argument is that in practice most members opt to take part of the pension as cash – the cash amount is often in the region of 25% of the fund. We consider that amending TM1 in this way would not be consistent with the intention of legislation. TM1 does not prevent SMPIs showing a cash sum and a reduced pension in addition to other information, but does require that the full projected pension at retirement is always shown.

In section 5 we consider the form of benefits which SMPIs assume members take at retirement.

The BAS would welcome responses to the following questions:

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)**

- 8. In respondents' experience what proportion of members on retirement opt to take annuities with index-linking, fixed pension increases or no increases? (paragraph 5.4)**
- 9. Do respondents have any comments on paragraphs 5.5 to 5.6 concerning the option to take a cash sum at retirement?**

6 ASSUMPTIONS

INTRODUCTION

- 6.1 This section discusses the various elements of the actuarial basis that are set out in Part 3 and Appendix D of TM1. We consider the rationale for the existing basis and the current key economic and demographic assumptions, and whether some of these assumptions should be changed.

CURRENT APPROACH – RATIONALE

- 6.2 TM1 explains the rationale for the existing set of assumptions. It states that the intention is to provide individuals with a broad indication of the level of benefits they might receive from their current levels of pension provision and future contributions.
- 6.3 It notes that for younger members a set of long term assumptions is more appropriate than a set of assumptions linked to market conditions. For older members the illustration is intended to bear some relation to what the member will actually receive on retirement: for these members a set of assumptions that reflects current market conditions is more appropriate.
- 6.4 The basis currently adopted in TM1 reflects a combination of these two approaches: a long-term approach for pre-retirement assumptions with a market related approach for the post-retirement assumptions.
- 6.5 TM1 states that for members close to retirement the use of a long-term accumulation rate may have less effect than variations in the cost of purchasing an annuity at retirement and that for younger members the effects should generally be reversed with the accumulation rate likely to have a bigger effect than variations in the cost of purchasing an annuity.

CONSISTENCY WITH ASSUMPTIONS USED FOR OTHER PURPOSES

- 6.6 In reviewing the assumptions for TM1 we have considered assumptions which are used for other purposes. For instance, the Pension Protection Fund (PPF) sets assumptions for determining liabilities of pension schemes for the PPF levy and calculations for pension schemes entering the PPF. These assumptions are chosen to reflect the cost of purchasing annuities from life offices. In reviewing the assumptions for TM1 we have paid attention to the assumptions set by the PPF although we note that the terms offered by insurers for group pension schemes may differ from those available to individual members.

ANNUITY RATES – MORTALITY

- 6.7 TM1 currently specifies that calculations for SMPs should use an annuity based on PMA92 and PFA92 mortality tables with medium cohort improvements.
- 6.8 The Continuous Mortality Investigation (CMI) published the PMA92 and PFA92 tables in 1999. These tables are based on experience collected from UK insurance companies between 1991 and 1994. In 2006 the CMI published a further set of tables (PCMA00 and PCFA00) which are based on experience collected from UK insurance companies between 1999 and 2002.

- 6.9 The CMI has recently published a series of tables, known as the S1 series, based on the mortality experience of self-administered pension schemes from 2000 to 2006. S1 tables have been produced for different categories of pensioner (such as normal health, ill health and dependent) and for different pension amounts.
- 6.10 As the PMA92 and PFA92 tables are out of date we consider that newer tables, reflecting more recent experience, should be used. We understand that the tables most commonly used by insurers for setting annuity rates are PCMA00 (males) and PCFA00 (females). We therefore propose that TM1 should require the use of these tables.
- 6.11 We are considering two possible approaches for future changes in mortality in TM1.
- 6.12 The first approach is for TM1 to require the same basis as the PPF currently requires for its levy calculations – medium cohort mortality improvement rates (published by the CMI) subject to a 1.25% floor for males and a 1% floor for females, all applying from the year 2000. However, the medium cohort improvement rates do not take account of mortality improvements after 1999 and this approach is therefore now somewhat out of date.
- 6.13 The second approach is to require the use of the CMI’s recently issued mortality projection model³, which allows recent experience to be blended with projected improvements. The CMI intends to update the model annually to take account of changes in mortality rates. We consider that it is likely that the output generated from this model will generally replace the cohort projections in annuity calculations.
- 6.14 The CMI model requires an assumption to be made about the rate of long term improvements, so that if this approach was adopted TM1 would need to specify the assumption to be made. For example, TM1 could specify that the long term improvement rates should be 1.25% for males and 1% for females, which would be consistent with the floor specified in the PPF levy basis.
- 6.15 The alternative base tables and improvement rates would not lead to a significant change in life expectancy for those close to retirement. However for younger ages they would result in men being assumed to live around two more years than is shown by the current tables. All other things being equal this would reduce the amount of pension shown on SMPs.
- 6.16 It has been suggested that providers should be allowed to choose alternative mortality assumptions which are appropriate for the workforce in question. This might be particularly significant if the workforce has characteristics which would suggest much lower life expectancy than that implied by the standard tables. However a disadvantage of this approach is that it would lead to different assumptions being used by different providers and could lead to inconsistency. In addition, it might be necessary to limit the assumptions that could be used in some way.
- 6.17 We would be interested in respondents’ views on these approaches.

³ <http://www.actuaries.org.uk/knowledge/cmi>.

ANNUITY RATES – INTEREST RATES

- 6.18 TM1 sets out a formula for determining the rate of interest to be used in calculating the annuity rate. The rate to be used is 50% of the sum of the FTSE Actuaries' Government Securities Index-Linked annualised Real Yields over five years assuming:
- a) 5% inflation; and
 - b) 0% inflation
- minus 0.5%.
- 6.19 We propose that TM1 should continue to use this formula but without the 0.5% deduction. Based on our discussions, we consider that this better reflects the rate of interest currently used by insurers to calculate annuity rates.
- 6.20 The effect of this change would be to increase the amount of pension shown on SMPs by around 5%. For younger members this might broadly offset the change to the mortality tables proposed in paragraph 6.10.
- 6.21 The interest rate proposed above is appropriate for a pension which increases in line with inflation. If TM1 is amended to allow projections to be made assuming that pensions do not increase then we would propose that the yield should be calculated as the higher of the yield proposed in paragraph 6.19 and the annualised yield on the FTSE Actuaries' Government 15 year Fixed Interest Index.
- 6.22 We would welcome respondents' views on the proposed change to the interest rate to be used for calculating annuity rates.

ANNUITY RATES – YOUNGER MEMBERS

- 6.23 A criticism of the TM1 basis has been that the use of an annuity rate linked to market yields leads to volatility of the pension amounts shown on SMPs. It has been suggested that this may confuse recipients of SMPs, particularly at younger ages. However many younger members of defined contribution schemes have much of their fund invested in equities and the volatility of the fund amount may be much greater than the volatility of annuity rates. Also for younger members the impact of fund value volatility can be significantly dampened by the impact of future contributions payable to retirement age.
- 6.24 It would be possible to remove some of the volatility at younger ages by using an annuity rate which is not linked to market conditions. However at older ages it would still be appropriate to use a market-related rate. A possible approach would be to use an annuity based on a constant assumed yield until a given age (such as 10 years before retirement age) and to use a market-related basis at older ages. This could lead to large inconsistencies in between the SMPs just before and after the given age. A refinement of this approach would be to use a progressively changing blend of fixed and market-related yields between the given age and retirement age, although this would make the calculations more complex.
- 6.25 We would be interested in respondents' views on these approaches and would welcome any other suggestions which might reduce volatility in SMP projections at younger ages.

ANNUITY RATES – REFERENCE DATE

- 6.26 TM1 requires that the gilt yields at 15 February are used to determine the interest rate for calculating the annuity for SMPs issued for the following scheme year. This ensures that there is consistency between schemes. However, using yields at a single date can result in large changes in the rate from year to year, particularly if yields on 15 February are relatively high or low. It has been suggested that an alternative approach would be to base the interest rate on the average yield over a period (such as the average yield on the first of the month from July to December). We would be interested in respondents' views on whether an alternative approach would be desirable. It would be possible for the BAS to publish, each year, the interest rate to be used.

RUNNING COSTS

- 6.27 TM1 requires that SMPs assume that, at retirement, expenses of 4% of the cost of purchasing an annuity are incurred. This is consistent with FSA projection requirements. This is a simple and broad-brush approach – for some schemes it will overstate running costs and for others it will understate them. It may be possible to produce a more sophisticated expense allowance which more accurately reflects the likely level of running costs. However we question whether such accuracy is needed, particularly as cost levels may change over time. Indeed, they are likely to change in the short term as a result of the proposals in the FSA's Retail Distribution Review affecting the remuneration of individual financial advisors.
- 6.28 The allowance for running costs before retirement is based on the actual level of running costs or an allowance of 1% of the fund value each year.
- 6.29 We would welcome views on whether the current assumptions for running costs are reasonable for the purposes of TM1, particularly the assumption that costs at retirement are 4% of the value of the annuity.

ACCUMULATION RATE

- 6.30 TM1 specifies that the maximum accumulation rate of funds before retirement is 7% pa. It notes that there is an implicit assumption that assets are invested predominantly in equity based investments.
- 6.31 The rate of 7% pa appears high in the current economic climate of historically low rates of inflation. However the assumption applies to the long term and moreover the specified rate of 7% pa is a maximum. We would welcome views on the suitability of 7% pa as the maximum rate in the long term.
- 6.32 TM1 requires the use of a lower accumulation rate if the provider expects that the use of the maximum rate will overstate a member's expected fund at retirement. We consider that in current market conditions providers should be scrutinising the accumulation rate that they are using for SMPs very carefully and using lower rates where appropriate, particularly if a member's funds are invested in cash or bonds.
- 6.33 We would be interested in finding out the approaches taken by providers when members' investments are in funds which are expected to accumulate at less than 7%pa.

RATES OF INFLATION

- 6.34 TM1 specifies how to convert the expected value of the fund at retirement into its value at today's prices, and how to project the level of future contributions into the pension arrangement. These calculations require assumptions to be made about future rates of price inflation and earnings inflation.
- 6.35 TM1 acknowledges that it is generally expected that in the medium to long term earnings inflation will run ahead of price inflation. However, in order to reduce calculation complexity the assumptions required by TM1 use the same rates for both – currently 2.5%pa.
- 6.36 As the illustrations are provided in real terms it is the interaction of the inflation assumption with the accumulation rate assumption that is critical. In line with our proposal not to change the maximum accumulation rate assumption, we are proposing not to change the price inflation assumption or the earnings inflation assumption.

GUARANTEES

- 6.37 Some pension arrangements are subject to guarantees, such as guaranteed annuity rates at retirement. Paragraph A2.13 of Appendix A of TM1 states that providers should consider giving a description of any guarantees which may apply. However, there is no requirement, in either TM1 or the governing legislation, for the calculations to take account of any such guarantees.
- 6.38 It has been suggested to us that TM1 should require illustrations to reflect guarantees. We would be interested in respondents' views on this.

WITH-PROFITS FUNDS

- 6.39 Section 6.7 of TM1 states that, where the investments are in a with-profits fund, the provider should make best efforts to provide an illustration in a manner consistent with TM1 and with the insurer's bonus policy.
- 6.40 It has been suggested to us that using anything other than an unsmoothed asset share is potentially misleading to the recipients of SMPs. We would welcome comments on whether the approach for with-profits funds in TM1 remains appropriate.

In section 5 we consider the assumptions used for SMPs.

The BAS would welcome responses to the following questions:

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)
11. Should TM1 allow providers to choose specific mortality tables which are appropriate for the members of the arrangement in question? (paragraph 6.16)
12. Do respondents agree with the proposal to change the yield used for annuity calculations? (paragraphs 6.18 to 6.22)

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)**
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)**
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)**
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)**
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)**
18. **Do respondents have any comments on the long term inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)**
19. **Do respondents have any comments on the long term earnings inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)**
20. **Should TM1 require SMPI projections to allow for guarantees? (paragraphs 6.37 to 6.38)**
21. **Is the approach for with-profits funds set out in section 6.7 of TM1 appropriate? (paragraph 6.39 to 6.40)**

7 INTERACTION WITH FSA HANDBOOK

INTRODUCTION

- 7.1 The Financial Services Authority (FSA) Handbook specifies how illustrations that are provided for personal pension and stakeholder pensions schemes at the point of sale, and when a plan is in force, should be prepared. This section considers the interaction of the requirements for SMPIs with those in the FSA Handbook.

FSA RULES

- 7.2 The FSA Handbook requires illustrations at point of sale to be expressed in projected money terms; consequently they are not directly comparable with illustrations produced on the TM1 basis, which are expressed in current money terms. In addition the FSA Handbook requires the pension at retirement to be projected using three different maximum rates of assumed investment return – 5%, 7% and 9%pa – whereas TM1 requires the use of a single rate (a maximum of 7%pa).
- 7.3 The FSA basis allows providers to personalise the nature of the pension taken at retirement – for example, providers can choose the assumed rate of pension increase and the percentage spouse’s pension. They can also assume that the member takes part of the pension as a cash sum at retirement. TM1 requires the assumption that no cash lump sum is taken, a specified rate of pension increase, and that, if a spouse’s pension is payable, it is 50% of the member’s pension.

TM1 AND FSA HANDBOOK CONSISTENCY

- 7.4 In *Policy Statement 07/18* (October 2007) the FSA stated “We fully appreciate the need for real projections to be calculated in a manner which is consistent with SMPIs. However, the DWP is currently considering replacing their detailed disclosure requirements, including prescription relating to the post sale regime for statements or SMPIs, with a more principles-based approach.”
- 7.5 The FSA allows projections which are consistent with the SMPI to be provided in addition to the standard projections as long as the material differences are explained.
- 7.6 We share the desire for consistency between point of sale projections and SMPI projections: differences can only cause confusion to individuals. There are three main differences between the TM1 basis and the FSA rules:
- a) The FSA requires three projections to be made assuming maximum rates of return of 5%, 7% and 9%p.a, unless these rates overstate the investment potential of the product. TM1 requires one projection to be made assuming a maximum return of 7% pa.
 - b) The FSA projections are not made in today’s terms and may therefore give significantly higher projected funds and pensions than TM1 projections which are shown in current money terms.

- c) The FSA allows the projections to be personalised and so assume various percentages of pension for spouses, that the pension will not increase or increase at various rates in retirement and that a cash sum will be taken at retirement.

7.7 The FSA reviews its rules regularly and we will continue to work with it to ensure consistency as far as is possible. In addition, the European Commission is consulting on proposals for Packaged Retail Investment Products (PRIPs). The Commission has concluded that product information requirements need to be made more consistent across investment products. The proposals may affect pension projections in the UK. The expected timetable of the PRIPs review means that it may not be possible to harmonise the TM1 basis and the FSA rules in the short term.

7.8 We will work with the FSA to investigate whether the bases can be made more consistent. Until the inconsistencies are reduced, we believe that it is possible for providers to provide information at point of sale and alongside SMPIs which explains the differences and could limit any possible confusion, such as:

- a) stating that SMPIs provided when the arrangement is in force will be based on the mid-point investment return assumption and that the pension illustrated will be lower because the FSA basis illustration has been stated in future money terms;
- b) showing a current money projection alongside the FSA basis projection ; and
- c) SMPIs showing a pension in a different format alongside an inflation-linked pension.

7.9 We would welcome views on this approach.

In section 7 we consider the interaction of TM1 with FSA rules for point of sale projections.

The BAS would welcome responses to the following questions:

- 22. Would pension scheme members benefit from the FSA and TM1 bases being harmonised? (paragraphs 7.4 to 7.7)**
- 23. Do respondents have any views on the approach set out in paragraph 7.8?**

8 DISCLOSURES

INTRODUCTION

8.1 This section considers TM1's disclosure requirements.

DRAFT DISCLOSURE REGULATIONS

8.2 Appendix A of TM1 sets out the information to be included with SMPIs. Some of the information is required by statute, in which case TM1 uses the word "must". In the case of information that is not required by statute TM1 generally uses the word "should".

8.3 The draft *Occupational, Personal and Stakeholder Pension Schemes (Disclosure of Information) (Amendment) Regulations 2010* were published on 6 January 2010. These Regulations would reduce the amount of information which must be provided with SMPIs. They would also permit some of the information which must currently accompany SMPIs to be made available through a website ("signposting"). The DWP's intention is that the changes will enable the production of shorter, simpler SMPIs.

TM1 REQUIREMENTS

8.4 We are proposing to adopt a similar approach to that adopted by the DWP in its draft Regulations. We propose that TM1 should continue to require providers to consider stating each of the important assumptions used in SMPIs and the key data (including fund value and contributions made) used in projections. For most of the other statements which TM1 currently states providers should consider giving, we propose to allow signposting. This should help to achieve the DWP's aim of shorter, simpler SMPIs.

In section 8 we consider the disclosures required by TM1.

The BAS would welcome responses to the following question:

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

9 TIMING OF CHANGES TO TM1

INTRODUCTION

- 9.1 The consultation period for this paper closes on 4 June 2010. We intend to issue an exposure draft of the revised TM1 in the summer of 2010, and the final version in the autumn of 2010.
- 9.2 We consider that it would be possible for SMPs issued for effective dates on or after 6 April 2011 to reflect the revised version of TM1. Given that statements will normally be issued some time after their effective date this should give providers sufficient time to make the required changes.
- 9.3 However, we recognise that providers will have to make a number of other changes to systems and procedures by 2012-13 because of changes to FSA and EU rules, prompted by, for example, Solvency II and the Retail Distribution Review. It has been suggested that it would be most efficient for providers to make several changes to systems at one time although it has also been suggested that it may be better for changes to be staggered. A later effective date for the revisions to TM1 would also allow a longer consultation period for the exposure draft.
- 9.4 We would welcome views on the timing of changes to TM1.

The BAS would welcome responses to the following question:

- 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?**

10 MISCELLANEOUS ISSUES

INTRODUCTION

10.1 This section considers a number of other issues concerning TM1.

ACCRUED PENSIONS

10.2 SMPIs are required to include a projection of the pension which members might receive if they continue to contribute to a pension arrangement at their existing rate. They are provided with no indication of how much of the pension is attributable to contributions which have already been made and how much of it relies on future contributions. We would be interested to know whether respondents believe that it would help members if the pension attributable to contributions already made was shown on SMPIs. Such information might also assist members understand how a change to the level of contributions could affect their pension.

UNCERTAINTY

10.3 The Disclosure Regulations require that SMPIs are accompanied by a statement that the amount of benefit does not represent a promise or guarantee. However there is no requirement for any uncertainty to be quantified. Uncertainty could be illustrated by providing additional information such as a range of pension amounts rather than a single figure. We understand that some providers do provide such additional information. However there is a view that there should not be a requirement to provide additional information as it would not benefit some recipients of SMPIs. We would be interested in respondents' views.

CONTRACTING OUT

10.4 Section 15 of the *Pensions Act 2007* abolishes contracting out on a money purchase basis with effect from an "abolition date", which is "such day as the Secretary of State may by order appoint". The Government has announced that it will introduce this change with effect from April 2012.

10.5 This change will be reflected in the next version of TM1.

FORM OF COMMUNICATIONS

10.6 There has been an increase in the use of electronic communication for pension scheme information since SMPIs were first introduced. This has been reflected in the DWP's draft disclosure regulations. The Government proposes to proceed with amendments to allow schemes to use electronic communications as their default method of communication if they wish. We would be interested in respondents' views on how, if at all, the production of SMPIs could be improved using such technology.

BEST PRACTICE

- 10.7 The Disclosure Regulations and TM1 prescribe information which must be shown on SMPIs, but do not specify the format in which it should be presented. It has been suggested that there should be more consistency between statements produced by different providers and that perhaps there should be a suite of “best practice” SMPIs maintained by an appropriate entity. We would welcome respondents’ views.

The BAS would welcome responses to the following questions:

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)**
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)**
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)**

11 INVITATION TO COMMENT

QUESTIONS

11.1 The BAS invites the views of those stakeholders and other parties interested in TM1. In particular the BAS would welcome views on the following issues:

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.
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)
3. Should the stated aim in paragraph 2.4 be modified and if so how?
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)
5. Could any changes be made to the structure of TM1 to improve its clarity? (paragraphs 4.2 and 4.3)
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)
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)
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)
9. Do respondents have any comments on paragraphs 5.5 to 5.6 concerning the option to take a cash sum at retirement?
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)
11. Should TM1 allow providers to choose specific mortality tables which are appropriate for the members of the arrangement in question? (paragraph 6.16)

12. Do respondents agree with the proposal to change the yield used for annuity calculations? (paragraphs 6.18 to 6.22)
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)
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)
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)
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)
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)
18. Do respondents have any comments on the long term inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)
19. Do respondents have any comments on the long term earnings inflation assumption of 2.5% pa? (paragraphs 6.34 to 6.36)
20. Should TM1 require SMPI projections to allow for guarantees? (paragraphs 6.37 to 6.38)
21. Is the approach for with-profits funds set out in section 6.7 of TM1 appropriate? (paragraph 6.39 to 6.40)
22. Would pension scheme members benefit from the FSA and TM1 bases being harmonised? (paragraphs 7.4 to 7.7)
23. Do respondents have any views on the approach set out in paragraph 7.8?
24. Do respondents have any comments on our proposal in 8.4 to allow 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?
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)

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)
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)
- 11.2 In addition to the specific questions listed above, the BAS invites respondents’ views on any other aspects of TM1.

RESPONSES

- 11.3 For ease of handling, we prefer comments to be sent electronically to basTM1@frc.org.uk. Comments may also be sent in hard copy form to:

The Director
Board for Actuarial Standards
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

- 11.4 Comments should reach the BAS by **4 June 2010**.
- 11.5 All responses will be regarded as being on the public record unless confidentiality is expressly requested by the respondent. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to publish should be submitted. If you are sending a confidential response by e-mail, please include the word “confidential” in the subject line of your e-mail.
- 11.6 We aim to publish non confidential responses on our web site within ten working days of receipt. We will publish a summary of the consultation responses, either as a separate document or as part of, or alongside, the exposure draft.

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FINANCIAL REPORTING COUNCIL
5TH FLOOR
ALDWYCH HOUSE
71-91 ALDWYCH
LONDON WC2B 4HN
TEL: +44 (0)20 7492 2300
FAX: +44 (0)20 7492 2301
WEBSITE: www.frc.org.uk

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