GN34: Illustration of Defined Contribution Pension Scheme Benefits

Classification
Recommended Practice

MEMBERS ARE REMINDED THAT EVERY GUIDANCE NOTE MUST BE READ IN THE CONTEXT OF THE PROFESSIONAL CONDUCT STANDARDS (PCS)

Application
Any actuary providing an illustration of defined contribution benefits (including defined contribution underpins and target benefit arrangements) provided by a pension scheme. Pension schemes for this purpose include approved and unapproved schemes, stakeholder pensions, personal pensions and additional voluntary contribution arrangements. Illustrations of benefits provided during an income drawdown period are also covered.

Legislation or Authority
None

Author
Pensions Board

Status
Approved under Due Process (Technical Amendment)

Version	***Effective From***
1.0	01.05.00
1.1	13.01.03

Adopted by BAS on 19.05.06

Ceased to apply on 01.04.11

1 Introduction

1.1 This Guidance Note refers to illustrations but should be understood to cover any projection of defined contribution pension scheme benefits.

1.2 The Guidance Note covers all illustrations including those that will be issued to scheme members and those not related to specific individuals such as those provided to the press and thence used to advise the general public.

1.3 This Guidance Note does not apply to illustrations, prepared in accordance with TM1, that are produced to meet the requirements introduced by The Occupational and Personal Pension Schemes (Disclosure of Information) Amendment Regulations 2002. However, where such an illustration is produced, the actuary should make clear that it does not fulfil the purpose set out in section 2.1 below, and should indicate what further illustrations would be appropriate.

1.4 Section 1.3 above applies equally where an actuary is producing an annual benefit statement in accordance with TM1 in circumstances where the illustration is not mandatory. Similar principles also apply where an actuary is producing an illustration in accordance with another basis prescribed by a regulatory or other authority, such as by the Financial Services Authority (FSA) or Inland Revenue, and where the illustration does not fulfil the purpose in section 2.1.

2 Purpose

2.1 The purpose of the Guidance Note is to require that appropriate illustrations are made and sufficient information is given to enable the recipient to appreciate the risks involved in a defined contribution arrangement.

2.2 Before starting an assignment, the actuary should be clear about the purpose of the illustration and the nature of any benefit promise.

3 Calculations

3.1 The actuary should be satisfied that, in his or her professional opinion, the illustrations are meaningful and realistic for individual members at all relevant ages.

3.2 The assumptions used should be consistent and reasonable.

3.3 Existing assets and future contributions (if any) taken into account in the illustration should be measured on bases consistent with the assumptions used.

3.4 If a member draws his or her benefit at the illustrated retirement age shortly after receiving an illustration on the same terms, and the economic environment is substantially unchanged, he or she should receive a benefit broadly equal to the amount in the illustration.

3.5 The actuary should describe or illustrate how the result will differ if the assumptions used are not borne out. Possible approaches to illustrating volatility include:

3.5.1 providing multiple illustrated benefits with variations in the key assumptions, for example different investment return and mortality assumptions;

3.5.2 quoting the effect of an addition to and a deduction from a key assumption, for example investment return;

3.5.3 a stochastic analysis, for example illustration of a 'funnel of doubt'.

3.6 The actuary should describe or illustrate how income drawdown benefits will differ if the assumptions used (including annuity purchase rates) are not borne out.

3.7 If the illustration shows different investment returns for different categories of investment, the illustration of volatility should also illustrate or explain the relative risks of these different classes of investment.

3.8 Benefit illustrations may be in real terms or monetary terms. For illustrations in monetary terms, an explanation of how the illustrated benefits should be adjusted to allow for inflation should be provided.

3.9 Administrative expenses charged to a scheme member's account should be taken into account.

4 Disclosure

4.1 The actuary should use his or her best endeavours to ensure that the illustration is presented to the ultimate recipient in a complete and balanced way.

4.2 If a specific calculation method (that is one required by a regulatory or other authority) has been used, then the illustration should make this clear. Where illustrations do not follow a particular regulatory method, such as FSA rules, the actuary should consider whether it is appropriate to draw attention to this in the illustration and to make clear that the illustration is not suitable for comparing with projections prepared on an FSA or other specified basis.

4.3 The illustration should contain a statement of the principal assumptions used to calculate the illustrated benefits.

4.4 The actuary should provide sufficient information to allow the ultimate recipient of the illustration to relate the benefits shown to his or her current income. The illustrated benefit may be a monetary amount, in real terms, or a percentage of projected salary.

4.5 The illustration should make clear what death benefits and what level of pension increases in payment have been included in the illustrated benefits.

4.6 In addition to providing basic information, the illustration should make clear:

4.6.1 which of the member's funds have been included in the illustrated benefits (for example whether the projection includes AVCs);

4.6.2 what level of future contributions has been assumed (including increases to future contributions);

4.6.3 whether any adjustment has been made to future contributions, for example to cover the cost of insured death benefits; and

4.6.4 if any asset values used are not market values, why these values have been used.

4.7 Income drawdown illustrations should explain the way in which the absence of the normal cross-subsidy from early deaths under an annuity contract may affect the benefits eventually secured when an annuity is purchased.

4.8 Spurious accuracy should be avoided. For many illustrations, illustrated benefits calculated to 3 significant figures will be adequate.

4.9 All illustrations should include appropriate risk warnings and advise the ultimate recipient to obtain regular updates of the illustration.

5 Comparison of Defined Benefit and Defined Contribution Benefits

5.1 Particular care should be taken in preparing an illustration that will be used to compare defined benefits and benefits from defined contributions, since it is possible that a scheme member will make an irrevocable choice of future benefit arrangements based on such an illustration.

5.2 The actuary should provide sufficient information to enable the scheme member to understand the difference between defined benefit and defined contribution as regards the relative risk borne by the employer and the employee. The assumptions used to project the defined benefit and defined contribution benefits should be consistent.

5.3 An illustration prepared for this purpose should show separately the illustrated benefits from existing assets and the illustrated benefits from future contributions, if any, so the recipient can compare both current accrued benefits and ultimate retirement benefits assuming service continues to the illustrated retirement age.

5.4 The actuary should ensure that the illustration draws the scheme member's attention to other benefits that may be advantageous to that member and which differ significantly between the arrangements being compared.