Proposed revision to AS TM1: Statutory Money Purchase Illustrations

Aon's response to consultation

Aon is pleased to submit its response to the FRC's consultation on proposed revision to AS TM1.

Aon is a leading global professional services firm providing a broad range of risk, retirement and health solutions, with more than 50,000 colleagues in 120 countries. We work with the trustees and sponsors of around 1,000 UK pension schemes. Globally, we work with more than 2,300 clients with assets totalling $3.8 trillion.

Executive Summary

We support the need for a review of AS TM1, given that it has not been reviewed substantially for several years. However, the review has been led by the fact that AS TM1 is now intended to be used for dashboard illustrations as well as for Statutory Money Purchase Illustrations; this means that AS TM1 will take on new significance, and it is crucial that the resulting output of the illustrations is meaningful and relatable for those who will be reading and using the information. We expect that once dashboards are able to show all pension information for members (particularly once all schemes are staged, which we realise will not be for some time), it is likely that the regular statement and SMPIs themselves will become less widely used; so any 'more helpful' information that might currently be included in (or signposted from) SMPIs might not be read. Consistency in the approach for accumulating the present fund and future contributions is important, but the illustration of the resulting decumulation of those funds must also be realistic, and we are concerned that the proposals will not achieve the latter aim. In particular, as most people will opt for a cash sum and take drawdown rather than an annuity, this combination would seem to be the appropriate approach to model in SMPI statements. And as the intention is that the illustration will be used for the dashboard, the need for realistic figures becomes even more important, because there is less opportunity to

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show additional content and supporting information on the dashboard (even within the ‘contextual information’).

The proposals for estimating annuities for those close to retirement seem particularly disproportionate, given the low level of popularity for this form of benefit.

However, we realise that a move to assuming that accumulated funds would be taken in the form of drawdown would need further consideration, and this might not be achievable in the timescale proposed for use in the first dashboard illustrations. It might therefore be necessary to continue to use an annuity-based approach in the short term – and in this case we agree that a non-increasing annuity (with no attaching benefits) is probably the best option, as it is likely to be closer to the level of drawdown income that might otherwise be chosen.

We are, however, concerned that quoting an annuity (which will no doubt be seen as expensive) is likely to steer readers into taking large proportions of their funds as cash.

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 support the desire for consistency in the approach used for accumulation when members start viewing different pots on dashboards; it is also necessary for the approach to be relatively simple, both for providers to comply and for readers to understand. The intended purpose of the dashboard illustration is to inform consumers. Any potential benefit from more ‘accurate’ projection figures is likely to be more than offset by the potential confusion and additional disclosures that would be needed if a more complex approach is adopted – there may not be much benefit to consumers in providers being able to fine tune their assumptions.

We also see the benefits of consistency with annual benefit statements. However, we do not necessarily agree that everything should be entirely identical across dashboards and benefit statements. We do not believe that the proposed approach will provide sufficient information to allow users to differentiate between providers’ investment offerings. Indeed, it would be concerning if decisions were to be made by individuals purely on the basis of this comparison.

As regards the approach for annuitisation, our concerns are set out in the introduction. We agree that the decumulation assumption would need to be defined quite precisely to ensure consistency, but we do not agree that annuitisation is the best approach for this.

We elaborate further in our responses to Questions 3 and 10.

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

The exposure draft suggests that the new AS TM1 will apply for illustrations issued from 1 October 2023, and this ties in with the date (shown in the draft indicative regulations) from which the value data must include illustrations. By this date schemes with over 10,000 relevant members, that are either master trusts or DC schemes used for automatic enrolment, should have connected to the dashboards; but the vast majority of schemes will be staging after this time. Given that there will already be disparity between the effective date of the new AS TM1 and the dates at which the very largest schemes must connect to the dashboard system, we suggest that an effective date as early as 1 October 2023 is not necessary. 1 April 2024 might be more realistic (and might enable consultation on further aspects of AS TM1 as discussed above).

We would point out that the 'dashboard availability date' (i.e. the date at which scheme members can access dashboards) has not yet been publicised, and we expect that this will be later than October 2023 (possibly as late as 2024).

As regards whether the proposed effective date of 1 October 2023 is achievable, in relation to the accumulation assumption there may be some difficulty in gathering historic information for volatilities in the timescale (although once providers and managers are geared up to providing these figures we expect that it will not be difficult to obtain figures going forward).

If the assumptions are prescribed then there will be no need for discussions with clients about appropriateness of assumptions. However, they will want to know to what extent the changes to the assumptions are market related and to what extent they are due to a change in methodology, and so time will be needed in order for Trustees to take advice and decide on next steps (i.e. communication with members, especially those who are taking retirement decisions, explaining why projections have differed from previous years, and changes to modelling tools that are based on SMPI assumptions).

In relation to the annuitisation assumption, the proposed changes in mortality assumption would need programming but we would expect this to be possible within the timescale. However, see above for our more fundamental concern that annuitisation is not the best approach for the illustration - but we appreciate that further consideration on this point would be challenging to complete by the proposed effective date of 1 October 2023.

In general, if the new AS TM1 is to be introduced from October 2023, the industry will need to know what changes are coming into effect by October 2022. If this cannot be achieved, then the TM1 effective date (and the date in the regulations) must be pushed back.

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

Given the objective of simplicity, the broad categories (equating broadly to cash, bonds, 'multi asset' and equities) seem reasonable. We acknowledge the rationale for choosing the volatility approach, as set out in the consultation document. However we have some concerns:

We are concerned that the proposed volatility-based approach could lead to inappropriately high return assumptions for long term gilts following fluctuations in long term yields, although the corridor for changes to volatility groupings would reduce this risk.

There needs to be some acknowledgement within the structure that recognises the differences in investment approach between active and passive funds. As an example. under the current rules, accumulation rates for active funds would commonly reflect a contribution to returns from manager alpha, though only to the extent that this offsets the broad difference between active and passive fund charges. This is to avoid spurious comparisons of net returns between passive and active funds in the same asset class. The proposed approach does not allow for the expected alpha return for an active fund. An active fund that is successful in dampening volatility without impacting on returns could end up in a lower expected return grouping (and vice versa for an active fund with higher than market volatility). It might be reasonable to assume that active management contribution is second order in importance to asset class and ignore it, but if so it would be better if this assumption is made explicit. In order to address the distortion we could suggest having another return level within the same volatility group e.g. 3a and 3b, 4a and 4b.

Where there are capital market expectations for an asset class those should be reflected in the accumulation rate to choose. So this should be asset class specific and not driven solely by implied volatility. In practice there will be overlap between the groups where a particular fund or asset class may not conform to the boundaries set. This is inevitable where the volatility is the only determinant of potential return.

There may be some benefit in providers having discretion to select the volatility / return grouping in some instances (i.e. leave one element there where discretion can be used). However, it may be that making the whole process consistent and transparent is of greater importance.

It is not entirely clear how the calibration will be carried out or the prospective returns for each grouping derived.

We would also point out that the exposure draft itself does not clearly set out the interaction between the volatility of the asset and the volatility group to which it is allocated (the relationship is more clearly expressed for pooled funds). This may be just a matter of terminology.

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

The proposed rates seem reasonable, although (aside from cash) the proposed assumptions could be regarded as slightly high relative to current assumptions.

Different asset classes have different relationships with inflation rate changes, and so the relative returns expected to be achieved differ between asset classes at different levels of inflation. The accumulation assumptions need to be consistent as far as possible year on year; but the reality is that the real return of asset classes will vary over time so this assumption should be kept under regular review and changed if necessary to reflect any changes to long term expectations.

In the related dashboard regulations there seems little provision for appropriate caveats to be added warning readers that the projected accumulated fund relies on particular assumptions.

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

We agree that the accumulation rate needs to take account of known future de-risking (whether lifestyling or within target date funds). For lifestyling this will need to be calculated by term to retirement; we agree with the proposal that allowance is made for the change in how a member’s fund will be invested over the period to their selected retirement date. For Target Date Funds, while they have an indicative glidepath, these can be dynamic in their asset allocation (i.e. they can change their asset allocation and risk profile at any time) and so applying this approach here will be more of an approximation than lifestyling because of the potentially changeable nature of the asset allocation.

However, there could be a risk of a systematic over-estimation of assumed returns with the proposed approach. For example if a projection starts 10 years from retirement, 100% in equities with equities being reduced 2.5% per quarter to end up at zero at retirement, then the proposed approach would result in the ‘equity’ return being used until the expected volatility had reduced enough that the fund would fall into the next lower volatility grouping. The assumed expected returns will be a step function (7% then 5% then 3% etc). A more granular estimate of the returns would be a smoother line over time. Whether the assumed returns end up a reasonable broad estimate would depend on the starting calibration and the step-down points – however, there could be a systematic lag in the assumed returns taking account of the de-risking.

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?

We agree that the volatility indicator needs to be recalibrated regularly although not so frequently that it impacts on SMPIs that are in preparation. 31 December seems a reasonable annual date and would not be

inappropriate for SMPIs being issued at illustration dates for the following end-March or early April.

Please refer to our response to Question 3. In addition we believe it is sensible to have a buffer to avoid the return assumptions changing for minimal changes in expected volatility.

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

It is reasonable over time that the returns would reflect the underlying asset mix so we believe this is a rational and proportionate approach, and one that is consistent with how with-profit funds will be valued in the prescribed 'value for members' assessment. However (i) underlying asset mix is not always known, and (ii) we would expect some drag relative to those expected returns given the cost of smoothing and cost of guarantees.

8. 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?

The approach seems reasonable given the relative lack of materiality currently for DC. However it would need to be revisited if illiquids become a more significant part of DC arrangements (for example within LTAFs). If government wants DC schemes to invest in private markets then forcing providers to assume 0% real return in projections will not encourage this. The limitation in assessing unlisted securities as a result of not being able to measure volatility is a potentially significant drawback of the proposed approach. As the rationale for inclusion of private equity in portfolios, for example, is to increase diversification and potential returns, this is potentially undermined by showing lower projected returns than listed equivalents. It may therefore be more appropriate to map volatility to the listed equivalent. From a risk perspective they would be placed in say group 3 or 4, depending on the asset class e.g. private equity could be group 4 and private debt might be better represented in group 3.

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

This seems a reasonable and proportionate approach and is consistent with the way you are proposing to deal with the de-risking phase of lifestyling.

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?

We have views on the issue of both whether lump sums should be illustrated and whether (and in what form) the accumulated fund should be converted to an annuity.

Lump sum

We believe that it should be a requirement for DC schemes to show lump sums on annual benefit statements given that the vast majority of members take tax free cash. In addition, the determination of tax free cash is more simplistic for DC schemes than DB schemes and so the removal of tax fee cash from a dashboard illustration due to being available from DB should not prevent DC annual benefit statements representing more closely how most members choose to take their benefits. In order to avoid confusion between amounts shown on annual benefit statements and dashboards we propose that two sets of figures feature on annual benefit statement – one allowing for no tax free cash and the other allowing for tax free cash.

We accept that illustrating a 25% cash lump sum could (while representing the most common approach now taken) be misleading if government policy changes on the tax nature of lump sums. However, we strongly believe that some messaging should be given on this facility (even if caveated by 'based on current legislation').

Annuitisation and form of annuity

As noted in the executive summary, we believe that requiring annuitisation is not representative of the actions that are commonly taken by DC fund holders. We are concerned that quoting an annuity (which will no doubt be seen as expensive, even on a non-increasing basis) is likely to steer readers into taking large proportions of their funds as cash instead. As dashboards are likely to provide little additional information (other than in 'contextual' information which might not be read) the member may not be aware of the other options available - for example drawdown.

If a drawdown illustration figure is to be permitted, we appreciate that decisions would need to be made on what assumptions should be made. If this approach were to be accepted, we would suggest that a simple figure of perhaps 4% of the fund could be assumed (ie representing a 25:1 annuity rate) with suitable explanation in the contextual information.

In terms of 'requests by members for ad-hoc illustrations' (noted in paragraph 4.4), in reality, only those who are very engaged with their pensions are likely to request this and, for some schemes, members will be expected to pay for additional illustrations.

Despite our views expressed above, if annuitisation is to be required for the illustration, we agree that a level annuity with no attaching benefits might be the best assumption - again with appropriate explanation in the contextual information. It is simpler and possibly easier to directly compare to other options and understand for members. However, such an assumption has disadvantages:

- It does run the risk of setting this as the default approach for users (or the industry) – i.e. a behavioural 'nudge' to start from this position (which might be deemed poor advice in the current high inflation environment). The consultation cites evidence of more people taking this option (if they do buy annuities – which most members do not). However, this evidence may become less relevant given the recent change in future inflation expectations and perhaps people's behaviour changes over time depending on what inflation is doing when they retire.

- Showing the maximum possible annuity available might not be seen as the best approach for a statutory illustration.
- It could result in a large increase from previous years' illustrations.
- Such an illustration is inconsistent with any DB illustration that might be available to the member on the dashboard – and would also lead to discrepancies where a member has benefits that are the maximum of DB and DC. However, in our view the objective of providing members with an indication of the benefit they are likely to have in practice should take precedence. Special rules can be applied for schemes providing benefits based on the maximum of DB and DC.

In terms of the comment made in paragraph 4.6, many insurers will argue that the reason for the higher proportion of level single life annuities being purchased is due to savers predominantly selecting the highest value annuity at retirement (often from a range of options, none of which meet the member's long term income needs), as opposed to savers making a more informed decision about the type of annuity that would best suit needs, or indeed whether their needs are better met going into drawdown. We would argue that dashboards would be more successful in informing and helping members make better decisions if it was clear what alternatives to a level single life annuity might provide e.g. an annuity increasing each year with an attaching spouse's pension, or how long the pot might last if that same level of income was taken as drawdown based on a model portfolio. This would also encourage savers to think about combined needs for couples and families in retirement. The consultation says "The methodology should not, as far as is practicable, cause or encourage unintended behaviours which are not in consumers' interests". We believe that showing level single life annuities will continue to encourage unintended behaviours.

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?

We have set out above our general view against the annuitisation requirement. However, if the fund is assumed to be converted into an annuity then:

a) for illustrations more than 2 years away from retirement date, we have no concerns from a practical perspective about the approach.

b) for illustrations within 2 years from retirement date we have significant concerns about the proposed approach from a practical perspective. The difficulties involved with establishing an accurate annuity value also seem particularly disproportionate given that most members are unlikely to purchase an annuity.

Using annuities based on those available in the market is more complicated than calculating an annuity on a prescribed basis. Paragraph C3.4 refers to an underpin of "the provider's own annuity rate" but for most money purchase schemes internal annuitisation will not be an option so that terms offered by third parties would need to be considered. There may be limited

recent experience as in practice members do not typically opt for annuity purchase. As a minimum, paragraph C3.4 should make it clear that an approximation to the terms which might be offered is acceptable for an underpin. In our view (given that members do not typically purchase annuities in any case) a proportionate approach would just be to adopt the same approach as for members more than 2 years from retirement and TM1 should state this. There should be no requirement for the ‘over 2 years’ approach to be underpinned by a current annuity rate or market rate.

Indeed it is possible that suggesting a basis for such ‘within 2 years’ cases is outside FRC’s remit.

Members within 2 years of retirement would not be required to receive a SMPI under the legislation, although SMPI statements are often provided to such members voluntarily (for example those who have not reached the stage where the retirement process would be started). One possible implication of prescribing a more complicated ‘best of’ approach for those close to retirement would be to discourage the provision of SMPIs to such members. And for the providers that do not commonly issue SMPIs to those within 2 years of retirement, if the ‘over 2 years’ approach is required to be underpinned by a current annuity rate or market rate, we believe that providers will just default to using the current annuity rate or market rate.

Where SMPIs have not been produced voluntarily for those close to retirement the information based on annuities available in the market will not have been calculated for them in advance so under the regulations the illustration would be required to be provided within 3 working days of a member’s request to the dashboard. We suspect that this would be completely impractical – causing unnecessary calculations for scenarios unlikely to be used by the member to take priority over important day-to-day administration.

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 have no concerns on the basis. Allowing for the latest mortality tables seems a sensible approach.

However, draft paragraph C3.11 says “The mortality improvement tables shall be the standard model…”. Although it specifies the CMI year and long-term rate to use, it is silent on the other CMI improvement parameters (ie Sk & A). The consultation document says “By specifying the mortality assumption in AS TM1 in the current form we are effectively assuming that these parameters will be taken at the Core values.” We are not sure if this is actually what all present users of AS TM1 infer, so it is helpful that FRC has now stated this in the consultation document as being the intention. However, it would be preferable if AS TM1 itself could state that any parameters not specified are to be assumed as being the Core values.

We believe that C3.11 should set out the current Core values for the Extended parameters at least, and note the CMI’s Core values for each of these. For the latest version of the model, these are:

- Period smoothing parameter S_K = 7.0
- Initial addition to mortality improvements A = 0%
- Weight for 2020 data w_{2020} = 0%
- Weight for 2021 data w_{2021} = 0%

And then note that for future versions of the guidance and CMI model, all Extended and Advanced parameters will be set at their Core values.

We believe that It is acceptable for this purpose to leave the projections as they are, with no explicit allowance for COVID.

13. Do you have any other comments on our proposals?

No.

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

We note in our response Question 11 above that we have significant concerns over the proposed approach for illustrations within 2 years from retirement date, from a practical perspective. We do not think that these issues are adequately captured in the impact assessment.

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