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Dear Director of Actuarial Policy

SPP response to FRC's Consultation Paper on Proposed revision to AS TM1: Statutory Money Purchase Illustrations

We welcome the opportunity to respond to this consultation paper.

Key Messages

Our key messages in response to this consultation are:

- We are supportive of the proposals to prescribe the accumulation rates used in SMPs, although we have some concerns about the methodology proposed in certain circumstances.
- The proposal to illustrate expected retirement income in terms of a single life level annuity is not consistent with how the majority of DC members currently utilise their pots at retirement - i.e. relatively few people are likely to buy an annuity at all (albeit that could change depending on future market developments), at least not at initial drawing of benefits or on standard rates. We understand that the purpose is to offer a comparator to other pension benefits, but then this is not like for like either, as DB benefits will generally have dependant pensions and increases. However, we appreciate this is a difficult problem to address (figures on different bases could be provided but this would add complexity) and the approach is simple and offers consistency across providers which appears to be a key aim of the changes. Given these figures will feed into dashboards we believe it is important that drawdown is also represented in information presented to individuals and perhaps the only way to do this is through interactive tools rather than more linear illustrations.
- Providers (particularly with legacy systems) will need time to implement any changes so it would be helpful if the revised TM1 could be finalised well ahead of the dashboard "go

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live” date (we note that the intended finalisation date of 1 October 2022 should support this).

Detailed Response

QUESTION 1: How supportive are you of the approach to prescribe the accumulation rate and form of annuitisation more precisely, in order to improve consistency across projections from different providers? In particular, do you have any concerns arising from the loss of independence and judgement allowed to providers to set these terms?

We agree with the principle that pension dashboards need prescribed accumulation rates and annuitisation rates across providers, so that projected DC pots and expected retirement income (ERI) are calculated on a consistent basis across aggregate DC savings. This should capture the specific investment characteristics of each pot without provider subjectivity resulting in different answers for identical solutions, which should be to members’ benefit. The revised approach will potentially take a cost out for providers as they will no longer need to take advice on assumptions if they are prescribed in TM1 and, in general, we do not envisage any significant issues with the loss of independence and judgement allowed to providers to set the assumptions.

However, there are complications that need careful consideration. The proposed method will set accumulation rates to funds which are categorised into different levels of risk based on their historic volatilities and will base volatility on the latest 5 years’ weekly price movements. There are clear situations where this could lead to misleading ‘expected’ returns:

- Allocations to very long dated gilts and investment grade credit. Rather at odds with the capital market theory, long dated gilts can display a very high level of volatility and yet they do not offer an equally high return. This is because investors use them to hedge long dated liabilities and this absolute volatility does not translate to risk that demands an additional return from investors. De-risking DC pots into long dated gilts used to be the norm within DC, and while this has become rather less prevalent with the appreciation that savers may instead access pension freedoms, it is still a prevalent enough investment that this issue deserves consideration.
- Different equity funds could find themselves in different groups, e.g., some in group 3 and some in 4, with a 2% pa difference in accumulation rates. This may not reflect the likely accumulation difference in practice.

We also note that care may be needed with member communications in advance of the revised SMPs being issued as the figures will potentially be materially different to previous SMPs (in particular a move to a flat rate single life annuity from indexed and/or dependant’s pension). There does not appear to be any requirement to add additional text to SMPs to explain this, and it would therefore be up to trustees and providers to provide that additional information to the member.

QUESTION 2: What are your views on the proposed effective date of 1 October 2023?

The implementation of the revised TM1 assumptions fits in with the Pension Dashboard deadline. As updates to systems can be a significant undertaking (especially for legacy systems) it is hoped that any changes are finalised well in advance of the October 2023 date to give as much time as possible to update systems and processes.

On the other hand some providers may appreciate the flexibility to be able to adopt the changes sooner rather than await the proposed dashboard go live date.

Some providers (perhaps such as AVC arrangements in DB schemes) may be entirely reliant on data from external sources (such as a number of fund managers) to allocate funds to volatility buckets making the process more difficult, but the lead in time would seem to be long enough for solutions to be put in place.

QUESTION 3: What are your views on the proposed volatility-based approach for determining the accumulation rate?

We have some concerns as outlined in Q1. We think there may be merit in considering combining the asset class and volatility approach to address some of these issues.

Question 4: Based on an assumed CPI of 2.5% do you find the accumulation rates proposed for the various volatility groups to be reasonable and suitably prudent?

The proposed accumulation rates look reasonable for growth assets and short dated fixed income instruments, but we would note again that long dated gilts can be volatile without a commensurately higher accumulation rate being appropriate.

Question 5: What are your views on the proposed approach to reflect derisking when calculating the accumulation rate assumptions?

We agree that adjusting for future derisking is important when making these projections. Providing guidance to providers as to how to implement this adjustment consistently is also important. We support the proposal that adjustments should be in line with the actual, systematic derisking.

Question 6: What are your views on the proposals that the recalculation of volatility indicator should be annually as at 31 December with a 0.5% corridor?

Overall we feel this approach is reasonable, although with some concerns noted below. We agree with an annual recalculation and recognise that using 5 years of historic data will provide smoothing. We have concerns that the corridor could result in exactly the issue that the FRC are seeking to avoid – identical funds using different assumptions, should a fund just caught in a higher group marginally reduce risk to fall into a lower group, for example, but not switch category due to the corridor. Perhaps consideration should be given to less of a cliff edge between categories, although any expansion in the number of categories will need to be balanced against the increased costs of implementation and maintenance this could cause providers.

We are also wary of the suggestion that extreme market movements should be tempered in the calculation. For example, some asset classes will suffer more than others from event risk, so volatility may appear low until it isn't. Reducing the impact of extreme market movements will understate the long-term risk.

Question 7: What are your views on the proposed approach for with-profits fund projections?

In the spirit of prudence the latter, rather than the former, approach would seem more reasonable (i.e. using the smoothed returns and therefore implying lower risk and therefore lower returns). We note there isn't a 'right answer' here as both approaches can be seen to be valid, and communications should ideally explain the approach being used.

Q8: Do you have experience of unquoted assets held in pension portfolios and what are your views of the proposed approach for unquoted assets? In particular do you regard a zero real rate of growth to be acceptable and if not please provide suggested alternatives with evidence to support your views?

Given the difficulty in estimating volatility in unquoted assets and the very low allocations, we can appreciate the rationale for proposing a zero percent real rate of growth but believe that this is far from ideal. Many initiatives are underway to increase the access to unquoted assets (e.g. LTAF's and the DWP's review: Facilitating Investment into Illiquid Assets), and we would not want zero return assumptions in any way being a deterrent to investment nor misleading in retirement planning as allocations grow. As unquoted assets are usually expected to deliver a higher return than their quoted counterparts (as a reward for the illiquidity) a listed proxy should be a prudent solution. Alternatively there has been significant work done on 'unsmoothing' models that adjust for the phenomena of a lower observed volatility, resulting from the lack of a market price ¹.

Question 9: What are your views on the proposed approach to determine the accumulation rate assumption across multiple pooled funds?

The proposed approach to projecting each asset class separately when members have chosen a number of funds appears sensible, although it may require additional work (and time) to bring together multiple sets of data for each constituent fund and this should be considered.

However, it should be noted that the approach can lead to anomalies. For example, the return for a 50%/50% investment in two different funds in volatility groups 3 and 4 would effectively be 6% pa, whereas a unitised fund with identical underlying investments in a single fund could be in a volatility bucket (3 say) leading to a lower aggregate return (say of 5% pa).

Question 10: What are your views on the proposed prescribed form of annuitisation and treatment of lump sum at retirement? In particular, does the recommendation to illustrate a level pension without attaching spouse annuity cause you any concerns in relation to gender equality or anticipated behavioural impacts?

This is an important point with a number of challenges but no easy answer to this. Using a level single life annuity is more reflective of how these benefits are taken in the event of an annuity purchase than increasing and/or with a spouse's annuity. However, it could cause confusion if compared to a DB pension (which will normally be increasing with spouse's benefits attached) on the dashboard, and the proportion of people taking benefits in the form of an annuity is now also low (with the majority taking cash or drawdown). Where people do buy an annuity, it is likely to take into account medical considerations (enhanced or impaired) and a standard mortality pool seems unlikely. So any form of annuity DC income is unlikely to be reflective of what a member will receive in practice. However, it is a simple approach and will aid comparability and consistency across providers.

In relation to gender equality, there is a slight issue here in that larger pots will belong to males (generally as evidenced by various reports highlighting a gender pensions gap) and in practice

¹ <https://www.ipf.org.uk/static/uploaded/27da2453-38e8-49ce-b5709f037272f1d0.pdf>

<https://www.aqr.com/Insights/Research/White-Papers/Demystifying-Illiquid-Assets-Expected>Returns-for-Private-Equity>

https://wpcarey.asu.edu/sites/default/files/2021-11/andrea_rossi_seminar_paper_november_1_2019.pdf

https://www.nber.org/system/files/working_papers/w9571/w9571.pdf

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3544854

such individuals may be more likely to buy an annuity with a spouse's pension attached to address this and add security for the spouse. Not illustrating on these rates could reduce the number of people that take this option, as individuals fail to consider this option as part of their retirement planning. However, the point remains that annuities with spouse's pensions attached generally are not currently purchased anyway. In our view, there are far more impactful issues to consider in relation to the gender equality in pension provision, such as helping provision become more equal.

Question 11: What are your views on the proposed approach to determine the discount rate assumption when used to determine the annuity rates for illustration dates which are a) more than two years from retirement date and b) less than two years from retirement date?

The approach a) seems sensible if the premise that providing an estimate of a single life level annuity is deemed the most appropriate, and the removal of the option to set the rate with reference to real yields is a welcome simplification.

The approach under b) seems sensible as it reflects what would be available in the market (although again note the points above about whether many individuals will purchase a single life level annuity at retirement in practice, it could be argued the potentially significant work required to provide current rates is disproportionate).

The only other point we would make is around whether 2 years out from retirement age is the appropriate change point given many people will take benefits early (although admittedly less so with annuitisation than other options).

Question 12: What are your views on the proposed new mortality basis for determining the annuity rates where the illustration date is more than 2 years from the retirement date?

We note that the changes are mainly to new equivalent standard actuarial tables and mortality projections models. Whilst this will require providers to update their systems, we believe it is appropriate to use the most recent tables and mortality projections model. We presume the intention is for the CMI model to be with the default parameters unless specified otherwise.

The use of a standard table will not take into account the circumstances of an individual purchasing an annuity. We would question whether the historic/current population of annuitants (on which standard tables are based) is likely to be reflective of those purchasing annuities in future, noting our comments above about the use of drawdown and enhanced/impaired annuities. However, again, we do not advocate a more granular approach on the grounds of simplicity.

Question 13: Do you have any other comments on our proposals?

No further substantial comment, although we would note it is worth keeping the approach consistent with other related regulatory requirements, if possible, e.g. with other DC illustrations being produced such as through modelling tools and costs and charges illustrations. Members often get very confused when their statement gives different growth rates to a modeller. We would also encourage consideration of the wider relevance of SMPI's and whether they could be online (with exceptions) for efficiency purposes.

Question 14: Do you agree with our impact assessment? Please give reasons for your response.

It is hard to comment on these without understanding the sources of the data that underpins the assessment. For example, in 6.11, have providers followed your advice? For legacy platforms

potentially they might not have.

Response ends

Yours faithfully

p.p. 

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