Consultation on the Financial Reporting Council's (FRC) proposed changes to the Actuarial Standard Technical Memorandum 1 (AS TM1)

Background and Scope

In February the FRC published a consultation paper on proposed changes to the Actuarial Standard Technical Memorandum 1 (AS TM1) to reflect the new environment that will exist once pensions dashboards display Estimated Retirement Income illustrations. AS TM1 specifies the assumptions and methods to be used in the calculation of statutory illustrations of money purchase (or DC) pensions. This is Hymans Robertson's response.

Our formal response to questions set out in the consultation paper is as follows;

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 are, in principle, in favour with aligning the set of assumptions used for Estimated Retirement Income (ERI) projections provided on pensions dashboards with the assumptions specified (in AS TM1) for use in SMPIs and to support greater consistency of approaches across providers. From the individual saver's point of view, it would improve consistency in projections from different providers and when aggregated the resulting ERI projections will also be consistent. We have significant concerns around the proposed accumulation rate methodology which will not enable fair comparisons across approaches from different providers.

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

We are comfortable with the proposed effective date of 1 October 2023. In addition, we are in agreement with the FRC's view for not needing transitional provisions as that could lead to potential inconsistencies.

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

Whilst at first this appears to be a simple approach for achieving consistency in the accumulation rates used across providers, as our analysis shows, it also has the disadvantage of penalising more sophisticated investment approaches, particularly those incorporating illiquid assets. For this reason, we are not supportive of the proposed volatility-based approach.

We note that the analysis underpinning the proposed volatility bandings suggest there is clear correlation between historic 5-year volatility, and forward-looking 15-year returns. While this is valid for most strategies, it does not address more sophisticated/innovative approaches that produce higher returns relative to risk taken, particularly those incorporating illiquid assets. We note that the analysis only considered equity, fixed income, money market, multi-asset and property assets which is a constrained view of the investible universe. Given the government and regulatory support for DC schemes to invest in less liquid assets given scope to improve retirement outcomes, and increasing scale leading to more complex approaches, we don't believe this analysis is complete for the purpose of incorporating future strategic evolution.

We have undertaken additional analysis to explore the potential impact of the proposed approach on different strategies. For this purpose, we considered:

- Different glidepath designs – ranging from more cautious to more sophisticated approaches inc. less liquid assets.
- Different methodologies – including current (based on our economic assumptions) and proposed methodology.
- Excluded the impact of wider changes to methodology/assumptions proposed in this consultation, to isolate impacts due to the accumulation rate methodology.
- A representative young contributing member, which helps to magnify potential issues given their time horizon.

What are the main observations from our analysis?

The proposed approach is generally more prudent than using our economic assumptions. In particular, for more cautious and balanced approaches projected retirement outcomes were around one third lower under the proposals. We are not overly concerned with this, and more concerned about fair comparability across different providers with different strategies.

Projected retirement outcomes were around 50-60% lower for strategies incorporating less liquid assets suggesting a disproportionate impact on more sophisticated strategies. In this scenario, we assumed a 30% allocation to less liquid assets in the earlier years, reducing to 15% at retirement.

We have listed some of the main concerns we have with the proposed approach, in light of this analysis and wider views:

- The proposed approach will have a negative and disproportionate impact on strategies with material allocations to less liquid assets. Despite the general consensus view that these will lead to improved retirement outcomes, consumers will be offered a contrasting view via information shared on their pensions dashboard. This could lead to negative behaviour from consumers, and worsening of their overall retirement outcomes.
- The proposed approach does not reflect the potential for the underlying value of some assets to be re-priced less frequently than monthly. This is a significant issue for less liquid assets. For example, based on our analysis, assuming quarterly repricing of underlying assets and a diversified illiquid portfolio (i.e. blend

of private equity, infrastructure and private credit) the proposed approach implies a forward-looking return assumption of 1% per annum (gross of charges). This is likely to be near 0% per annum after allowing for charges. In practice, we would anticipate returns materially higher than from equivalent listed/liquid markets. This is a significant source of the differences we observed in projected retirement outcomes.

- With fixed return assumptions, the impact of charges is always to reduce the projected retirement outcome i.e. negative. In practice, it is possible to achieve a better retirement outcome with strategies that incorporate higher charges. We do, however, acknowledge that this approach supports better comparability between smaller and larger arrangements where the difference in charges can be significant.
- We think the proposed approach could lead to unwanted variability in accumulation rates from the same provider in future, given jumps in rates between volatility bands. This will be most apparent if we progress through a full economic cycle in quick succession, since the historic 5-year volatility figures could vary materially from one year to the next.

What alternative approaches could address the issues we have listed above?

We think it makes sense to design the approach to support the greatest level of fair comparability between approaches. The methodology should not overly disadvantage one approach vs. others, particularly where this acts against government and regulatory support and industry consensus around the opportunity to improve retirement outcomes e.g. for less liquid assets.

Maintain the current approach

The current approach requires the accumulation rate to be set to give a fair representation of future looking returns from the current strategy, and to be consistent with the 2.5% per annum inflation assumption. This has the benefit of allowing those closest to the investment approach to determine the fair return assumption relative to the charges paid by members. The downside is the potential for different views/approaches for setting forward-looking return assumptions to reduce the consistency of comparisons between providers. The FRC's own study of growth assumptions (illustrations after April 2020) shows that there is some variation in accumulation rates assumed, but they are broadly similar, particularly for insurers. The variation is generally within +/-1% p.a. for equity. A 1% change leads to a c. 20% change in retirement pot under our analysis for a balanced approach. This impact is less significant than the negative impacts of the proposed methodology, and so we still prefer the current approach to the proposals.

Fixed accumulation rate assumptions for different asset classes

To satisfy the aim of achieving greater consistency between approaches, we would support the use of fixed accumulation rate assumptions. The key is how these are derived to maximise the ability to fairly compare projections from different providers with different investment approaches. It will also be necessary to have a sufficient range of asset class groupings so providers can reflect innovations they have introduced which could lead to improved retirement outcomes.

Drawing on the FRC's study of growth assumptions and our forward-looking return views for alternative asset classes, our suggestions would be along the lines of the following:

Asset class grouping	Gross accumulation rate	Comment
Private equity	8% per annum	*Assume Listed equity + 2% per annum (prudent)*
Unlisted infrastructure and private credit	7% per annum	*Broad (gross) assumption*
Listed equities and listed alternatives (e.g. REITS and listed infrastructure)	6% per annum	Similar to historic rates used across providers. *Similar returns assumed from REITs and listed infrastructure*
Property	5% per annum	*Broad (gross) assumption*
Multi-asset / DGF	5% per annum	*Broad (gross) assumption for moderate risk approach*
Alternative credit (e.g. global, higher yield and multi-asset credit)	4% per annum	*Broad (gross) assumption*
Corporate bonds	2% per annum	Similar to historic rates used across providers
Gilts and cash	1% per annum	Similar to historic rates used across providers

The accumulation rates should be reviewed periodically to ensure these reflect up to date long-term economic views. This could be achieved through consultation, for example at 3-year intervals, to benefit from industry challenge/consensus.

Question 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?

Yes, although for the reasons set out above we do not believe the methodology is suitable.

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

We agree with the proposed approach to reduce the prospective accumulation rate in line with the automated lifestyling de-risking glidepath. This approach will not only be more accurate and more consistent than making an approximate (downward) adjustment to the overall projection rate for later years, but it will also tie in with the proposed volatility-based approach for prescribing accumulation rates and associated projections throughout the lifestyle journey.

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?

In our view, the proposal for an annual (as at 31 December) recalculation of the volatility indicator with a 0.5% corridor is appropriate given the various other considerations set out in the consultation. In terms of the recalculation frequency, we agree that monthly recalculation would indeed be too onerous and would not add justifiable value, instead annual recalculations should capture genuine secular changes to the volatility of a fund over time, as well as reduce the impact of extreme market movements. As the majority of pension schemes have adopted a scheme year-end of 31 March, recalculation of the volatility indicator as at 31 December should give providers sufficient time to perform the recalculation in order to prepare the SMPI for the following year. We also agree that introducing a corridor of 0.5% around the boundary of the volatility intervals should help reduce erratic and idiosyncratic movements year-on-year that are beyond the control of the manager/provider.

However, for the reasons set out above we do not believe the methodology is suitable.

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

We agree that measuring volatility in a with-profits fund based on unsmoothed returns will be more consistent with the approach proposed for regular funds i.e. one that uses actual asset performance, as opposed to return-adjustments made in the short term in order to smooth out the peaks and troughs of performance. The underlying assets of a with-profits fund can be assumed to be no different to other regulated pooled funds with similar investment policies and so it is reasonable to postulate that they will have similar long-term risk/reward profiles. As such the volatility-based approach for calculating the accumulation rate of and projections for with-profits funds is appropriate. In the case of with-profits funds that have underlying guarantees, the current AS TM1 regime already allows for SMPIs to reflect the terms of the guarantee where these would deliver a higher pension benefit than that of the standard assumptions.

Question 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?

We agree that the value of separately-held unquoted assets (as opposed to those held within a pooled portfolio) as displayed on a pensions dashboard should reflect the latest available valuation of the assets. However, for the illustration of ERIs, we do not support the proposal to use a zero rate of growth for unquoted assets. Notwithstanding the difficulties in estimating volatilities where the asset price is unquoted, these assets still have a risk/reward profile that are generally considered to offer a higher rate of return than current assumed CPI of 2.5% per annum. We suggest attributing accumulation rate assumptions in line with our proposals under Question 3.

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

For policies or plans that contain multiple pooled funds, we agree with the proposed approach to assume future allocations in line with the current allocation. This is a pragmatic solution to overcoming changes in historic allocations over time that result from different funds rebalancing strategies, active choice of individuals to switch investments, or passive choice such as lifestyling.

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?

Given the intention to illustrate the ERI of all pensions held by an individual in a manner that encourages comparison, we are in agreement with the proposal to not illustrate tax free lump sum at retirement and to show the full income potential as the ERI. That being said, most members do not purchase an annuity at retirement, so we have a fundamental concern around the use of this assumption to determine potential income levels in retirement, albeit as long as the assumption is consistent comparability will be possible.

In practice, individuals will use their retirement savings for various purposes e.g. cash (either one-off sum, or ad-hoc withdrawals), income (mostly drawdown) or annuity and potentially as rainy day savings. It's therefore impossible to attribute a single approach that is relevant for all scenarios. We are therefore in favour of simplicity, provided there is adequate signposting to guidance/tools available for individuals to tailor their approach.

For this purpose, a fixed income assumption would be appropriate. We would be supportive of the '4% rule' i.e. to assume a 4% p.a. level of sustainable income in retirement (or annuity conversion factor of 1:25). We believe this is preferable to overly engineering a set of annuity assumptions that is unlikely to reflect the needs of a vast majority of savers (more reasons below).

In our view, there are a couple of problems with using flat, single life annuities, as proposed;

- Whilst it may be the case that currently most people buy flat, single life pensions, do we want to perpetuate this by not publicising the alternatives? Especially if average pot sizes will increase over time due to auto-enrolment.
- It may encourage under-saving / complacency, as realistically people need inflation protection and households with a single wage earner need spouse's pensions.

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?

Notwithstanding our comments on the use of an annuity approach more generally:

a) We are supportive of the proposal to simplify the approach to calculating level annuities, as this will provide greater consistency across projections. The approach to calculate the discount rate based on a fixed interest yield index is our preferred method.
b) We are supportive of the proposal to use a market consistent annuity rate for illustrations that are within 2 years from retirement. We would expect to see clarity from the FRC around what these rates should be to ensure consistency is applied across providers.

Our broader observation on this question is as follows; given that consistency is the objective that lies at the heart of these proposals, it would perhaps be easier for all concerned if market-consistent annuity is used for those more than 2 years from retirement, as well as for those within 2 years from retirement. Indeed, this reasoning could be extended further in that the FRC could just publish an annuity rate to be used across the board every year.

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?

Notwithstanding our comments on the use of an annuity approach more generally:

We have some reservations on the proposed new mortality basis for determining the annuity rates where the illustration date is more than 2 years from the retirement date. This is based on evidence from our sister company Club Vita. Their benchmarking suggests (1) the updated PFA16 and PMA16 tables represent too light a mortality assumption for a typical pensioner, and more generally (2) the wide range of mortality rates seen amongst pension scheme members that suggests a one-size fits all approach would lead to potential negative implications for some members. Please see the full response to this question provided separately by Club Vita.

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

In light of current market volatility, we agree to retain the 2.5% inflation assumption, however we would like to see this reviewed on a regular basis, noting that the Government's target inflation rate is 2%.

We have no further comments on the remainder of the proposals.

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

Benefits

We agree with the impact assessment's main stated benefit of the proposed changes, to facilitate direct comparison between a member's various pensions on a consistent basis. Aligning the calculation basis for Estimated Retirement Income projections with the assumptions specified (in AS TM1) for use in SMPIs should achieve this result. Members will be able to take comfort from the knowledge that their ERI projections viewed on a pensions dashboard is consistent across all their pensions, and should therefore be able to make more informed decisions relating to how they engage with their savings. For similar reasons, we are in favour of the intention to standardise the terms on which a member's pension fund at retirement is converted to an income. We have a number of concerns around the specific assumptions/methodologies proposed and have suggested alternatives which we believe will serve these aims more effectively, be simpler to administer and not act against wider industry innovation and practices.

Costs

The increased costs for providers in complying with the proposals should be minimal as the calculation process that is being suggested is fairly simple and the majority of providers should have access to monthly unit prices for the past five years (or since fund inception if shorter). Having said this, the alternative proposals we have suggested should be simpler and cheaper to implement in practice. Our view is that the additional costs associated with the proposed approach relative to our proposals are not justified, and are not likely to lead to a meaningful benefit for consumers. Indeed, we feel that some of the proposals could lead to negative behaviours as indicated.

Prepared by:-

Lionel Suares

Callum Stewart

31 May 2022

For and on behalf of Hymans Robertson LLP