Financial Reporting Council

Feedback Statement and Impact Assessment

AS TM1: Statutory Money Purchase Illustrations

February 2024

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Executive Summary

1. The Financial Reporting Council (FRC) consulted in November 2023 on revisions to the accumulation rates in Actuarial Standard Technical Memorandum 1 ('AS TM1'). The FRC received eight written responses to our consultation, which came from a mixture of consultancies, industry bodies and pension providers. This executive summary draws out the key areas in which feedback was provided.

Proposed Increases to Accumulation Rates

2. The majority of respondents agreed or stated they did not disagree with the proposed changes to accumulation rates (increasing the rate for volatility groups 1, 2 and 3 by 1% but keeping the rate for volatility group 4 at 7%).

3. Some respondents gave arguments for a larger increase for volatility groups 1, 2 and 3 but stated that on balance they were comfortable with a 1% increase.

4. Two respondents disagreed with increasing the accumulation rates for volatility groups 1, 2 and 3. They expressed the view that recent changes in the market outlook are short/medium-term indicators and that there is insufficient evidence of a change in the long-term investment outlook. These respondents also raised a concern that the proposed accumulation rate of 6% (nominal) for volatility group 3, which is used by many self-invested personal pension (SIPPs) providers where volatility data cannot be reliably determined, is higher than the maximum permitted 'intermediate rate of return' of 5% (nominal) set by the Financial Conduct Authority (FCA) for point of sale or ad hoc illustrations (under the FCA's Conduct of Business Sourcebook (CoBS 13)). However, we note that the assumptions under AS TM1 were already different to those under CoBS 13, including the maximum rate net of inflation (see paragraph 24).

5. The majority feedback was supportive of the proposed changes to accumulation rates, with the arguments for a larger increase for groups 1, 2 and 3 being offset by those suggesting making no increase. The FRC has therefore published AS TM1 v5.1 in line with the proposed changes to accumulation rates.

Other areas of feedback

6. A number of respondents commented on known limitations of the use of volatility groups to determine accumulation rates for defined contribution investments. This included highlighting that certain funds, including index linked gilts, could be in volatility group 4 but this was not representative of reasonable long-term expected returns for these funds. The FRC addressed this limitation in the feedback statement published in October 2022. The FRC is not currently reviewing the volatility approach, which was introduced in AS TM1 v5.0 with effect from 1 October 2023.

7. The majority of respondents were supportive of the proposed effective date of 6 April 2024, although two respondents gave the view that confirmation of the rates by 15 February 2024 could leave insufficient time for some providers to update systems for implementation by 6 April 2024, and respondents requested the FRC confirm the revised standard as soon as possible. The FRC has finalised the standard with the effective date of 6 April 2024 as proposed.

8. Some respondents queried the requirement for AS TM1 v5.1 to be effective for statutory illustrations based on *'calculations performed'* on or after 6 April 2024, rather than where the *'illustration date'* is on or after 6 April 2024. The FRC has maintained the proposed approach to setting the effective date to ensure consistency in the implementation date of v5.1 with the wording in paragraph C.2.8 of AS TM1 which sets out the periods to be considered in the calculation of 5-year volatility for an investment.

Introduction and background

1. The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC is responsible for setting Technical Actuarial Standards in the UK.

2. Since 6 April 2003 money purchase pension arrangements have been required to provide members with Statutory Money Purchase Illustrations (SMPIs). These illustrations are governed by the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 as amended. Legislation requires that statutory illustrations 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.

3. The FRC has been the prescribed body since 6 April 2007 and fulfils its obligations through the publication of Actuarial Standard Technical Memorandum 1: Statutory Money Purchase Illustrations (AS TM1). AS TM1 specifies the assumptions and methods to be used in the calculation of statutory illustrations of money purchase pensions, also known as defined contribution pensions.

4. Providers' point of sale and ad hoc projections are subject to the assumptions set within CoBS 13 issued by the FCA.

5. In November 2023, the FRC issued a consultation paper on proposed changes to AS TM1 v5.0, which included an exposure draft of the proposed revised standard AS TM1 v5.1. The consultation closed on 4 December 2023.

6. This paper provides a summary of the feedback received and sets out the FRC's response. The final version of AS TM1 v5.1 is issued alongside this paper.

Summary of Responses

Responses to the public consultation

1. The FRC received eight written responses, which have been published on the FRC website. The table summarises the number of responses by respondent type and a list of respondents is set out in Appendix 1.

Category of Respondent	Number
Industry bodies	3
Consultancies / professional services firms	4
Pension schemes/providers	1
Total	8

2. Respondents covered three main forms of defined contribution pension provision: trust based pension schemes, contract-based schemes and SIPPs. The respondents relating to trust and contract-based schemes were broadly supportive of the proposed accumulation rates, although specific points were raised which are discussed below. The two responses relating to SIPPs were consistent in their concerns, suggesting accumulation rates should remain unchanged, and also highlighting differences between the proposed rates and the maximum permitted 'intermediate rate of return' of 5% set by the FCA for point of sale or ad hoc illustrations (under CoBS 13).

3. In this section we summarise the points raised in written submissions and provide comment on the FRC's position.

Question 1: Do you agree with the proposed change to accumulation rate for volatility group 1 (from 1% p.a. to 2% p.a.)? If not, what alternative accumulation rate do you think would be appropriate for this group? Please provide supporting evidence for any alternative view.

4. All eight respondents answered this question.

5. Six of the eight respondents either agreed with the proposed change or stated that they did not disagree with the proposed change. Of these, two respondents noted that there are arguments for a larger increase to this accumulation rate but were comfortable with the

proposed increase from 1% to 2% to avoid giving unrealistic expectations of long-term growth in cash holdings and to help achieve stability of assumptions over time.

6. Two respondents disagreed with the proposal. While they agreed that there has been an increase in short to medium-term outlook for returns of funds in volatility group 1, they did not consider that there is sufficient evidence that recent changes represent a change in the expected return for these funds over the long-term.

FRC response

7. We acknowledge the arguments made for retaining the current accumulation rate assumptions for volatility group 1, but this is balanced by other responses making an argument for a greater increase based on current market conditions. We also note that the majority of responses are supportive of or do not disagree the proposed change.

8. While the two respondents who disagreed with the proposals consider that there has not been sufficient evidence that that recent changes represent a change in the expected return for these funds over the long-term, they have not disagreed with the rationale set out in the consultation and the analysis further detailed in section 4 of the technical analysis paper, nor have they provided supporting evidence for their view.

9. FRC has therefore finalised AS TM1 v5.1 with the proposed accumulation rate of 2% for volatility group 1.

Question 2: Do you agree with not amending the accumulation rate for volatility group 4? If not, what alternative accumulation rate do you think would be appropriate for this group? Please provide supporting evidence for any alternative view.

10. All eight respondents answered this question.

11. Five of the eight respondents agreed with the proposal or stated that they did not disagree with the proposed change.

12. One respondent stated they believe there should also be an increase in this accumulation rate for group 4, suggesting a raise from 7% to 7.5% reflecting higher expected return for higher risk fund, and avoiding 7% appearing to be a 'cap' on returns. However, this respondent noted that the rationale for the FRC's proposal is clear and they also acknowledge there are arguments against setting rates than are not whole percentages.

13. Two respondents commented that the accumulation rate of 7% currently used for volatility group 4 in AS TM1 is different to the FCA's CoBS 13, which specifies assumptions for point of sale and ad hoc projections) where the intermediate rate of return must not exceed 5% for a pension scheme. These respondents reiterated concerns raised during the consultation on AS TM1 v5.0 that this difference could lead to customer confusion and challenges for providers in fulfilling their responsibilities regarding customer understanding under Consumer Duty requirements.

FRC response

14. As the majority of responses are supportive of the proposal, the FRC has finalised AS TM1 v5.1 with the proposed accumulation rate of 7% for volatility group 4. Our analysis, as set out in the technical paper, suggests that an accumulation rate assumption of 5% (in combination with other assumptions under AS TM1) for funds in volatility group 4 would understate reasonable prudent expectations of returns for most funds falling in this group. Comments on consistency between CoBS 13 and AS TM1 are considered in paragraph 24 below.

Question 3: Do you have any other comments on the proposed accumulation rates as set out above?

15. Seven of the eight respondents answered this question.

16. Three respondents commented that they agreed with the proposed increase by 1% to the accumulation rates for volatility groups 2 and 3 or stated that they did not disagree the proposed change.

17. Five respondents noted that certain asset types, particularly index linked gilts, have experienced significant recent volatility which would place them in volatility group 4, giving accumulation rates that they believe are not consistent with long-term return expectations for that asset type. Respondents made two suggestions for further changes to AS TM1 to address this issue:

    - One respondent suggested increasing the boundary between volatility groups 3 and 4 from 15% to 17% to reduce the risk of gilt funds falling into volatility group 4.
    - Two respondents suggested expanding the circumstances where volatility group 3 could be used (as set out in paragraph C.2.15 of AS TM1 v5.0) to include scenarios where the volatility group for a fund is deemed to be unreasonable.

18. Two respondents commented that many investments held within SIPPs default into volatility group 3 which currently has a 5% accumulation rate under AS TM1 v5.0 which is the same as the maximum permitted intermediate rate of return under CoBS 13. These respondents disagreed with the proposed change in accumulation rate for group 3 to 6% as they felt this would increase the inconsistency between AS TM1 and CoBS 13 projections, reducing understanding for pension savers.

FRC response

19. As noted in paragraph 1.5 of the consultation paper, this consultation relates to the proposed changes to accumulation rates. The FRC is not currently reviewing the general approach of setting accumulation rate assumptions based on an investment's 5-year volatility of monthly returns, which was introduced in AS TM1 v5.0 with effect recently from 1 October 2023.

20. The FRC recognise that the price volatility of index linked gilt funds, may overstate their level of risk and their potential for future returns. This was considered and commented on in the

consultation on AS TM1 v5.0 published February 2022, and we considered it was acceptable due to the relatively low prevalence of index linked gilt investment in money purchase funds, particularly for savers further from retirement where the accumulation rate has the most significant impact on the pension illustrations.

21. As noted in section 3 of the technical analysis, the FRC identified that a number of fixed income funds within the data set analysed (primarily index linked gilts) had a five-year volatility in the range of 15.0%-15.5%, which would lead to them being in volatility group 4 (although the action of the 0.5% 'corridor' described in AS TM1 v5.0 paragraph C.2.12 may leave these funds in group 3 this year).

22. In the technical analysis, the FRC considered the impact of increasing the boundary between volatility groups 3 and 4. As noted in paragraph 3.17 of the technical analysis, such an increase would cause more funds (typically equity funds) to move down from group 4 to group 3 than it would prevent from moving up. This could cause a particular issue in communicating this change to members where there would be funds where the volatility had increased from one year to the next and yet they had moved down a volatility group.

23. The FRC considered the suggestion of expanding the circumstances where volatility group 3 could be used to cover scenarios where the volatility group for a fund is deemed to be unreasonable. This approach, however, would give additional potential for inconsistency between providers in returns assumed for the same funds. Consistency between providers is a key aim of the FRC in setting AS TM1 v5.0, particularly with the future use of these figures in illustrations on Pensions Dashboards. Given the expected low prevalence of index linked gilts investment for money purchase savers further from retirement (where accumulation rates have more impact on illustrations), the FRC considers that the negative impact from stepping away from a principle of consistency would outweigh the benefit.

24. The FRC recognises that the assumptions within AS TM1 differ from those in CoBS 13. These include the accumulation rates, which are the subject of this consultation, but also other assumptions such as the inflation assumption, salary increases and prescriptions on the form of annuity assumed to be taken. The FRC also notes that while the current nominal accumulation rate assumption for volatility group 3 of 5% is the same figure as the maximum permitted intermediate rate of return assumption under CoBS 13, this masks the fact that the net rate of return, after allowing for inflation, already differs (2.5% under AS TM1 compared to a maximum of 3.0% under CoBS 13 intermediate rate projection) and that it is the net rate of return which determines the illustrated growth of a fund up to retirement date.

25. The FRC has finalised AS TM1 v5.1 with the proposed accumulation rate of 4% for volatility group 2 and 6% for volatility group 3.

Question 4: Do you agree with the proposed effective date of 6 April 2024?

26. All eight respondents answered this question.

27. Five of the eight respondents agreed with the proposed effective date.

28. Three respondents requested the FRC publish the outcome of the consultation before the 15 February 2024 date given in the consultation paper, to maximise the time available to make system changes if a 6 April 2024 effective date is maintained.

29. Two respondents gave the view that 6 April 2024 would be too soon because:

- As the rates would only be finalised by 15 February 2024, this would not allow enough time to update systems by 6 April 2024.
- AS TM1 v5.0 only became effective 1 October 2023 and they suggested a minimum period of 18-months before making changes is appropriate to allow a period of stability for members in the approach.

30. One respondent suggested that:

- The effective date for AS TM1 v5.1 should be brought forward to be for illustration dates on or after 15 February 2024; and
- SMPIs with an illustration date on or after 15 February 2024 should use an annuity based on interest rates at 15 February 2024.

31. This respondent noted many schemes have end-March or 5 April illustration dates, and for these illustrations:

- The first point above would mean the 2024 illustration would be on AS TM1 v5.1 and so, given that the 2023 illustration was on AS TM1 v4.2, there would be no need to use AS TM1 v5.0 at all for these illustration dates. This would avoid the need to communicate two separate changes in approach (from v4.2 to v5.0 and then from v5.0 and v5.1) to members, and avoiding making two system changes.
- The second point above would mean that illustrations are based on more recent annuity assumptions, with the reference yield used to set the annuity being no more than a year prior to the illustration date.

32. This respondent also suggested allowing early implementation on a discretionary basis for illustration dates on or after 30 September 2023.

33. Four respondents questioned the proposed wording of AS TM1 v5.1 being effective for statutory illustrations based on *'calculations performed'* on or after 6 April 2024, noting that the *'illustration date'* is a more clearly defined date and would be a more appropriate reference date for which version of AS TM1 to use. These responses also suggest paragraph C.2.8 of AS TM1 v5.0 should be amended to refer to the *'illustration date'* rather than when the *'calculation is performed'*.

FRC response

34. As noted in paragraph 1.4 of the consultation paper, the feedback statement for AS TM1 v5.0 the annual process to review the appropriateness of accumulation rate assumptions and volatility group boundaries annually:

- Based on data up to 30 September.
- Allowing a one-month consultation in November on proposed changes if necessary.
- The FRC would aim to publish the revised AS TM1 by 15 February for application in the following financial year.

35. The chosen deadline of 15 February to finalise the revised standard is consistent with the required update to the annuity discount rates based on yields at 15 February each year. While we would aim to finalise the revised standard as early as possible in the year, a date significantly before 15 February would not be possible due to the need to consult on proposed changes and for appropriate governance processes to be followed.

36. AS TM1 v5.0 strongly advises providers to take account of the possibility of changes to the assumptions when devising systems for producing SMPIs. The majority of respondents did not raise a concern over the time period between publishing the updated standard and the effective date of these changes. The FRC considers that bringing the effective date forward to 15 February 2024 (both for the changes to accumulation rates and the annual update of the annuity interest rate i.e. for the finalised standard to be effective immediately), would be unreasonable and not allow time to make any system changes.

37. The FRC considers that the accumulation rates in AS TM1 v5.0 are no longer appropriate and should be updated as soon as reasonably possible. Any further delay in making changes will increase the impact of members receiving benefit illustrations which do not reflect reasonable return expectations.

38. The FRC has not allowed for early adoption of v5.1 on a discretionary basis, as this would reduce consistency of projections with different assumptions being used by different providers for the same or similar funds.

39. The exposure draft of AS TM1 v5.1 proposed an effective date for statutory illustrations '*based on calculations performed*' on or after 6 April 2024. This wording was used to ensure consistency between the accumulation rates used and the 5-year period considered for the volatility calculation, as per C.2.8 of AS TM1 (which also relates to the date period *'in which the calculation is performed*').

40. The FRC are aware of providers that have interpreted the 'date calculation is performed' to be the same as the *'illustration date'*. We are comfortable that this approach is consistent with the intention of AS TM1 v5.0.

41. However, the FRC notes that it is possible to take a different interpretation whereby the *'date calculation is performed'* is different to the *'illustration date'*. The FRC considers it inappropriate

to amend C.2.8 to refer to *'illustration date'* at this stage of the process without further consultation or outreach. Given the need to finalise the revised standard by 15 February, the FRC intends to conduct further stakeholder engagement in due course on this matter to consider if further amendments may be appropriate in any subsequent review.

42. Based on the comments received, we have maintained the proposed effective date for statutory illustrations based on calculations performed on or after 6 April 2024.

Question 5: Do you agree with our impact assessment? Please give reasons for your response, and estimates of costs where possible.

43. Six out of eight respondents answered this question.

44. Four respondents agreed that updating the accumulation rates would be simple and incur minimal costs.

45. One respondent agreed that the impact assessment was reasonable but expressed concern that these changes would occur alongside significant other changes in the pension industry, such as abolition of the Lifetime Allowance, and potentially Pensions Dashboards developments. They suggested that coordination of timing with any other regulatory changes could improve the budgeting of providers implementing changes.

46. One respondent agreed that the update to the assumptions in their systems would have minimal cost but commented that there may be significant cost in educating members, both from adopting the volatility approach to setting accumulation rates required by AS TM1, and also from the proposed changes to the assumptions used.

FRC response

47. The written responses indicate stakeholders are in broad agreement of the impact assessment as set out in the consultation paper. As such, the impact assessment performed and communicated as part of the consultation in November 2023 remains valid.

48. The FRC recognise the comment regarding the communication of the move to a volatility approach to setting accumulation rates, and this was considered and responded to in the consultation on AS TM1 v5.0. Subsequent communications relating to updated assumptions are expected to be more limited.

General comments

49. One respondent noted that the inflation rate in AS TM1 is 2.5% whereas it is 2% in CoBS 13 (for the intermediate rate projection) and asked for alignment of this assumption. This was considered and commented on in our consultation on AS TM1 v5.0 published in October 2022. The FRC's consideration on the inflation assumption was set out in paragraphs 3.3 to 3.6 of the consultation paper and we consider the current long-term inflation assumption of 2.5% continues to be reasonable.

50. One respondent pointed out two errors in numbering in the exposure draft of v5.1 in referencing paragraph B.6 instead of B.6.1 in paragraphs B.6.2 and B.6.3. These have been corrected.

Impact Assessment

Benefits

1. The change ensures the accumulation rate assumptions in AS TM1 continue to remain up-to-date given latest economic conditions and outlook. This in turn will ensure all SMPIs and Estimated Retirement Income illustrations on future pensions dashboards remain appropriate.

Costs

2. The amendment to the accumulation rate assumptions is expected to result in minimal costs to providers relating to:

   - Updating parameters within SMPI calculation systems, and testing of these updated parameters; and
   - Updating accompanying communications to SMPI users.

3. At the time of finalising AS TM1 v5.0 in October 2022, the FRC stated our intention to carry out an annual review of accumulation rates and volatility boundaries, and AS TM1 v5.0 states that the methods and assumptions used may be changed as a result of regular reviews of the standard. We anticipate providers will have developed systems in such a way to enable these parameters to be updated annually.

4. As a result, the FRC anticipate the cost of any system changes to be relatively low and outweighed by the above benefits to users.

Appendix 1 – List of respondents to consultation

The FRC received 8 written responses to the consultation, none of which were confidential. These responses are published on the FRC website. The respondents were as follows:

- The Association of British Insurers.
- The Association of Consulting Actuaries.
- Aon.
- Buck.
- Curtis Banks.
- The Investment & Life Assurance Group.
- Mercer.
- Willis Towers Watson.

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