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Proposed revisions to AS TM1: Statutory Money Purchase Illustrations

Thank you for the opportunity to respond to your consultation on proposed revisions to AS TM1.

Established in 1836, Legal & General is one of the UK's leading financial services groups and a major global investor, with over £1.4 trillion in total assets under management as at 31 December 2021, of which a third is international. We also provide powerful asset origination capabilities. Together, these underpin our leading retirement and protection solutions: we are a leading international player in pension risk transfer, in UK and US life insurance, and in UK workplace pensions and retirement income. Through inclusive capitalism, we aim to build a better society by investing in long-term assets that benefit everyone.

We agree with the objective to ensure illustrations use consistent assumptions once members are able to see all of their pensions in one place on pensions dashboards. There are considerable differences in the assumptions used across the industry and we are supportive of standardisation. However, we have a number of concerns with the proposed volatility-based approach which could result in the rates being inappropriate versus reasonable assumptions for performance.

The volatility approach will also be challenging for providers who hold externally managed investments on their platforms. The research required to determine volatility will require a significant amount of work which we believe has been underestimated in the impact assessment.

For these reasons we strongly recommend a method for setting growth rates that is based on asset class.

We also have reservations on using a zero real rate of growth for unquoted assets given the government's desire to encourage trustees to invest in illiquid assets. Using a zero rate for all such assets would seem counterintuitive to the rationale that illiquid assets have the potential to deliver better returns for members.

We are supportive of the proposal to standardise the annuity basis and treatment of lump sums, but there appears to be an inconsistency in the rationale for change. Not least that providing a single life level annuity for DC will not be consistent with most DB schemes which almost always provide joint life inflation linked income.

We would also note that the proposals as they currently stand are introducing further divergency from the FCA COBS basis. Whilst we appreciate that those illustrations are out of scope of this consultation, an inconsistent approach is not a good experience for members and firms who are responsible for issuing illustrations on both bases will require additional work and cost to maintain two separate sets of assumptions.

Finally we would emphasise the need for the final version of TM1 to be published as early as possible to give firms sufficient time to update systems and, if necessary, research and obtain the required data to calculate volatility. There is a significant amount of regulatory change scheduled for 2023, not least the implementation of the pensions dashboard itself, so we would ask for at least a 12 month period between publication and implementation.

We hope our response is helpful and constructive and would be happy to discuss the points covered in more detail. Please do not hesitate to contact me if I can be of any further assistance.

[redacted]

Colin Clarke
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Questions

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 recognise that inconsistencies in assumptions will be brought to light by the introduction of pensions dashboards. However, whilst ERIs could be consistent in terms of the accumulation rate and annuitisation, they will still differ because of the effect of charges. A member with the same current fund value, same contributions and identical investments in two pension schemes will not see the same ERI if the charges are different.

   Having said that, we agree that there are considerable differences in growth rates used currently for identical, or broadly identical, funds and are supportive of prescribing the accumulation rate and form of annuitisation to improve consistency between providers. We have received feedback from trustees and EBCs that some providers are potentially more generous with their assumptions than others for essentially the same investment strategies. The benefits of a prescribed approach outweigh the loss of independence. However not allowing any element of judgement could result in inadvertent (im)prudence although judgement will still be required where a fund does not have a 5-year track record.

   Aside from growth rates and annuity assumptions, there can also be a large degree of judgement required in setting the initial level of contributions (particularly amongst product providers who are not close to sponsoring employers and their payroll systems) and determining whether or not they should be projected to increase. We accept that there needs to be some judgement in determining the initial level of contributions, but the default should be to increase contributions in line with the inflation assumption as this is probably the expectation for the vast majority of members and will aid consistency on the Dashboard.

   Finally, whilst we appreciate that illustrations prepared under FCA COBS rules are out of scope of this consultation, there will be instances where members receive illustrations under multiple regulatory regimes where the growth rate assumptions will differ. An additional divergence is being introduced by the differing mortality rate assumptions which will require system development work to deliver.

   From a member perspective, this issue is particularly amplified in situations where members are in partial drawdown. Whilst drawdown benefits are out of scope of the pensions dashboard, members will still continue to receive an annual drawdown statement as prescribed by COBS which will include a projection. Members in partial drawdown will also receive a SMPI in respect of the benefits that have not been crystallised. The first year of crystallisation could be particularly confusing for members.

   If both the crystallised and uncrystallised benefits are invested in the same funds, providers will need to consider how best to communicate the reason for using different growth rate and annuitisation assumptions.

   This is one of a number of areas where regulatory requirements differ between trust and contract-based schemes. Now would seem an appropriate time to review whether this is still appropriate going forwards if consistency is the ultimate aim of this exercise.

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

   Whether or not the proposed effective date is achievable will depend on when the final version of TM1 is published. We will need as much lead in time as possible to implement any system changes required and determine the initial volatility assumptions. We would also appreciate full clarity on whether this is based on the date of issue or the end date of the statement. For example, would a statement produced as at 30 September 2023 but issued after 1 October 2023 need to use the new or old assumptions?

Our main concern is with the proposed revision to the mortality basis which as previously stated will require system development and will be inconsistent with illustrations produced under COBS rules.

Providers will also need to consider what other activities will need to be planned for. Given the change in assumptions, illustrations issued on the revised TM1 basis after October 2023 could look substantially different to those issued prior. The growth rate assumptions will be higher than before in some instances, and lower in others.

This will inevitably prompt questions from members and trustees – particularly if the projected figures are lower. Whilst we appreciate that the illustrations are estimated it will generate additional queries from members, advisers and trustees which will require additional resource to handle the extra demand on our front line and support teams.

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

Having considered the options outlined, we believe that prescribing accumulation rates by asset class as referred to in paragraph 3.18 would be more practical and appropriate than a volatility-based approach.

We have reviewed volatility figures calculated by Legal & General Investment Management over five years from December 2016 to December 2021 and have mapped those to the table in paragraph 3.13. Broadly speaking the results are as follows.

Growth Rate	Historic 5-year Volatility	Typical Funds
1%	0% - 5%	Cash, short-dated bonds
3%	5% - 10%	All duration conventional bonds, TDFs to 2050/5, Distribution. Diversified, Multi-Asset Fund
5%	10% - 15%	TDF 2050/5+, Long bonds, some global/emerging market equity
7%	15%+	Index-linked Gilts, Property, area/country equity, some global/emerging market equity

Our observations from this analysis are:

- Long bonds and index-linked gilts are very unlikely to deliver returns of 5% to 7% in the future given current yields. This would be a material change to our current growth rate assumptions.
- We would expect emerging markets to at least perform in line with area/country equities
- Our world emerging markets fund has volatility of 14.89% and global emerging markets has 15.06%. These funds are very similar in their investment objectives and asset holdings. Based on the proposed growth rates, this would result in a 2% per annum difference for only 0.17% difference in volatility over 5 years. Over 20 years that is a difference of nearly 50% in the projected pot size, which is very difficult to justify. It would be preferable to have

a minimum growth rate of [1%] for volatility <5%, a maximum growth rate of [7%] for volatility >=15% and use interpolation to derive the growth rate for volatility rates in between (rounding to 1dp).

- An accumulation rate of 7% for most equity is much higher than our best estimate (a return of 4.5% above the assumed rate of inflation is not prudent) and most academic research suggests that a lower rate would be more appropriate.

Quoted SIPP investments and collective investment funds, of which there are thousands, could cover a very large range of individual asset holdings, and obtaining monthly price information (including details of share splits, M&A, selecting an alternative where the asset hasn't got 5 years price history (IPOs), foreign currency(?) etc.) is not practical and will rely on third parties who may charge for providing the information. Furthermore, without a statutory obligation on data holders/owners to provide price information we may not be able to comply and may have to pass on excessive costs of complying.

Investment trust quoted prices will reflect a discount/premium to NAV and will be more volatile than the value of the underlying assets. This will result in a higher growth rate than justified by the underlying assets.

Notwithstanding our preference for an approach based on asset class, we suggest either allowing non-collective assets to follow the same approach as unquoted assets, or (preferably) allowing providers to map or allocate them to 'appropriate' volatility groups, recognising that this introduces an element of subjectivity and industry guidance would inevitably be required. However, even then there will be thousands of potential collective assets that could be held within SIPPs so this may need to be widened to include all assets not managed by the provider.

With regard to prudence, whilst we accept that contributions can be reduced closer to retirement, members would need to consider the implications of higher contributions earlier in the context of their wider finances. Similarly, overpaying earlier could prove detrimental closer to retirement if a member subsequently exceeds the lifetime allowance. We agree that shortfalls discovered too late may be unbridgeable but equally, excess savings cannot be refunded and could have a material tax implication that would outstrip performance.

Our experience also shows that commodity funds can be extremely volatile, but because they are uncorrelated to the broader market of investable assets, they have low expected returns. A volatility approach would therefore not result in a realistic growth rate for such funds.

Requiring a 5-year period over which volatility is measured could be risky. For example, there have been 5-year periods where equities have experienced low volatility but over the longer-term, returns would warrant using a higher growth rate.

We would also question whether a 2.5% inflation rate is appropriate. Hopefully the current economic situation and high inflation will not endure beyond the short term, but this will need to be kept under close review. Plus of course this is different to the rate required for FCA COBS illustrations and have expanded on this further below.

Whilst we agree that there can be large variation within asset classes, this tends to be a lot lower than the variation across asset classes. Whilst this could be seen as sub-optimal, our view is that it is less sub-optimal than simply looking at realised volatility.

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

We believe the proposed approach seems sensible. However, not all target date funds (TDF) will use a fund building block approach.

TDFs by nature are not programmatic and have only recently been introduced and will not have an established practice referred to in paragraph 3.24. However, the Exposure Draft paragraphs C2.5 and C2.6 would provide sufficient scope to use anticipated re-balancing.

6. What are you views on the proposals that the recalculation of volatility indicator should be annually as at 31 December with a 0.5% corridor?

If volatility is the chosen basis for determining the accumulation rate then we are supportive of this proposal.

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

Legal & General no longer operates a with-profits fund. However, some of our customers hold externally managed with-profits policies within a SIPP. As stated in our response to questions 3 & 4 on assets in SIPPs generally, we would be reliant on third parties to provide us with the required information so the proposed approach would be challenging in this situation.

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?

A zero real rate of growth would be a simple approach to take. However, there is a strong drive from the government to encourage DC schemes to invest more in illiquid assets, which would include unquoted.

We expect that this will predominantly be achieved within pooled fund structures (although it will still take 5 years before volatility can be fully measured), but there will be trustees who might invest directly in an unquoted asset.

The rationale for the government's approach is that illiquid investments have the potential to deliver better returns for members, so using a zero real rate of growth in illustrations in all instances may not reflect that. This could result in the illustration being undervalued and could lead members to overestimate contribution levels and generate negative perceptions on the potential benefits of diversification into this asset class. Under the proposals, a member investing in a pooled fund holding 50% equity and 50% illiquids would very likely get a very different projection from a member investing 50% in an equity fund and 50% in a separate illiquid investment.

However, we recognise that there may be situations where a zero growth rate is appropriate but there should be flexibility to also use an accumulation rate that is better aligned to the long-term performance that unquoted assets are expected to achieve.

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

Our current approach is to use the underlying asset allocation of all the sub-funds to determine the growth rate. This gives a consistent answer irrespective of whether a member invests in the composite fund-of-funds or directly in the underlying components.

Averaging volatility for the entire composite would not seem appropriate and our current approach is aligned with your proposal in paragraph 3.53. The point made above on pooled funds and illiquid investments held separately would also be relevant here.

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?**

Our own experience concurs with paragraph 4.6 in that the most common annuity chosen, even by people that receive regulated advice, is on a single life level basis. Historically we have chosen to use a joint life, inflation linked annuity but will be implementing a change to reflect current market practice to coincide with the launch of the new simplified annual benefit statements from October this year.

However, we do not have any insight into our customers' wider financial circumstances. It is possible that people have other sources of inflation-linked income and/or their dependants may have sufficient income of their own. This may be more prevalent for current retirees who are more likely to have DB pensions than the future generations of people who will become more reliant on DC as their primary source of pension income in retirement.

The proposed basis is unlikely to provide consistency with DB. Most DB schemes are subject to minimum requirements for indexation, particularly but not limited to those that were previously contracted out and provide GMP or Section 9(2B) benefits. Many will also provide a dependant's pension either by statute or voluntarily. And the state pension is currently subject to the triple-lock.

We also note that there is no mention of a guarantee period and would recommend that this should also be prescribed.

With regard to lump sums, we agree that the rules for calculation are complex, but it is likely to be 25% of the fund for the vast majority of DC members. We have approximately 90,000 members who are potentially entitled to lump sum protection greater than 25%, which represents only 2% of our total membership.

Our own research[1] indicates that whilst most if not all DC savers elect to take the maximum lump sum available, many are doing so without needing all of it. This is of course part of a wider debate on educating people on the best way to use their retirement savings but in light of this research we would be supportive of your proposal not to include it as part of the illustration. However, we would note that this would not be in line with current market practice, unlike choosing a single life level annuity so there appears to be an inconsistency in the rationale for change.

Having said that, the availability of the tax-free lump sum is seen by many as a valuable incentive to save into a pension. We therefore need to be mindful of whether the removal of this from illustrations leads to poor outcomes. If the final decision is to remove the option to illustrate for a lump sum, the resulting member behaviour will need to be watched carefully for any unintended consequences, such as stopping or reducing contributions or opting out of pension saving completely.

It is also possible that once members receive their first statement using the revised assumptions, they may perceive that the option to take the lump sum has been withdrawn. Providers would be best advised to ensure members are appropriately informed of the reason why the lump sum has been removed from the statement to avoid any misunderstanding and provide other ways to illustrate this.

[1] LGIM Research: Like it or lump it. Retiree attitudes to tax-free cash

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 are happy with the proposed approach.

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 are comfortable with your proposed basis other than the inconsistency with COBS as previously noted.

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

    We have already mentioned the inconsistency between TM1 and COBS for the proposed growth rate assumptions, but this is also the case for inflation. Even if the unadjusted growth rate assumptions were aligned, members would still receive different illustrations using real rates of return.

    Given that the government's target is 2% which as you know is the current basis set out in COBS, we do not feel it is appropriate to have different assumptions for what essentially amounts to the same purpose (i.e. reflecting the impact of inflation) and recommend that TM1 is aligned with this.

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

    Our main concern is on the additional amount of work required to calculate the volatility for SIPP investments and pooled funds that have been available for less than 5 years. We appreciate that a zero growth rate will be permitted for unquoted assets, but SIPPs will also hold quoted assets where researching the monthly unit prices will take a significant amount of time, as will the (subjective) work required to find a suitable mapping for pooled funds younger than 5 years.

    The further divergence between TM1 and COBS assumptions will also cause issues for providers who are required to issue illustrations on both bases as we will need to ensure our systems can accommodate both.

    We believe that the additional work required as a result of this change has been underestimated.