Financial Reporting Council

AS TM1: Statutory Money Purchase Illustrations

Version 5.0 Guidance

June 2023

Contents

Introduction

Purpose

1.1 The purpose of this guidance is to assist pension **providers** in applying AS TM1 v5.0 to produce **statutory illustrations**.

1.2 The defined terms used in AS TM1 apply to this guidance. If and to the extent that this guidance conflicts with provisions set out in AS TM1, then AS TM1 will prevail.

1.3 References to paragraphs in AS TM1 are preceded by the corresponding letter for their section (for example 'paragraph C.2.15'). Where paragraph references are not preceded by a letter, they refer to paragraphs within this guidance.

Determining volatility groups and accumulation rates

Circumstances where volatility cannot be reliably determined

2.1 Paragraph C.2.15 refers to circumstances where it is not possible to reliably calculate the **volatility** for all or a part of a member's **current fund.** The below sets out some of the circumstances where we anticipate this may apply. This is not intended to be an exhaustive list, and **providers** should apply paragraph C.2.15 in any other circumstances where they consider **volatility** cannot be reliably determined.

- For unlisted assets or other assets which have a market value determined less frequently than monthly. This would include any direct investment in property, private equity, infrastructure or private debt.
- For investments made by a fund manager on a non-pooled basis (e.g. a discretionary fund manager) and the fund manager has not calculated the **volatility**.
- Where the fund manager (or third party platform provider, if used) for a **pooled fund** is unable to provide sufficient data to determine the fund's 5-year monthly volatility. We request that **providers** send details (including fund name and fund manager or platform provider) of any funds for which this exemption is applied to FRC on an annual basis. This can be done by emailing ASTM1@frc.org.uk.

2.2 We also anticipate paragraph C.2.15 will apply for individual stocks (as opposed to **pooled funds**) selected by the **member**. Although in principle it is possible to calculate the volatility for each stock, this would not be proportionate to the aims of AS TM1.

2.3 We do not expect paragraph C.2.15 to be applied in the following circumstances:

- Where investments are made in **pooled funds** through a fund platform operated by the **provider**. In these circumstances share price history should be available for each **pooled fund**, and this can be used to calculate the **volatility group** for each **pooled fund** in line with paragraphs C.2.7 to C.2.14.
- If multiple investments are made through a fund platform, for each of which a **volatility** can be reliably determined then paragraph B.3.4 applies in determining the total **net nominal accumulated fund**.
- Cash balances, where we would generally anticipate **providers** are able to satisfy themselves that these would fall into the lowest **volatility group** if paragraphs C.2.7 to C.2.10 in AS TM1 were followed.

2.4 In applying the terms of paragraph B.3.4 where a **member's current fund** includes some investments for which a **volatility** can be reliably determined and some investments for which (as described in paragraph 2.1 of this guidance) it cannot:

- For investments where paragraph C.2.15 does not apply, paragraphs C.2.7 to C.2.14 apply for determining the **volatility group** for that investment.
- For investments where paragraph C.2.15 does apply, the resulting **accumulation rate** would be that applied for **volatility group** 3.
- The projections of the different elements of the portfolio should be aggregated after being projected individually.

Movement between volatility groups

2.5 Paragraph C.2.12 states that 'Where an investment has previously been assigned a **volatility group**, it should remain in this **volatility group** unless it breaches the limit of that group at the calculation date by more than 0.5%.'

Initial implementation of volatility groups

2.6 Paragraph C.2.12 is not applicable the first time a **provider** assigns an investment to a **volatility group**, such as in the following circumstances:

- The first SMPI calculation involving this investment after AS TM1 v5.0 is adopted.
- The first year of an investment's existence (in which case, in line with paragraph C.2.10, a reference fund will be needed to determine the investment's **volatility group**).
- The first year a **provider** offers a particular investment as an investment option.

Application of paragraph C.2.12 after a change in volatility boundaries

2.7 The FRC regularly reviews the suitability of the **volatility** boundaries against the prevailing market conditions which may lead to a revision by the FRC of the boundaries of the **volatility groups**.

2.8 The 0.5% limit as defined in paragraph C.2.12 should be applied by **providers** to the boundaries between **volatility groups** in place *at the time of the calculation*. This is illustrated by the scenarios below.

2.9 In the initial year, the **volatility** of the investment is calculated as 9.6%. As this falls between 5% to 10%, the **volatility group** assigned is 2. Paragraph C.2.12 is not applied. In the following year, AS TM1 has been revised and the **volatility group** boundaries for Group 2 are now 6% to 12%. The below table shows the resulting **volatility group** depending on the **volatility** at the next calculation date.

Scenario	Volatility at the next calculation date	Assigned Volatility group	Comments
A	11.7%	Group 2	The volatility of the investment is within the boundaries for group 2
B	12.4%	Group 2	The volatility now falls within 0.5% of the (updated) volatility group boundaries for group 2.
C	12.6%	Group 3	The volatility is higher than the updated boundaries of the volatility group assigned last year by more than 0.5%.

Application of paragraph C.2.12 across multiple years

2.10 Paragraph C.2.12 should apply each year based on the **volatility group** an investment was assigned in the previous year. An example is given below:

Year	Group 2 volatility boundaries (as per AS TM1)	Volatility at the next calculation date	Assigned volatility group	Comments
1	5% - 10%	9.6%	Group 2	
2	5% - 10%	10.2%	Group 2	The investment was assigned to group 2 in the previous year and the volatility is within 0.5% of the group's boundary.
3	5% - 10%	10.4%	Group 2	The investment was assigned to group 2 in the previous year, and the volatility remains within 0.5% of the volatility group boundary.
4	5% - 10%	10.6%	Group 3	The volatility is more than 0.5% above the volatility group boundary.

Lifestyling and target date funds

3.1 Paragraph C.2.5 of AS TM1 v5.0 states: 'Where the investment strategy includes **lifestyling** it must be assumed that the fund switches occur in the future at the ages anticipated in the program.'

3.2 Paragraph C.2.6 of AS TM1 v5.0 states: 'Where investment is in a **target date fund**, the accumulation of the fund should be calculated in the same way as would be done for an equivalent **lifestyling** arrangement as specified in paragraph C.2.5.'

3.3 Paragraph C.2.5 refers to fund switches that are changes which are programmatic in nature, in the sense that they are programmed to occur in the absence of any action by the **member**. **Providers** are not expected to make allowance for fund switches where **members** need to initiate any action to change their investment strategy.

3.4 If de-risking in either a **lifestyling** or **target date fund** would occur in the absence of any action by the **member**, but the exact timing and/or size of the investment switches are not known in advance (for example, if they are left in part to the discretion of a fund manager), C.2.5 is applied such that the **provider** is expected to make an assumption as to the timing and nature of the switches based on any investment mandate of the manager and communications to the **member**.

Lifestyling funds

3.5 For **lifestyling** programs, application of paragraph C.2.5 will mean that **accumulation rates** depend on age. An example is given below:

- A **member** is issued an SMPI with an **illustration date** on their 54th birthday. Their expected retirement age is 65.
- Under the **lifestyling** program they are in, the **member's** pension is currently invested in a fund that lies in **volatility group** 4 with an **accumulation rate** of 7% (Fund A). On each of their birthdays from age 55, their pension will automatically be rebalanced, such that 10% is switched to a lower-risk fund in **volatility group** 2 with an **accumulation rate** of 3% (Fund B).
- To the extent the **accumulation rate** for each separate investment remains constant, the following **accumulation rates** are therefore expected:

Age	Fund allocation	Accumulation rate	Calculation
54	100% Fund A	7%	
55	90% Fund A 10% Fund B	6.6%	= 90% x 7% + 10% x 3%
56	80% Fund A 20% Fund B	6.2%	= 80% x 7% + 20% x 3%
57	70% Fund A 30% Fund B	5.8%	= 70% x 7% + 30% x 3%
58	60% Fund A 40% Fund B	5.4%	= 60% x 7% + 40% x 3%
59	50% Fund A 50% Fund B	5.0%	= 50% x 7% + 50% x 3%
60	40% Fund A 60% Fund B	4.6%	= 40% x 7% + 60% x 3%
61	30% Fund A 70% Fund B	4.2%	= 30% x 7% + 70% x 3%
62	20% Fund A 80% Fund B	3.8%	= 20% x 7% + 80% x 3%
63	10% Fund A 90% Fund B	3.4%	= 10% x 7% + 90% x 3%
64	100% Fund B	3.0%	= 100% x 3%

- If the **member** has £10,000 invested, and no **future contributions** are expected to be paid, the accumulated pot at retirement (before it is reduced for charges and inflation) would be:

$$£10{,}000 \times 1.07 \times 1.066 \times 1.062 \times \ldots \times 1.034 \times 1.03 = £17{,}090$$

3.6 In line with paragraph A.1.2, any alternative calculation approach which would result in a **statutory illustration** which is not materially different could be used.

3.7 In the example above, for a **member** *with no expected* ***future contributions***, if an average **accumulation rate** of 5.0%pa over the period were used this would give an accumulated pot at retirement of £17,103.

$$10{,}000 \times 1.05^{11} = £17{,}103$$

The provider could use this simplified approach to the extent the **statutory illustration**, after applying charges, inflation, and the **annuity rate**, is not materially different from that calculated under the approach set out in 3.5.

Target date funds

3.8 Paragraph C.2.6 of AS TM1 v5.0 states: 'Where investment is in a **target date fund**, the accumulation of the fund should be calculated in the same way as would be done for an equivalent **lifestyling** arrangement as specified in paragraph C.2.5.'

Accumulation phase

3.9 **Target Date funds** ("TDF") should be treated as if they are **lifestyling** programs, in that the switches to a different asset allocation should be treated as switches to different funds. An example is provided below:

- A TDF is currently invested entirely in return-seeking assets. Starting 31 December 2024, it will begin rebalancing its investment such that an extra 10% of bonds are held at the end of each year. The switches are assumed to occur at the end of each year, with the fund switching to 100% lower-risk investments by the beginning of 2034.
- An SMPI is issued as at 1 January 2024.
- The fund's 5-year **volatility** up to 30 September 2022 (being the 30 September preceding the start of the financial year) is calculated as 16%, placing it in volatility group 4, with an **accumulation rate** of 7%
- A reference fund based on the assets that the fund is expected to hold at the end of the de-risking period is identified by the **provider**. This has a **volatility** to 30 September 2022 of 7%, placing it in **volatility group** 2, with an **accumulation rate** of 3%.
- The table shows the **accumulation rates** over the period up to retirement:

Year	TDF target allocation	Total return	Calculation
2024	100% equities	7%	
2025	90% equities 10% bonds	6.6%	= 90% x 7% + 10% x 3%
2026	80% equities 20% bonds	6.2%	= 80% x 7% + 20% x 3%
2027	70% equities 30% bonds	5.8%	= 70% x 7% + 30% x 3%
2028	60% equities 40% bonds	5.4%	= 60% x 7% + 40% x 3%
2029	50% equities 50% bonds	5.0%	= 50% x 7% + 50% x 3%
2030	40% equities 60% bonds	4.6%	= 40% x 7% + 60% x 3%

Year	TDF target allocation	Total return	Calculation
2031	30% equities 70% bonds	4.2%	= 30% x 7% + 70% x 3%
2032	20% equities 80% bonds	3.8%	= 20% x 7% + 80% x 3%
2033	10% equities 90% bonds	3.4%	= 10% x 7% + 90% x 3%
2034	100% bonds	3.0%	= 100% x 3%

- If the **member** has £10,000 invested, has a retirement date of 1 January 2035 and no **future contributions** are expected to be paid, the accumulated pot (before charges and inflation) at retirement would be:

$$£10{,}000 \times 1.07 \times 1.066 \times 1.062 \times \ldots \times 1.034 \times 1.03 = £17{,}090$$

De-risking phase

3.10 The calculation of **accumulation rates** for TDFs are expected to be consistent with **lifestyling** programs in both the accumulation and de-risking phases. During the de-risking phase, TDFs will typically hold a combination of an 'on risk' investment strategy and a de-risked investment strategy.

3.11 For a TDF in the de-risking phase, **providers** are expected to therefore use an appropriate blend of:

- An **accumulation rate** appropriate for the assets held at the beginning of the de-risking period, calculated based on the **volatility** of an appropriate reference fund.
- An **accumulation rate** appropriate for the assets the fund is expected to hold at the end of the de-risking period, calculated based on the **volatility** of an appropriate reference fund.

With-profits

4.1 Paragraph A.1.4 of AS TM1 v5.0 states: 'If a **member's current fund** is invested in a with-profits fund (including with-profits deferred annuity contracts) the **statutory illustration** should be provided in a manner consistent with AS TM1 and with the insurer's bonus policy.'

4.2 Paragraphs C.2.13 and C.2.14 set out the process for assigning a **volatility group** to with-profits policies.

4.3 **Providers** are expected to assume that the market value of the underlying assets in a with-profits fund grows in line with the **volatility group** determined for that fund, as set out in paragraphs C.2.3 and C.2.4. However, we recognise that the pension fund available to the **member** at retirement will not necessarily be the **current fund** increased by this **accumulation rate**, but may be affected by decisions on awards of bonuses (including any terminal bonus) to policy holders. In complying with paragraph A.1.4, **providers** of with-profits policies are expected to make an appropriate estimate of what would be available to the **member** following any rules or principles for their specific with-profits arrangements, assuming the underlying fund were to grow in line with the **accumulation rate** determined under AS TM1.

4.4 With-profits **providers** may wish to consider the following when determining their estimates (although this list is not intended to be exhaustive):

- Any declared bonuses and guarantees
- The effect of smoothing on the **current fund** value
- Current bonus policy for regular and terminal bonuses, and how this would be applied, if AS TM1's **inflation rate** and **accumulation rate** assumptions for the underlying assets are borne out
- Charges and expenses, and their relationship to bonuses and the growth of the underlying investments

Guaranteed annuity terms

5.1 Section C.3.12 of AS TM1v5.0 states: "Account must be taken of guaranteed annuity terms available to the member which produce a higher amount of initial pension as at the retirement date than would be produced using the assumptions in this Part C. Where account is taken of guaranteed annuity terms, this should be stated alongside the statutory illustration." The below sets out clarification guidance on how this paragraph is applied.

Disclosure requirements when guaranteed annuity terms are applied

5.2 Where guaranteed annuity terms are available to a member, the guaranteed annuity rate should be compared to an annuity rate using the form and basis prescribed under AS TM1 paragraphs C.3.1 – C.3.11. The **statutory illustration** is calculated using whichever annuity rate results in a higher initial pension. This must be the amount quoted in the annual benefit statement and for the ERI provided to pensions dashboards.

5.3 Where a benefit statement contains a **statutory illustration** based on applying a guaranteed annuity rate (rather than the annuity rate set out on paragraphs C.3.1 – C.3.11 of AS TM1), the benefit statement should include a statement that the illustration was calculated using the guaranteed rate.

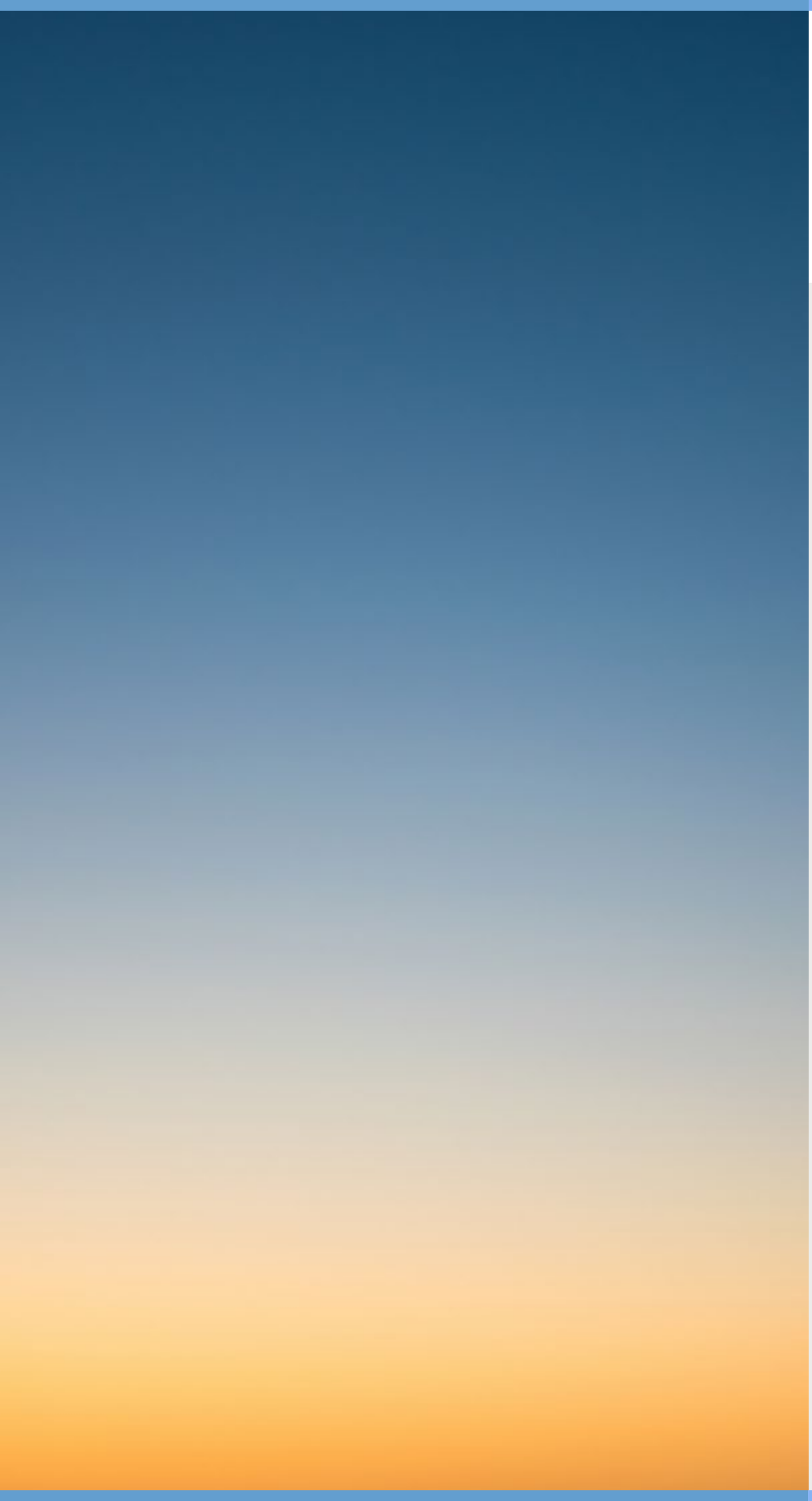
5.4 When a benefit is subject to a guaranteed annuity rate, **providers** may (but are not required to) provide an additional illustration on benefit statements, to illustrate the pension available both with and without the guarantee, with appropriate wording to indicate which of the figures is based on the guarantee.

5.5 Paragraph 5.4 above applies regardless of whether the guaranteed annuity rate results in a higher or lower initial pension than the rate prescribed under AS TM1 paragraphs C.3.1 – C.3.11.

Different forms of guaranteed annuity

5.6 If guaranteed annuity terms are available to a member in a form of annuity which differs from the form prescribed in paragraphs C.3.1 – C.3.11 of AS TM1 (for example, if the guaranteed annuity is increasing or has a spouse's benefit), this guaranteed annuity rate should still be compared against the annuity rate prescribed in paragraphs C.3.1 – C.3.11 of AS TM1. No adjustment should be made to the guaranteed annuity rate to convert it to a consistent form of annuity (unless such consistent form would be available to the member with a guaranteed annuity rate applied). The annuity rate that results in the highest initial pension amount should still be used to calculate the **statutory illustration**.

5.7 Where multiple forms of annuity with guaranteed rates are available, whichever of these would result in the highest initial pension should be used for the comparison with the pension prescribed under AS TM1 paragraphs C.3.1 – C.3.11.



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