The Actuarial Profession
making financial sense of the future

Consultation Response
Financial Services Authority

CP12/10 chapters 3 and 4: Product Projections and Transfer Value Analysis

30 August 2012

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

The Actuarial Profession
making financial sense of the future

Sandra Graham & Donald Cranswick
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

30 August 2012

Dear Sandra and Donald,

Response to the FSA on Chapters 3 and 4 of CP12/10

The Institute and Faculty of Actuaries welcomes the opportunity to respond to chapters 3 and 4 of CP12/10. In developing our response, and also our response to chapter 5 which we have separately addressed to the FRC, we have sought to take a customer perspective, particularly asking ourselves whether the proposals improve the information presented to customers at the times they need to make important financial decisions.

To prepare this response, we set up a working group of actuaries drawn from a range of practice areas. These actuaries worked with their colleagues and other contacts to prepare this response which gives us confidence that the views we are presenting here are representative of our membership. We have obtained the views of a range of actuaries across the life, pensions and investment modelling fields and have been pleased at the commonality of opinion we have found.

Following discussions with you earlier this month, we recognise that the FSA's focus in this consultation is primarily directed at point of sale illustrations. Whilst we have structured our response with this objective in mind, we believe that due to the fact that the same FSA rules regulate projections on existing business, this cannot be entirely overlooked.

In summary, the thrust of our response is:

- We support the proposals in chapter 3 in relation to CPI-linked annuities, although we have identified, and proposed a solution to, a key anomaly
- We agree that lower projection rates need to be used in many circumstances
- We consider that a 5% maximum intermediate growth rate is not the most appropriate way of addressing the concern that the current maximum rates are being too readily applied
- We consider that greater guidance on and flexibility in application of the current approach can provide materially improved customer information in many circumstances
- We are concerned that the current approach, as implemented by regulated firms, does not bring out the downside risks associate with short term, high equity investments, nor with income drawdown products
- We believe consistency, as far as possible between the SMPIs and the FSA illustrations, provides considerable value to customers and that the FSA could generally have given more consideration to the suitability of projections issued to existing policyholders, whether SMPI or otherwise.

We recognise that the consumer detriment we have identified in relation to short-term projections cannot necessarily be solved without wider amendments to the current approach than envisaged in the CP. However, we encourage the FSA to examine this issue in depth as part of its subsequent development work in the projections area.

We set out our detailed response below in the form of answers to the specific questions asked in the CP. We have also produced an analysis of the value to customers of projections in different circumstances, together with some expanded thoughts on the better positioning of the low and high projections. We attach this as an Appendix to our response in the hope that the FSA may find it of value when considering the next steps to improving the customer benefits of the projections regime.

Chapter 3, Question 4

As set out in our response to CP12/4, we support the introduction of an explicit assumption for revaluation based on CPI, compared to revaluation based on RPI, and so are pleased to see this proposal. We also support the proposal for revaluation based on CPI to be 2.0% p.a. However, we recommend that the differences between RPI and CPI (and absolute assumptions) are kept under review by the FSA and, should the gap materially reduce, particularly the gap caused by the averaging or 'formula' methodology, then the need for, and size of any, differentiation should be reassessed. We are aware that the Consumer Prices Advisory Committee and the Office for National Statistics are actively reviewing the inflation indices at the current time.

Chapter 3, Question 5

We support the proposal to set the CPI-linked annuity interest rate to be 0.5% p.a. higher than the RPI-linked annuity interest rate, given the 0.5% p.a. difference in CPI and RPI rates for revaluation in deferment.

However, whilst we support the rate for CPI-linked annuities, we have concerns regarding the proposals for LPI increases based on CPI (the concern essentially stems from the simplicity of the existing approach for LPI increases). The most significant concern relates to anomalies that arise between equivalent LPI increases that are based on CPI and RPI.

This is best illustrated through an example of a relatively common increase – price inflation with a cap of 5% p.a. and a collar of 3% p.a. For this example, we use yields as at 14 February 2012 (although the equivalent conclusions are drawn at different dates). This would lead to annuity rates considerably higher for a CPI based benefit than an RPI based benefit, which is a complete anomaly when elsewhere the proposals lead to lower annuity rates for CPI based benefits compared to RPI based benefits (because there is an expectation that CPI will be lower than RPI). Under COBS 19.1.4(e) if the increase is RPI-linked then, as the collar is below 3.5% and the cap is above 3.5%, the index-linked rate is simply used (i.e. -0.6% p.a. for the date in question). However, if this same increase was CPI-linked rather than RPI-linked, then under the proposals as the collar is 3% p.a., fixed rate escalation based on the cap should be used. This would mean using an annuity interest rate of 2.9% p.a. and a pension increase assumption (in line with the cap) of 5.0% p.a. So the equivalent net rate is -2.0% p.a.

As set out in our response to CP12/4, our preference for LPI increases was either:

- For the FSA to specify example pension increase assumptions for different types of pension increase, with a requirement for other increases to be consistent

- To use a more robust approach based on the commonly used Black-Scholes option pricing formula. We would be happy to input into the work required to ensure appropriate assumptions are used.

We believe that the introduction of an explicit CPI-linked assumption makes one of these alternative approaches even more attractive and we would strongly support a change in approach. Please see our response to CP12/4 for more details on our proposed approaches.

If however, the FSA does not want to change the approach for RPI-linked LPI increases at the current time and simply wants CPI-linked LPI increases to follow a similar approach, then we would suggest that the following would be more appropriate (and avoids the above anomaly):

- For caps of 3.0% p.a. or below, fixed rate escalation based on the cap should be used
- For collars of 3.5% p.a. or above, fixed rate escalation based on the cap (if there is one) should be used (this would then lead to the same increases for RPI-linked and CPI-linked LPI increases for collars at this level)
- For collars between 3.0% p.a. and 3.5% p.a. (but not including 3.5% p.a.) fixed rate escalation based on the collar should be used (this provides a sliding scale for a 0.5% differential between RPI-linked and CPI-linked LPI increases for lower collars to no differential for higher collars).

Chapter 3, Question 6

We don't have any comments on the cost benefit analysis.

Chapter 4, Question 7

The FSA have presented no evidence that many firms are continuing not to comply with the current requirements to use lower projection rates where a product is unlikely to achieve these rates, mentioning only evidence gathered prior to the issuing of the 'Dear Compliance Officer' letter in 2009. On the other hand, we are aware of firms which have completed or are near to completing major systems developments to fully implement these requirements for unit-linked funds. We are also aware of firms which use lower rates than the maxima for with-profits funds, for example to reflect equity backing lower than 67%.

We are also aware that assessing whether, in the words of the current rules, the maximum rates 'overstate the investment potential of the product', there is considerable scope for difference of opinion.

We do not consider that the proposed alternative wording will, of itself, change the obligation on firms to use lower rates where necessary, as the current rule COBS 13 Annex 2 2.4(1) R already uses the word "must". So, although we do not object to the proposed change, we consider that for it to be effective, the FSA should consider using other mechanisms to ensure compliance, for example

- A clear statement of expectations from the FSA regarding the circumstances in which using the maximum rates is appropriate
- Clear indications from the FSA in its feedback to CP12/4 of their views on what might be appropriate assumptions for one or more lower return potential asset classes at the present time, encompassing not just the intermediate rate but the higher and lower rate as well
- Use of existing enforcement mechanisms such as regulators visits to companies and the resulting risk mitigation programmes, or more specific action in particularly blatant cases
- For with-profits funds, the FSA should consider if specific obligations on With-Profits Committees and With-Profits Actuaries to review the appropriate growth rates to use would improve the standards of governance in this area.

Chapter 4, Question 8

Maximum Intermediate Projection Rate

We agree with the FSA's broad conclusion that the central rate used in projections ought now in many cases to be lower than the 7% maximum allowed under current rules, given the current economic outlook and the low yields currently available on gilts and other high-rated bonds. We understand the FSA's frustration if some firms are not following as stringently as the FSA would expect the current requirements to use a rate lower than the maximum where this would be appropriate. However, we do not believe that applying a single maximum rate of 5% is the most efficient method of achieving this objective and that such an approach risks increasing other aspects of customer detriment.

In particular, we consider that some customers (and possibly some financial advisers, too) inevitably compare point-of-sale projections for different products and from different providers and draw conclusions in relation to relative investment potential. If the differences in potential are not allowed to be properly reflected, misleading conclusions may be drawn. We therefore recommend that the FSA maximum intermediate projection rate should be clearly stated to apply only in circumstances where is currently intended that policyholders will be invested 100% in equities (or assets of similar or higher return potential) throughout the policy term, with lower central projection rates being mandated in all other circumstances.

A key drawback of providing guidance, as at present, that the maximum rate is based on a broadly 67% equities, 33% bonds mix is highlighted if a customer invests separately in a 100% bond fund (growth rate lower than maximum) and a 100% equity fund (growth rate capped at maximum), when their total illustrated benefit will be lower than had they invested in a single managed fund with a 67% equity content (growth rate equal to maximum).

Our suggested alternative approach would remove the drawback highlighted above, as the managed fund projected growth rate and the average rate for the two separate funds would be the same. Moreover, the difference in investment potential between the 100% equity fund and the 67%/33% fund would be seen in the illustration whereas before it would not have been.

We believe that concerns that some firms would not apply this approach adequately are best addressed directly via the mechanisms we have suggested in our response to Q7.

Some of our members have also pointed out that the frequency with which asset mixes are rebalanced to the desired asset mix will impact the way in which the return develops and it might be necessary to allow for this in the calculation of the average rate.

We also recognise following our recent meeting that you are concerned that many policies which start off as 100% equity invested might adopt a lower potential investment strategy at a later stage in their life, and so their original projection would turn out to have been too optimistic. However, it seems to us inappropriate to assume that this will invariably be the case. Indeed, when ongoing projections such as SMPI are considered, it seems important to us that the effect of changing the equity backing can be seen in changes to the projection rates at the time. Where a product is being purchased with a feature which will automatically make an investment change at a later date (e.g. 'lifestyling'), we consider that the current rules already require this to be reflected in a lower projection rate. If you concur, the FSA may wish to draw firms' attention to this interpretation of the rules in its feedback statement.

We consider that, if the FSA decides to adopt our suggestion, the maximum rate (for a 100% equity fund) could be set at a higher rate than 5%, and within the range recommended by PwC, namely 6.5% to 8%. Doing so would be consistent with the FSA's intention to adopt the recommendations of the PwC report. It may be reasonable to take a value towards the lower end of this range (e.g. 7%) to reflect the concerns expressed in the report and by the peer reviewers that the immediate prospects look to be more negative than positive. However, given that the rules require a lower projection to be provided to reflect outcomes worse than the median, care needs to be taken not to adjust the median for longer-term adverse outcomes which are already effectively reflected in the lower projection, especially given the proposed widening of the 'spread' to the lower projection rate.

Leaving the maximum central rate at 7% but more rigorously guiding on and policing the use of lower rates other than for a 100% equity mix may still result in lower projections in many cases, but only where appropriate, and will additionally enable the relative return potential of different asset mixes to be correctly illustrated.

Low and High Growth Rates

We are generally supportive of the FSA's desire that firms widen the 'spread' between high and low growth rates although question whether the proposed changes to the maximum low and high projection rates, which will tend to result in a +/-3% spread being used in most circumstances, is the best way to achieve this. For example, for a portfolio of equities with a reasonable volatility assumption, a 4% or 5% spread would be more reflective of a reasonable range of outcomes on either a historical or future model basis, whereas a spread of less than 3% might be appropriate for cash or bond funds.

We therefore consider that it would be better for the FSA to leave the maximum 'high' projection rate unchanged (or even to increase it) and to set the maximum 'low' projection rate no lower than 3%. However, to accompany this with a clear statement that firms are expected to select an appropriate high and low rate to reflect the volatility of the underlying asset mix, consistent with their selection of the intermediate rate.

For example, if the three maximum rates were 3%, 7% and 9%, then it might be reasonable to expect a firm to select rates of 2%, 7% and 9% for a 100% equity fund but 3%, 5% and 7% for a fund with lower risk/return expectations (and a 50:50 fund would be 2.5%/6%/8%). We have intentionally suggested an asymmetrical spread, partly to reflect the greater importance of illustrating downside risk and partly to avoid the 'telephone numbers' effect at high rate of return.

We also note that in their 2003 report, PwC wrote '*It will be seen from Table 2 above that illustrations which are limited to the intraquartile range (half the likely outcomes) will tend to give the appearance that equity based investments are superior to others*' and also, '*...the current illustration rules do not truly indicate the volatility of investments*'. We consider that our proposed approach will go some way to meeting this criticism whilst not requiring a change to the current rule framework. In the longer term, however, we agree with PwC that customers would be better informed if the low and high growth rates were required to be broadly reflective of a particular more extreme percentile (see also our comments on short-term projections below).

We are also concerned that the risks associated with income drawdown products are underplayed by the use of a low rate. This fails to highlight the risks of 'path dependency' (i.e. that the cash fund remaining depends not only on the average return over a period but also on the individual return between successive income payments).

Tax Adjustment

We consider that it would be more appropriate for the tax deduction to be different for the low, intermediate and high growth rates, along the lines of the numbers PwC derive in 1.4.6 of their report (rounded to 0.25%, 0.5% and 0.75% respectively). The FSA could also usefully make clear that COBS 13 Annex 2 already effectively requires a firm to make a different adjustment should the product and asset mix be expected to be taxed at materially different levels.

Consistency with SMPI

We consider that there is considerable value to customers of consistency between the FSA projection basis and that for SMPI. Whilst the impact of any difference between a nominal £ point of sale projection and a real £ SMPI after one year in force might not be obvious to most customers, there are circumstances where a more direct comparison can be made, including:

- Where a real £ FSA projection is also issued at point of sale
- Where a nominal £ projection is issued to accompany an SMPI
- Where a customer with existing SMPI and non-SMPI pensions receives a real £ FSA projection on the latter.

We also see the need for SMPIs to reflect the return potential from different asset mixes, and so would advocate the FRC giving the same indications as the FSA that the maximum (of an unchanged 7%) should apply to 100% equity funds only and of what would be a reasonable rate to assume for a cash and/or gilt fund.

Short-term Projections

Not all point of sale illustrations are for long terms, for example substantial contributions can be made to pension plans in the run-up to retirement. For a fund with a material equity content, even wider spreads within the more liberal constraints we have suggested above are unlikely to give a reasonable indication of the volatility of the outcome, especially for terms of under 5 years. We think that this could materially misinform policyholders of the risk associated with short-term equity investment. A low projection representing a negative return would be more informative for short durations, as the FSA point out in paragraph 4.6 of the CP.

We consider that COBS13 Annex 2 2.4(1)R is unclear as to whether it requires the low projection rate to reflect the reasonable downside potential of the product or merely to be somewhat arbitrarily below the intermediate projection rate. We are not aware of any firms which take the former interpretation. It would be helpful if the FSA could clarify its interpretation of the rule in this regard in its feedback statement.

We appreciate that it is always open to firms to use lower rates than the FSA maximum for the lower short-term projection. However, we consider it unrealistic of the FSA to expect firms unilaterally to adopt an approach which they would perceive as setting themselves at a competitive disadvantage, notwithstanding the better information provided to customers. We suggest that only regulatory pressure (or possibly an industry-wide initiative) is likely to lead to this better customer outcome.

Use of a materially larger 'spread' between low and intermediate rates than between intermediate and high rates would be likely to give customers a misleading perception of the balance of upside and downside risk, so the appropriate spread to the high illustration rate for short durations needs to be considered at the same time as that to the low. This needs to be done in a way which does not allow customers to be given unrealistic return expectations, for example by emphasising the relatively low probability of both the high and the low projected growth rates being the actual outcome. Moreover, as we have mentioned earlier, the growth rates illustrated on the upside and downside need not be symmetric, provided that this is clearly explained.

Introducing different assumptions for short duration projections would (and should) also constrain existing business projections for similar durations under the FSA rules, and we expect that this would have a materially larger implementation cost for most firms than a change for point of sale projections. We therefore suggest that this question, both for point of sale and for existing business projections, is dealt with in a future consultation. The FSA (and the FRC) could, however, as an interim measure, consider improving the quality of written volatility risk warnings accompanying shorter term projections (note1).

Existing Business

We recognise that the FSA rules do not require projections to be issued for existing business. However, projections are issued where firms consider they would be helpful to customers and, when they are issued, they are subject to the same the FSA rules as for point of sale projections. Any consideration of changes to the latter should therefore take into account any impact it may have on the former.

In particular, a number of firms issue reprojections in respect of mortgage endowments under the relevant ABI Code of Practice. Whilst it is important that policyholders are not given excessive projections that underestimate any shortfall at maturity, it is also important that they are not misled as to either the central expectation or the volatility of the shortfall. We therefore consider that our recommendations for changes to the FSA proposals and also the need to consider shorter duration projections in more detail will be particularly relevant to this class of policyholder. We might also expect the FSA's cost benefit analysis to consider the impact on firms of having to issue reprojections at materially lower rates in some cases after the rule changes come into force.

Firms also issue projections for classes of pensions business not subject to SMPI, where similar issues arise as these customers approach retirement.

Note 1 In this context, we note that one of the peer reviewers of the PwC report, Professor Mark Freeman, comments (in his footnote 4)"The statistical point here is that the 90% confidence interval and the level of tail risk are both likely to be materially higher than at the times when the 2003 and 2007 reports were written. While a detailed analysis of these uncertainties lies outside the terms of reference for this report, investors interested in downside risk should be made aware of these issues."

Chapter 4, Question 9

We agree that the cost of implementation, either of the original proposals or of our suggested amendments to them, should not be material.

However, we are less sure that there will be a net balance of customer benefit from the changes as proposed. We hope that our suggested changes will rectify this.

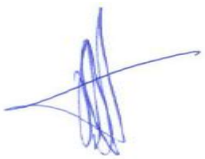
We also consider that the customer benefits potentially arising from the wider changes we have proposed for further consideration, relating to shorter duration projections and to the consistent setting of the low and high projection rates in a way which would be informative to customers of different levels of risk, would have genuine consumer benefit and should be considered contrary to the FSA's conclusions in paragraph 4.14 of the CP.

Response to Chapter 5

We attach a copy of the response we are sending to the FRC for your information.

In conclusion, The Institute and Faculty will be happy to meet with the FSA again to explain its suggestions in more detail and would also hope to be able to assist the FSA in any further review of the projections regime it may undertake.

Yours faithfully,



Derek Cribb
Chief Executive
The Institute and Faculty of Actuaries

APPENDIX

It is important that customers receive information that helps them make informed decisions on the possible outcomes from a product and that this information does not give a misleading impression about the level of risk in the product. Whilst the unaccompanied presentation of projections is no substitute for proper financial advice, many customers will not obtain advice, and will base decisions solely on what is sent to them by product providers.

Given the wide range of product types, asset allocations and duration of investment that the projection rates are intended to cover it is vital that providers do use appropriate projection rates otherwise there is likely to be significant customer misunderstanding and so potential detriment.

It would appear from the terms of the PwC report and the general content of the COBS rules is that the purpose is to give customers an illustration of possible outcomes from longer-term (e.g. 15-year) life and pension accumulation products where the outcomes are dependent on future investment returns and other variable factors, as part of the sales process.

However, illustrations on life and pensions products are provided in a variety of other circumstance, including:

- For new products of terms materially shorter than 15 years, including increments to pensions products close to retirement.
- For new products with decumulation (providing income) rather than accumulation (saving)
- For existing products, including SMPI and mortgage endowment projections, particularly as retirement or maturity nears.

These differences mean that projection rates for one purpose may need to be materially different from those for other purposes and so one model and calibration is unlikely to be appropriate in all situations. We therefore suggest that the FSA needs to adopt a broader approach to determining the appropriate projection rates for different circumstances and how they should be calibrated. In doing this, it is useful to segment the problem along the lines described in Table 1.

The table below gives our comments on the appropriateness of the model and its calibration in different uses.

Table 1	
Long-term Accumulation (new investments, 10-15 year plus horizon, single and regular contributions)	**Value to customer** Has value to customers in terms of illustrating the broad outcomes from a particular product including potential variability. Need to be able to show lower mid return and lower variability for lower risk asset mixes so customers can make informed decisions. Important that this is consistent with the POS and so SMPI/FSA illustrations should be consistent (i.e. same model and same calibration), although query whether same deflation factor appropriate for all three growth rates. **Appropriateness of the model** The model is only really valid for single contributions but the path dependency[2] from regular contributions can reasonably be ignored so can be used for all accumulation problems. **Appropriateness of the calibration** Calibration appropriate for a 67/33 equity/bond underlying asset mix. Requirement for lower rates will address lower risk mixes but not higher.

[2] 'Path-dependency' refers to a product for which the differences in investment return in individual periods influences the outcome as well as the average return over the period. Most products other than the simplest single contribution products have some degree of path-dependency but its effect is generally most significant in decumulation products.

Table 1 cont.	
Short-term Accumulation (existing funds, single & regular contributions)	**Value to customer** Has most value to customers as they need to be able to make an informed decision about whether they reduce risk exposure as retirement/maturity draws closer. **Appropriateness of the model** Probably more appropriate than in the long-term case as regular contributions have less impact. **Appropriateness of the calibration** Inappropriate as designed for longer term illustration. Needs to be more conditional on current market conditions in particular reflecting increased volatility and downside risk. Should also be capable of reflecting 'lifestyling'.
Decumulation (immediate income withdrawal from a product)	**Value to customer** Limited value as customer will already have had some sort of financial plan. Any realistic long-term projection will have a huge range of potential outcomes and regular reviews of the customer's position are critical rather than a single point of sale projection. **Appropriateness of the model** Inappropriate as allowing for path dependency is critical. Will give misleading illustrations **Appropriateness of the calibration** Inappropriate as the average term is much lower in decumulation and needs to reflect the particular investment and most importantly the volatility of that investment

We now consider the FSA's recommendations in relation to each of these.

Long-Term Accumulation

The underlying FSA model for product illustrations is appropriate for an accumulation type product (pensions or life) with the appropriate calibration. Continuing to use it for POS illustrations, annual review illustrations are appropriate (subject to our comments on calibration). Ideally the models used be consistent across different regulators (i.e. SMPI and FSA illustrations should use the same model, although the consistent integration of deflationary factors into the former needs careful consideration)

As stated in the body of our response, we consider that the maximum rate should be set reflecting expected equity returns. This would then allow providers to use appropriate returns for the actual asset classes they are invested in something the FSA requires them to do. Moving to a 100% equity base would also make it much simpler to have a consistent approach with SMPI.

We believe the differences between asset classes should also be reflected in the flanking rates. As under our proposal, the maximum rate would now be based on equities the flanking rates should also be based on that type of investment. We also believe that it would be helpful to indicate that the flanking rates should be derived from a real world stochastic investment model[3]. For the purposes of these projections we think that illustrating the 90th and 25th percentile (from a model consistent with the mid rate used being the 50th percentile). We have explained the rationale for asymmetry in the body of our response.

[3] Note that we are not proposing that providers should be required to use individual stochastic projections, just that they should consider the outcome from a real-world stochastic model when setting deterministic flanking rates for different asset mixes.

Analysis of UK equity returns over the last 100 years gives the nominal percentile returns shown in the table below:

	5 years	15 years	Suggested maximum rates in long-term projections
90th Percentile	0%	4%	2%
75th Percentile	3.5%	6%	
Median	9%	9.5%	7%
25th Percentile	16%	14%	10%
10th percentile	20%	18%	

Short-term Accumulation

From a customer's perspective the projections that are given at short terms are potentially more important than those over the longer term and drawing misleading conclusions from them can lead to potentially significant customer detriment. Many of the concerns that the FSA express in the CP about volatility and short term uncertainty are real issues for customers as they get close to retirement or maturity. The current proposals do little to address these concerns.

Current market conditions have a much bigger impact on the potential outcomes of customers at shorter terms and even though the proposed new the FSA projection rates (2/5/8) have significantly reduced the lower rate they are still not adequately going to capture the downside risk for such customers.

This can be illustrated by consider what the probability is of an investor five years from maturity with a current value of £100k invested in a balanced fund 67%/33% equities bonds getting less than the lower the FSA projection rate. Using an appropriately calibrated stochastic model (volatility reflecting current market conditions) suggests there is a 25% chance of getting less than what the lower FSA projection rate (2%) would illustrate. This risk increases as the term remaining reduces.

This suggests that the 2% rate is much too optimistic. We consider that a lower projection around the 10th percentile outcome is appropriate and more likely to be where the customer would expect a 'low' outcome would be pitched. Clear warnings that the outcome could be lower still would still be required, of course. This means that the lower rate needs to be negative at shorter durations.

As a consequence of the above we believe that projection rates and in particular the flanking rates need to vary by term. Where such extra volatility is applied to the lower rate providers should be permitted to apply similar changes to the higher rate. Failure to allow this would lead to unbalanced projections, apparently showing much greater downside risk than upside potential. This could result in some customers abandoning products it would have been appropriate for them to keep and would also lead to reluctance of providers to adopting such an approach.
If the FSA were to give guidance on what was appropriate for a 100% equity fund, it might look something like this.

	1 year	*5 years*	*Long-term rate*
90th Percentile	*-5%*	*0%*	*2%*
Median	*7%*	*7%*	*7%*
25th percentile	*12%*	*11%*	*10%*

Decumulation

The FSA model for product illustrations is inappropriate for a decumulation type product (pensions or life) due to the path dependency. In many situations the product that a customer has bought is being used to generate their income in retirement and so it is vital that the risks are understood in particular the risk of running out of money before they die.

The FSA projections cannot deal with this and in many situations will give an overly optimistic and misleading impression of the safety of the income.
We illustrate this with two examples:

Example 1: A 65 year old with a £500k pension fund invested in a balanced fund taking 90% GAD in (capped) drawdown of £27kpa. The FSA illustration at 2% would give a minimum income at 75 of £22.5k per annum. Using a stochastic model the chance of the customer getting less than the £22.5k is about 1 in 5 which again is significantly under illustrating the risk. In this example If we want a 1 in 10 chance then the lower rate would need to be set to zero, however, due to the path dependency the extent to which the FSA illustration is "wrong" depends on the income level.

Example 2: A 60 year old with a £500k pension fund invested in a balanced fund taking £30k per annum in a Flex drawdown. The FSA illustration at 75 at 2% would show that a £30k per annum annuity could be purchased ie that there is no chance of ever running out of money.

Using a stochastic model would give a 1 in 10 chance of having run out of money completely by age 75.
Given the materiality of the misrepresentation of risk when using the FSA projection model irrespective of the calibration we would recommend that the FSA reconsiders the position in the CP that there is little benefit to customers in using alternative models to represent risk. With the introduction of flex drawdown, the removal of the requirement to purchase an annuity and the growth in numbers of people retiring and taking income we think it is vital that the FSA undertake a formal consultation on how risk during decumulation should be communicated to customers.

In relation to the current consultation if the FSA still believes that these illustrations should be provided to customers then a number of changes should be made:

- The lower rate should be reduced to 0%
- Stronger risk wording about the possibility of income reducing/running out before death
- Providers encouraged to give a probabilistic statement about the chances of reducing/running out of income alongside the illustration.

Tax
We support the view in the PwC report that the tax adjustment of a fixed percentage reduction for all growth rates is overly simplistic. It is also clear from the PwC report that the position in practice is too complex to represent accurately in illustrations without significant extra cost, which could not be justified.

However the report does provide a basis for adjusting the gross returns for different asset classes which could be used in setting the prescribed equity and gilt rates for use in a life fund. This can be simplified to a tax rate of 20% applied to equity growth above 6% (the first 6% being dividend income and capital gain up to the inflation allowance as set out in the PwC report) and a 20% rate also applied to the fixed interest return. The table below illustrates this for a 100% equity mix and a long-term projection.

Equity Growth assumptions	*Gross products*	*Taxed products*
90th Percentile	*2%*	*2%*
Median	*7%*	*6.5%*
25th Percentile	*10%*	*9%*

For unit trusts / OEICs where firms choose to provide projections the tax treatment of equities is the same as in a tax exempt wrapper and so firms may choose to use the gross equity returns but should use appropriate net rates for fixed interest assets and property.

Note: Our letter in response to the FRC consultation in chapter 5 is appended overleaf.

The Actuarial Profession
making financial sense of the future

Paul Kennedy
The Director of Actuarial Policy
The Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

30 August 2012

Dear Paul,

Response to FRC on Chapters 5 of CP12/10

The Institute and Faculty of Actuaries welcomes the opportunity to respond to chapter 5 of CP 12/10. In developing our response, and also our response to chapters 3 and 4 which we have separately addressed to the FSA, we have sought to take a customer perspective, particularly asking ourselves whether the proposals improve the information presented to customers at the times they need to make important financial decisions.

In preparing this response, we set up a working group of actuaries drawn from a range of practice areas. These actuaries worked with their colleagues and other contacts to prepare this response which gives us confidence that the views we are presenting here are representative of our membership. We have obtained the views of a range of actuaries across the life, pensions and investment modelling fields and have been pleased at the commonality of opinion we have found.

In summary, the thrust of our response is:

- We agree that the assumptions in AS TM1 should be as far as possible consistent with those in COBS 13 Annex 2
- AS TM1 should continue to specify a maximum rate. This should be 7% and should only apply to funds which expect always to have 100% equity content. Other funds should be required to use a lower rate that reflects the lower risk premium available on the classes of assets they are invested in.
- We have made a similar recommendation to FSA and, if FSA adopt this approach, AS TM1 and COBS 13 Annex 2 will be consistent.
- We do not consider that AS TM1 should set a maximum rate as low as the 5% currently proposed by FSA.

As we have emphasised in our response to the FSA, an approach which requires the projection rate used to reflect the underlying asset mix may require clear guidance as to the regulator's expectations as to how that discretion will be exercised and also some degree of policing of compliance. The FRC have recently made clear in a FAQ that they consider that the Pensions TAS applies to advice given by actuaries on the rates selected for illustrations[1]. However, not all entities required to produce SMPIs are advised by actuaries (nor necessarily follow

[1] In this context, we would like to draw the FRC's attention to the fact that C 1.24 of the Insurance TAS states that individual benefit projections provided to policyholders is not covered by the Insurance TAS. As actuaries employed by insurance companies are likely to provide advice on SMPIs, it appears that they would be subject to the Pensions TAS for that advice but not to any TAS for essentially identical advice on illustrations under COBS 13 Annex 2. The FRC may wish to consider this anomaly, and whether making the Insurance TAS applicable to advice on illustrations under COBS 13 Annex 2 might not assist the FSA with ensuring compliance, a matter about which they express some concern in the CP.

that advice even if sought) and we would urge the FRC to consider how best to ensure that AS TM1 is applied appropriately in all circumstances.

Question 1

We believe consistency as far as possible between SMPIs and the FSA illustrations provides considerable value to customers. Whilst the impact of any difference between a nominal £ point of sale projection and a real £ SMPI after one year in force might not be obvious to most customers, there are circumstances where a more direct comparison can be made, including:

- Where a real £ FSA projection is also issued at point of sale
- Where a nominal £ projection is issued to accompany an SMPI
- Where a customer with existing SMPI and non-SMPI pensions receives a real £ FSA projection on the latter.

However, we do not advocate consistency at all costs, especially with regard to the growth rate, as each regulator needs to make its own decision as to the most appropriate outcome for the relevant customers, bearing in mind the objectives of each type of regulation. Moreover, it seems inappropriate to constrain occupational scheme SMPIs, where no KFI is ever given, to maximum returns allowable under COBS13 if these are artificially constrained rather than set with reference to the assets a fund is invested in. We do not support limiting the accumulation rate to 5% p.a., which we view as artificially cautious for a 100% equity fund.

In this context, it is worth noting that AS TM1 requires that the accumulation rate used "*must take account of the expected returns from the current and anticipated future investment strategy of the member's funds*" and so the use of a generic rate reflective of the average of a wide range of individuals is unlikely to be compliant.

Going forward, consistency, if achieved, will be best maintained if the FSA and the FRC coordinate future revisions of their bases and consult each other when issuing supporting material, FAQs, etc. This should increase efficiency and minimise potential misunderstanding.

We enclose a copy of our response to the FSA for your information.

Question 2

(a) On balance, we agree AS TM1 should continue to specify a maximum accumulation rate, so long as this does not artificially constrain SMPIs.

We are aware of anecdotal evidence of some providers using the current maximum as a default accumulation rate. Version 2.0 of AS TM1 does state clearly how providers should set the accumulation rate and, coupled with the message in the BAS' (FRC's) FAQ 5.6, we believe the risk of providers using the maximum as an inappropriate default has been much reduced. A maximum rate provides some protection for members against providers using unrealistically high accumulation rates, so we favour retaining it for the time being and perhaps reviewing the position once practice under version 2.0 has become well established.

As we have pointed out in our response to the FSA, we consider that policing the proper selection of a growth rate relative to the earnings potential of the anticipated asset mix is important. We consider the following actions could be helpful.

- A clear statement of expectations from the FRC regarding the circumstances in which using the maximum rates is appropriate.
- Clear indications from the FRC in its feedback to CP12/4 of their views on what might be appropriate assumptions for one or more lower return potential asset classes at the present time, encompassing not just the intermediate rate but the higher and lower rate as well.

- Joint working with other regulators to ensure proper application of AS TM1 (e.g. with the FSA for SMPIs issued by life insurers).

The Institute and Faculty of Actuaries would be happy to work with the FRC to publicise your expectations to our members.

(b) If the FSA chooses to base its intermediate projection rate on a 100% equity (or growth) fund, then we believe the SMPI maximum accumulation rate should be the same rate.

Otherwise, we do not believe the SMPI maximum accumulation rate should be the same as the FSA's intermediate projection rate, particularly if the latter is reduced to 5% pa. There is no fundamental relationship currently between the FSA intermediate projection rate and the maximum SMPI accumulation rate. An important feature of the FSA illustrations is the facilitation of a comparison of a similar product between different providers (e.g. the impact of charges), whereas the main purpose of the SMPI is to alert a member to the likely level of his pension at retirement. Using an unduly low default rate still allows comparability, but detracts from the relevance of an SMPI. The FSA rate is currently predicated on a typical balanced fund asset allocation, as explained in the PwC report on investment return assumptions. This is too conservative for many SMPIs, where members may chose to be completely invested in equity funds.

We believe a suitable maximum rate should be appropriate for 100% equity funds. The PwC report suggests a range for equity returns of 6.5% - 8.0% pa. The current maximum of 7.0% pa therefore seems a prudent maximum rate going forward.

(c) We would be happy for AS TM1 to either adopt the FSA intermediate rate if it adequately reflects a 100% equity fund or, if not, to continue with 7.0% pa as a maximum accumulation rate until the next review.

Having a maximum for SMPIs different from the FSA intermediate rate may give rise to a presentational difficulty for insurance providers or intermediaries issuing SMPIs for the first time following the sale of a product. A member may wonder why he has an SMPI using an accumulation rate of 7.0% pa when his KFI assumed only 5% pa growth (albeit with higher and lower flanking illustrations). There is also the problem of members comparing their current provision, through an SMPI, with new business illustrations.

The different aims of each type of illustration, possibly different formats of the illustrations and better communication will help explain the difference if one proves to be necessary. However, we have urged the FSA to take proper account of the risks of customer confusion from inconsistency when deciding their response to CP12/10.

We are of the opinion that a lower rate than this should be used when the funds are wholly or partially invested in assets where a lower return is expected, or if it is expected that the fund will be switched into such assets, perhaps as part of a lifestyling program.

Question 3

We agree the wording for the mortality assumption in AS TM1 should be changed along the lines of the wording proposed in Chapter 2.

Question 4

We do not believe that a 4-week consultation period will cause any difficulties.

Question 5

We are generally supportive of a change from 6 April 2013, including that for the mortality assumption. However, we are also aware that if the FSA set a different latest date for implementing its changes, it may cause problems for life insurers who will also have to amend systems for SMPIs. We suggest that this would be a good area for the FRC and the FSA to work together with the industry to minimise the cost of implementation.

Question 6

We recognise the issues set out in the impact assessment and would re-emphasis that these provide additional reasons for consistency between the FSA and the FRC regimes.

General Comments and areas where we would like the FRC to do further work

A key purpose of SMPIs is to trigger members whose likely pensions are lower than anticipated to review their position and take appropriate action in the years before retirement. These actions can include increasing their contributions, deferring their target retirement age, reviewing their investment options, or adjusting their retirement income expectations. The advent of NEST and the impact of the Retail Distribution Review may result in large numbers of scheme members with relatively small pension pots. Many of these members will be unlikely to choose to incur the cost of seeking financial advice before retirement. Members of occupational DC schemes likewise seldom take individual financial advice in addition to the generic information that is made available. In the absence of any alternative structure for the provision of advice to such members, we believe the SMPI will become an increasingly significant tool for members' financial planning.

We recognise that the FRC is constrained by the legislation from altering the nature of SMPIs, however, we suggest that the FRC, the DWP and other relevant regulators monitor the behaviour in this respect of small pot holders, and other DC members, with a view to undertaking a general review of SMPIs The aim of such a review should be to improve the relevance and accuracy of the projection for individual members, and, in particular, whether SMPIs adequately convey the potential variability in the projected pension as members approach retirement.

Yours faithfully,

Derek Cribb
Chief Executive
The Institute and Faculty of Actuaries