Consultation Document by the Financial Reporting Council on

AS TM1: Statutory Money Purchase Illustrations

Introduction

Section 7 of the consultation paper on the Exposure Draft version 4.0 of "AS TM1: Statutory Money Purchase Illustrations" (SMPIs), issued by the Financial Reporting Council (FRC) in November 2013, invites the views of stakeholders and interested parties in advance of the 13 December 2013 deadline for such responses.

I am a Fellow of the Institute and Faculty of Actuaries (IFoA) and currently hold a practicing certificate to act as a Scheme Actuary to pension schemes. My responses to the consultation paper are based on my understanding of SMPIs within the context of advising final salary schemes, some of which have money purchase sections which fall under the remit of SMPIs.

My personal views are provided in the same order as the issues are presented in Section 7 of the consultation paper.

1. Do respondents agree with the proposed approach to the allowance for cash in the calculation of the statutory illustration (paragraph 3.3)?

The proposed changes to SMPIs, due in part to revisions to The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 [SI 2013 No, 2734] which come into force on 6 April 2014, include scheme-specific and member-specific illustrations to reflect the specific features of the particular pension scheme and the specific circumstances of the member.

The revised regulations now permit the personalisation of SMPIs to reflect the form of pension that he member might choose at retirement, including amending the calculation methodology to assume a lump sum up to the maximum permitted under the scheme rules or legislation is taken.

Initially, SMPIs were introduced to provide a level playing field, using fairly prescribed actuarial assumptions, which provided end-users with a broad, indicative common currency approach to illustrate the possible value of their accumulated benefits in today's monetary terms. With the exception of the accumulation factor, which requires actuarial justification based on the current and expected asset-mix, the other actuarial assumptions were highly prescribed in AS TM1.

The relaxation to permit SMPIs to show a lump sum, as a deduction from the nominal accumulated amount available at retirement, presumably will not preclude providers from showing the pension benefit available at retirement assuming that no allowance for commutation is made. Indeed I would expect that providers will continue to provide an illustration of the member's pension with no allowance being made for the option for members to take part of their entitlement as a cash lump sum, not least to allow members to make a like-by-like comparison with previously issued SMPIs. This in turn would increase the complexity and the volume of figures being provided to members on the illustration.

The FRC needs to be clear going forward whether the SMPIs are intended to be a broad generic illustration of the possible benefits available at retirement or a tailored illustration of benefits given the particular scheme and member-specific circumstances. Providers have always had the option of providing members with an alternative tailored illustration based on actuarially justified assumptions out-with the constraints of AS TM1. It could be argued that

the provision of a lump sum on retirement is more relevant to members closer to retirement, at which point a more realistic illustration should be afforded to members based on prevailing market conditions rather than long-term averages.

There have already been several iterations to SMPIs and from the point of view of providers the FRC should bear in mind the potential system limitations in light of such changes to facilitate the provision of personalised statements.

2. What are respondents' views on the proposed approach to the cash assumption (paragraphs 3.6 to 3.8)?

The proposed calculation methodology is to generally allow up to 25% of the fund to be taken as a cash lump sum and that this is deducted from the nominal accumulated fund.

I am content with the proposed calculation methodology for the cash assumption and expect that most providers will assume that all members will take the maximum possible cash lump sum afforded under the scheme rules or legislation.

3. Do respondents agree with the proposed approach to the spouse's or civil partner's pension (paragraphs 3.10 to 3.12)?

The revised regulations do not specify a certain percentage for the dependant's pension payable to a spouse or civil partner on death (previously this was specified as being 50% of the member's pension). Consequently it is proposed that SMPIs are permitted to provide a range of values up to the maximum permitted under the scheme rules or legislation.

I would expect that providers will continue to provide an illustration of the member's pension assuming that the member elects to secure a pension of 50% for their spouse, civil partner or other dependant. It is unlikely that providers will have reliable and up-to-date member-specific information available to justify an alternative and highly subjective assumption in the range from nil to 100% of the member's reduced pension to allow for such an option to be exercised art retirement.

If providers gave an alternative to the currently specified 50% assumption then I would expect them also to provide additional figures based on the existing basis to allow members to make a like-by-like comparison with previously issued SMPIs. Again this would increase the complexity and the volume of figures being provided to members on the illustration.

Whilst certain members will not retire with an eligible spouse to purchase a contingent pension it is difficult to pre-empt what a member may or may not elect on retirement based on their particular personal circumstances. Indeed such spurious assumptions could be extended to base the cost of securing a pension using the spouse's actual age rather than the assumed three year differential between male members and their female spouse.

4. Do respondents agree with the proposed approach for the interest rate used for annuity rates when providers illustrate non-escalating pension (paragraphs 3.19 to 3.23)?

The annuity rate should be a broad indication of the market price of securing an annuity, which may in turn be purchased in thirty or forty years' time, based on the prevailing market conditions and the appetite of the providers of such annuity products at that time as well as allowing for the tax regulations then in-force.

Whilst two alternate approaches have been considered by the FRC, I consider that the yield on the FTSE Actuaries' Government 15 year Fixed Interest Index to be the most appropriate as a long-term proxy for the expected buy-out cost afforded by market participants whilst

appreciating that such a simplified approach cannot capture all of the complexities involved in pricing annuity business.

The provision of a pension which does not increase whilst in payment will obviously provide the member with a higher level of income than an increasing pension. I consider that such an illustration should come with a standard health warning and an illustrative table to demonstrate the potential erosive effects of price inflation are likely to have on the purchasing power of such a pension.

5. Do respondents agree with the proposed approach for the interest rate used for annuity rates when providers illustrate a pension that increases at other rates (paragraph 3.25)?

I am content that the current formula for calculating the net interest rate to evaluate annuities linked to price inflation (based on the FTSE Actuaries' Government Securities Index-Linked annualised Real Yields) over five years remains a valid and consistent approach to adopt.

I am content that it is impractical for the FRC to prescribe rules and formulae which cover all of such potential scenarios. For annuities which increase at a different rate from RPI price inflation, I agree that the provider should derive consistent and justifiable assumptions based on CPI, collars, caps etc.

It is noted that the FRC intend to make a full review of inflation-linked annuities and the interest rate used for non-increasing annuities during 2014 and this is welcomed to ensure that there is consistency in the approaches adopted for non-increasing annuities and those for inflation-linked annuities.

6. Should AS TM1 suggest that providers should disclose the accumulation rate used net of inflation (paragraphs 3.28 to 3.29 and 3.36)?

I cannot see what benefit would be gained by the disclosure of the net accumulation factor to the end-user. The disclosure of further figures will only serve to confuse members with little or no gain in their appreciation or understanding of the underlying calculations.

7. Do respondents agree with our proposal not to amend the price inflation assumption (paragraph 3.32)?

I am content for the assumed future level of price inflation to remain at 2.5% per annum as this is consistent with the longer term views of future price expectations.

8. Do respondents agree with our proposal not to amend the earnings inflation assumption (paragraphs 3.33 to 3.34)?

Currently the FCA rules require that price inflation is set at 2.5% per annum and earnings inflation is set at 4.0% per annum (1.5% per annum real) whilst SMPIs have point estimates of 2.5% per annum for both price and earnings inflation.

It is not intuitive that the rates of price inflation and earnings inflation are equivalent in the longer-term. Whilst it is acknowledged that earnings inflation can vary considerably during a member's working life-time, it is still expected to out-strip price inflation over the medium to longer term. It is therefore expected that members will receive a real compensation over and above price inflation regardless of age, occupation or seniority.

Whilst the dual equivalent assumption for price and earnings inflation no doubt simplifies the calculations for SMPIs this cannot be the sole over-riding factor in deciding whether or not earnings should or should not be assumed to out-strip price inflation.

However on the basis of simplification and on the grounds of prudence, I am content that the long-term assumptions for earnings inflation and price inflation remain at 2.5% per annum. This rationale does raise the issue of whether the SMPI should represent a realistic or prudent projection whilst noting that it is desirable to reduce the likelihood that the SMPI overstates the potential benefits available at retirement.

9. What other aspects of AS TM1 do respondents suggest should be considered in our review of AS TM1 next year?

In my opinion the SMPIs should have a greater focus on the risk and uncertainty inherent in such long-term money purchase projections. Such sensitivity or scenario testing should consider alternative accumulation rates and different expected costs of securing an annuity at retirement.

Rather than increasing the number of point estimate values provided to members, they will be better informed by an illustration or statement describing the inherent uncertainties within the illustration without being overly prescriptive or containing statistically spurious modelling.

As members get closer to retirement, say within five years of their normal pension age, it is reasonable to consider the use of short to medium term assumptions and also considering the available market annuity rates to provide members with a more realistic illustration of their likely benefits.

It is important that stakeholders and users of SMPIs have a clear understanding of the purpose of the illustrations and also the limitations of such point estimates.

10. Do respondents agree that the changes to AS TM1 should be effective for statutory illustrations issued on or after 6 April 2014?

Yes. The proposed time-scale will give providers sufficient time to ensure that their computer systems can accommodate the proposed changes as well as prepare the necessary literature to ensure that members are provided with suitable transitional information.

The comments contained in this response represent the personal views of the author and are not necessarily those of my employer.

I am content to submit this contribution to the IFoA with the aim of ensuring that the wider public are served by the provision of accurate and appropriate information with which can be relied on and for users of such information to be able to make informed decisions.

I am content for my response to be regarded as being on the public records.

Steven Wishart

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