LCP INSIGHT CLARITY ADVICE

LCP's response to the FRC's consultation on proposed revisions to AS TM1: Statutory Money Purchase Illustrations ("SMPIs")

26 May 2022

This document sets out LCP's response to the Financial Reporting Council's consultation published on 14 February 2022 (the "Consultation").

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, and business analytics. We have over 800 people in the UK, including 150 partners and over 200 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 90% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 10% relates to insurance consulting, business and health analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Our high-level comments on the Consultation

- We are not in favour of a volatility-based approach for determining accumulation rate assumptions. We believe that a methodology based on accumulation rates by broad asset class (equities, gilts, corporate bonds, cash etc) would be more understandable by members and easier for SMPI providers to undertake.
- On decumulation, whilst we acknowledge that there is no one 'right answer' for turning the projected fund into an estimated retirement income, we have concerns with the proposed non-escalating single life annuity approach. We have put forward an alternative suggestion based on assuming initially members are invested in drawdown and later switch to an annuity.

Overleaf we provide answers to the questions in the Consultation.

We are happy for LCP to be named as a respondent to the Consultation and happy for our response to be in the public domain. We are happy for you to reference our comments in any response as long as you attribute them to LCP.

We look forward to seeing the final version of AS TM1 in due course and trust that our comments are helpful.

David Everett
Partner

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LCP's response to the questions in the Consultation

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 supportive of improving consistency across projections from different providers, which like you, we see as essential in a pensions dashboard world. We also agree that there should be consistency between projections available on dashboards and SMPIs.

In principle we have no concerns about the loss of independence and judgement in what, after all, is only a projection, so long as the accompanying disclosures make clear that the projections have been made on a prescribed basis. It may also be necessary, in relation to the first SMPI provided on whatever is the settled new approach, for providers to warn recipients that the projections may differ significantly to those previously supplied.

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

Given that you expect to publish the updated version of AS TM1 by 1 October 2022 and also the nature of the proposed changes, we believe that a year should be sufficient for most, but not all, SMPI providers to implement the changes (see our answer to Question 3).

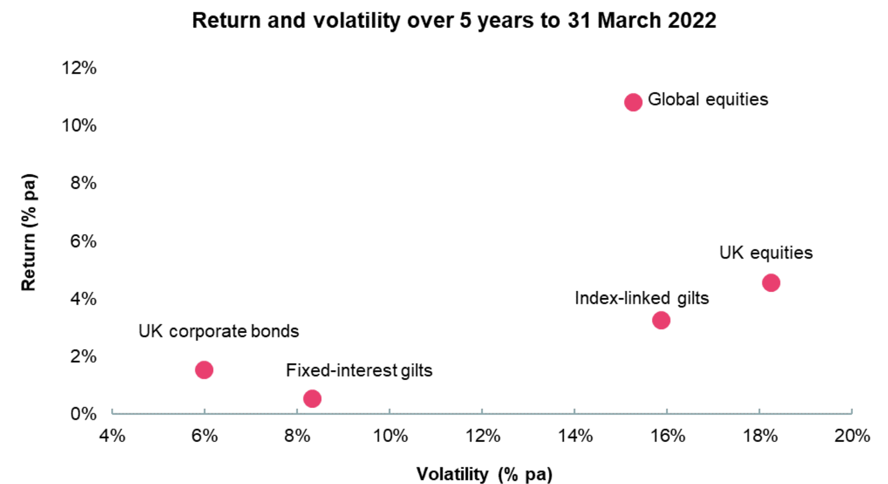
We see the bulk of the work being undertaken in the proposed volatility-based approach in order to determine the accumulation rates. We think that this will throw up a number of challenges.

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

It was difficult for us to assess whether to support this approach given the limited information in the Consultation document published on 14 February. We raised our concerns with you and thank you for, as a direct result of this, putting back the consultation deadline and holding a webinar on 13 May to present to a number of stakeholders the work you undertook with the assistance of the University of Bath. We also thank you for sharing a draft of a technical paper with us and other stakeholders on that call, which you intend to publish after the consultation period ends.

Whilst appreciating the desire to remove judgment in how individual funds are allocated an accumulation rate, and hence achieve greater consistency in SMPIs, we have a number of concerns with the proposed approach:

- We think that savers will have difficulty with the concept that a fund's expected future performance is directly related to the volatility of its past performance. Whilst the academic research provides some support for such a link (although, in our view, the correlation is not particularly high), there will be plenty of exceptions at a fund level and, to a lesser extent, at an asset class level. The latter is evidenced by the following chart, which looks at the returns and volatility (annualised standard deviation) of those returns over the 5 years to 31 March 2022 using weekly data. Using this data under the proposed approach, we understand that fixed-interest gilts and corporate bonds would be given an accumulation rate of 3% pa whereas the accumulation rate for index-linked gilts and equities would be 7% pa. Assuming index-linked gilts have the same accumulation rate as equities, and a much higher accumulation rate than fixed-interest gilts, is unrealistic.



Source: Bloomberg data, LCP calculations. Returns in £ terms.

Continuing with this theme, there can be periods where equity volatility is low, but this should not distract from their long-term performance. Your technical paper shows that had you been proposing this methodology around 5 years ago a fair number of equity funds would have been allocated a 3% pa accumulation rate (whilst some bond funds would have been allocated a 5% pa accumulation rate).

- As you acknowledge, funds can go through periods of high then low volatility, whilst their long-term prospects remain largely unchanged. Under the volatility methodology such funds could switch accumulation rate bands, sending out the wrong message as to their likely long-term returns.
- Funds, particularly those set up on a multi-asset basis, can over time change their asset allocation and hence their potential investment return volatility. There is a

danger under your approach that providers will be rating funds by reference to past volatility that is no longer relevant. This issue would not be the case if the accumulation rate was set based on the broad asset class(es) in which the fund is invested in at the time of setting the accumulation rate.

- The requirement to calculate the volatility of individual investment funds to determine accumulation rates for each of them will be burdensome to providers. Whilst the volume of work may be manageable for occupational pension schemes where there is limited investment choice – and can potentially be undertaken by investment advisers (albeit at extra cost to trustees) – this is not going to be the case for SIPP providers operating off platforms, where there may be access to thousands of funds. In contrast, setting prescribed accumulation rates based on broad asset classes is far less burdensome, since most funds invest in only one broad asset class, and it is simply a matter of categorising them to determine their accumulation rate.
- We are concerned that the methodology could cause unintended consumer behaviour, such as unnecessary switching between similar funds because one has a higher accumulation rate assumption than another due to the inherent limitations in the methodology. More worrying still is that a focus on 'high volatility equalling high returns' could result in individuals switching away from a sensible diversified strategy to a high volatility one since the methodology implicitly assumes you get more return for more volatility. Volatility and risk are not the same. As the chart above shows, index-linked gilts can be very volatile but for some investors they may still be a low risk asset, for example, those who wish to match future inflation-linked payments, such as insurers and some pension scheme trustees.

Finally, it is also not clear to us how you will keep your proposed methodology under review.

For the reasons set out above, we are not in favour of adoption of the volatility-based approach to setting accumulation rates.

The approach we favour is one of setting accumulation rates by asset class, which is essentially a variation on how AS TM1 has operated to date. We appreciate the concerns you have with such an approach, but we don't think they are insurmountable. We comment as follows:

- We don't agree that the framework would need to define the prescribed accumulation rate for all asset classes in the market. Rather, we suggest that it is only necessary to set accumulation rates for key asset classes, since the vast majority of funds only invest in one asset class and by definition very few are not invested in one of the main asset classes. We believe that prescribing accumulation rates for the following six investment types would cover almost all the investment funds in the market:
    - Equity funds
    - Cash / money market funds
    - Gilts (fixed interest and index-linked) funds
    - Corporate bonds funds
    - Diversified growth / multi-asset funds
    - Property funds
- For the very few funds that don't invest in the key asset classes mentioned, we suggest a catch all "Other" category is set with a conservative accumulation rate (for example 3% pa). Where a fund is a mixture of asset classes, the projection assumption could be an appropriate blend of that relating to the constituent classes.
- To simplify the approach, we suggest that there is no distinction made between setting assumptions for actively managed funds and passively managed funds for a particular asset class. It should be made clear to members that the assumption of no active management outperformance has been taken to simplify the approach and it is not suggesting an active fund is more or less likely to outperform a passive fund.
- Another suggested simplification is to not distinguish between different types of equity fund.
- To reduce reliance on a single source for setting the asset class accumulation rates, we suggest that the FRC obtains in-house central asset class assumptions from a panel of investment professionals and then takes an average to arrive at the prescribed accumulation rates for the SMPIs. We suggest this exercise is carried out annually. We would be happy to provide figures for this.
- It is more likely under this asset class approach that members understand that what is being attempted is an illustration that is broad brush. If too many asset classes are defined each with their own projection assumption there is a danger that recipients of the illustrations may see them more as predictions than assumptions.
- Any methodology will need to be kept under review, but the simpler you make it the less likely it will need to be overhauled. Clearly where a new financial instrument emerges which is also fairly widely used by DC funds then consideration will need to be given as to whether the broad categories we propose should be extended. However, we expect such situations to be quite rare.

We suggest that such an approach is much easier to describe to members and for them to understand than your volatility-based approach and will not place an undue burden on SMPI providers to operate. Whilst there will be some judgment left to the SMPI providers (mainly in constructing accumulation rates for funds with multiple asset classes) it will be far less than under the current system and therefore unlikely to significantly affect the consistency of the rates used for different funds.

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?

We agree that long term price inflation, as measured by the Consumer Prices Index, should be assumed to be 2.5% pa. However, this needs to be kept under review, especially so now as there is risk that higher inflation could become endemic.

We note that the exposure draft of version 5.0 of TM1 does not explicitly state that the inflation assumption is Consumer Prices Index inflation. The final version of TM1 should state that it is in order to avoid any confusion.

We question whether accumulation rates should be "suitably prudent". We note that the rates you propose are either 1% pa or 1.5% pa lower on this account. It is not clear to us why SMPIs should be undertaken on a cautious basis, although we appreciate that for those near retirement, having too much is a nicer problem to have than having too little.

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

We are content with your proposal to adopt the first of the two approaches you mention. It seems more appropriate to us to reduce the accumulation rate in the future years in which the de-risking is expected to take place rather than make some approximate adjustment to the overall projection rate.

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?

Setting to one side that we do not support your volatility-based approach, we are content with an annual recalculation and setting this as at 31 December each year in order to give some time for the calculations to be completed and for any change to volatility group to be put through before the following 6 April. However, although this should be doable for pension providers who offer limited investment options, we don't see how this will be feasible for the SIPP platform providers.

We are content with the concept of a corridor and setting it at 0.5%. However, if the consequence of switching was not so severe (see our next paragraph), it would not be necessary to have a corridor.

As, according to your analysis, volatility group switching is quite frequent, the consequence of such switching needs to be considered given that accumulation rates will increase or reduce by at least 2% pa. Where this happens members will receive a SMPI in the year post switch containing projected income that looks very different to that in their previous year's SMPI, especially for younger members. One can envisage a situation where an individual experiences good investment performance in a year and as a result their current fund value increases, but their projected estimated retirement income falls due to their funds experiencing a volatility group downgrade.

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

Your proposed approach seems theoretically better than the alternative you describe. We leave it to with-profit providers to comment on its practicability.

8. Do you have experience of unquoted assets held in pension portfolios and what are you 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 think you may be unduly prudent in your proposed treatment of unquoted assets. Clearly, you cannot use your volatility of returns approach, but assuming, in effect a 2.5% pa nominal return, which is slightly below that which you are expecting lower volatility fixed rate funds to achieve, seems too low. It also seems to be in tension with Government policy to encourage DC investment in such assets because of the higher returns that can be achieved. We think this is another argument in favour of setting accumulation rates by investment type – in the case of unquoted assets, by reference to public market rates in equivalent assets (so assume, for example, and for simplicity, the return on private equity is the same as public equity).

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

Setting aside our disagreement with the use of the volatility-based approach, your suggestion seems reasonable. In particular we agree that volatilities should not be determined at the sub-fund level.

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 agree with your suggestion that the ability to take tax-free cash at retirement should be ignored. Whilst the vast majority of people take the tax-free cash and within a DC context there seems to be little reason not to, for illustration purposes such cash would need to be turned into a retirement income equivalent. So, it is simpler to assume that the cash is not taken at all.

We agree that the current flexibility in the choice of annuitisation should be removed – in order to facilitate ready comparison by the individual across their various pension pots.

It is less clear to us why the estimated retirement income should be obtained through annuitising on a single life non-escalating basis. Your logic, of aligning with current market practice, whilst true of the small minority that annuitise, ignores the fact that many take cash or enter drawdown.

Turning to each aspect in turn:

- We accept that given societal changes over a number of years, it may no longer be appropriate to require an illustration with an attaching contingent spouse or partner benefit, especially given that since April 2016 the State Pension is provided on a single life basis. However, there are counterarguments – such as comparability with DB pensions and the signal that may be given, for men in particular, not to annuitise on a joint life basis.
- We think it important to illustrate an income that is more sustainable in relation to inflation. Not to do so risks exaggerating the retirement income that will actually be available to the individual, with their potentially choosing to make less pension savings in the accumulation stage.

We suggest that your benchmark should be a broadly inflation-proofed level of retirement income, initially achieved through drawdown, with annuitisation at a later age, say age 75. We have called this a 'flex first, fix later' approach. How you achieve this we leave to you, but one possibility might be to continue to assume a notional annuitisation, allowing for a modest, but fixed rate of pension increases.

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 understand your logic for proposing a new and different treatment for those less than two years from their retirement date. However, we are concerned at the additional cost that would be incurred, particularly by occupational pension scheme trustees, in undertaking the work. It is also not clear to us whether under your approach the individual will receive 'further insight' into their likely future retirement income, when, as you say, their actual retirement income on an actual annuitisation could be very different due to lifestyle and/or health adjustments.

Therefore, we suggest that you don't distinguish between those more than and those less than two years from their retirement date – a date that may be somewhat notional, as far as the individual is concerned, in any event. The issue you are concerned with may be better dealt with through disclosure wording.

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 agree that you should move to the latest available base mortality tables.

We agree that no change is needed to the current unisex construction.

We are content for the CMI mortality improvement model to continue to be used, with an implication that 'core values' are used. However, we think that you should consider making some adjustment to reflect the adverse impact that Covid has had on mortality. See our Longevity report published on 5 May 2022 for further details.

Given our answer to Question 11, we think that the mortality table you settle on for those individuals more than 2 years before their retirement date should also be used for those within two years of that date.

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

Not on your proposals, but we suggest that as the focus is currently on the basis for SMPIs, this in turn should influence the next review of FCA illustrations with an objective of achieving consistency between SMPIs and FCA illustrations.

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

Not entirely. Whilst for some pension providers the additional costs are manageable, for others, especially in the SIPP market, your proposed volatility-based approach may prove to be too challenging, both on a cost and a practical level.