

PROPOSED REVISION TO AS TM1: STATUTORY MONEY PURCHASE ILLUSTRATIONS

Hargreaves Lansdown consultation
response

May 2022

**HARGREAVES
LANSDOWN**

INTRODUCTION

Hargreaves Lansdown is a leading provider of pensions, both to individuals and through the workplace, as well as being a leading provider of retirement services. Our services are available with and without personal financial advice. Our pension products include the HL SIPP and HL Workplace SIPP, and other products including Lifetime ISA, Cash ISA and Stocks and Shares ISA.

Our purpose is to empower people to save and invest with confidence; building the nation's financial resilience. We want to provide a lifelong, secure home for people's savings and investments that offers great value and an incredible service, and makes their financial life easy.

Our experience at providing services to 1.7 million ordinary investors trusting us with £141.2 billion (31 December 2021) and helping them to engage with and manage their pensions and long-term investments gives us a wealth of experience at how to deliver good savings outcomes for individuals. Our views are informed by this and a deep knowledge of the workplace pension sector through the HL Workplace team that offers an auto-enrolment scheme to 488 employers, accounting for over 150,000 members. In addition, we provide retirement services to 25 of the FTSE100.

We welcome the opportunity to respond to this consultation and appreciate the extensive work and ongoing industry engagement from the Financial Reporting Council. If you have any questions on this response or wish to discuss further, then please contact Phil Warner ([REDACTED])

Executive Summary

Although we agree that accumulation rates should be prescribed, we strongly disagree with the proposed volatility-based approach. Instead, further work should be undertaken on either developing a consistent asset-based approach or a single accumulation rate. The time and effort expended on this work should be commensurate to that expended on developing the volatility-based approach.

A volatility-based approach will not be easy for pension members to understand, creating a spurious impression of accuracy and ultimately undermining trust in pensions.

The tens (potentially hundreds) of thousands of annual calculations the pension industry would undertake to determine which of four accumulation rates to use would be a highly disproportionate industry burden for no member benefit, removing resources which could otherwise be used to improve member outcomes.

The Estimated Retirement Income should be a single life, inflation linked annuity shown before the deduction of tax-free cash. This then frames a pension as being primarily to provide a sustainable retirement income and illustrates the effect of inflation over a retirement of thirty years or longer. Alternatively, an annually reviewed, prescribed income rate is a simpler way of achieving the same objective.

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 support the approach to prescribe both the accumulation rate and how the Estimated Retirement Income is shown. We do not have any concerns if providers are prevented from setting these terms.

AS TM1 currently sets out a consistent approach for producing SMPs. It specifies that the chosen accumulation rate must '*be justifiable and consistent with the inflation rate assumption*' (C.2.5) and '*consistent from year to year*' (C.2.6).

Requiring the provider to take account of '*the expected returns from the current and anticipated future investment strategy*' (C.2.3) did mean that this element of judgement within a consistent approach could theoretically result in different Estimated Retirement Incomes for otherwise identical pensions. For SMPs from different pensions which are pushed to members on different dates this was unlikely to be a significant issue as there would be several reasons why Estimated Retirement Incomes could differ.

With the introduction of pensions dashboards it will become more important that Estimated Retirement Income figures are as consistent as possible. Members will be able to compare the Estimated Retirement Income for several pensions side by side. Even small differences in assumed growth rates could lead members to mistakenly believe that a pension using a higher growth rate will provide a higher retirement income. This could result in a perception that providers would consider the business impact when determining growth rates. However unjustified this perception, it would undermine trust in pensions.

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

An effective date of 1 October 2023 would be achievable if asset-based growth rates were used. This date would be far more challenging if a volatility-based approach was adopted, mainly due to the sheer volume of calculations required to be undertaken by each provider once the required data had been sourced. Please also see our response to question 14.

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

We strongly oppose adopting the proposed volatility-based approach for determining the accumulation rate.

- It is at best unhelpful, and at worst misleading, to suggest a direct relationship between historic volatility and future performance.*
- General market volatility could cause all assets to change volatility group*
- Unquoted assets would be assigned a volatility group based on a speculative volatility assessment*
- Providers do not have the data to calculate five-year volatility on all pension assets.*

- *The proposed approach does not meet the principle that the assumptions and resulting illustration should be easy to describe to savers and be understood by them.*
- *The determination of the accumulation rate assumption will place an undue burden on providers.*
- *The proposed approach creates a spurious impression of accuracy, magnified when applied to individual investments.*
- *Any benefits of using individual volatility-based approach instead of an asset-based approach are disproportionate to the burdens this would impose.*
- *The stated objections to the asset-based approach could be overcome*
- *A single accumulation rate, regardless of investment, should be given further consideration.*

Higher volatility does mean more, and more rapid, price movement. Taking this measure in isolation does not mean a greater potential for a higher return or loss in relative to a lower volatility investment, although it does correlate with extreme events. There are other aspects of risk to consider. For example, liquidity risk can increase returns if there is higher demand and lead to more rapid loss if there are more sellers than buyers. This liquidity risk is not included in a volatility measure unless it has already crystallised within the fund. Another example is credit risk for fixed income investments, again not caught by a volatility measure unless the risk has already crystallised.

Even if you accepted that a more volatile investment has a greater potential for a higher return relative to an investment with lower volatility, the reverse must also be true. This greater potential for loss, will never be brought out in illustrations which assume year on year growth.

There is a risk that a change in general market volatility causes all assets to change between volatility groups requiring a corridor (question six) and a regular review of *volatility groupings and accumulation rates against the prevailing market conditions* (paragraph 3.14). Paragraph 3.46 also states that for unquoted assets *a current value becomes subjective and it becomes speculative to assess the volatility of such an asset*. Both these issues demonstrate that, even conceptually, the proposed volatility-based approach is flawed.

Providers will not have the data to calculate five-year volatility on all pension assets. There might be an assumption that providers have this data, however providers will actually have the Synthetic Risk and Reward Indicator (SRRRI) calculated by the fund manager. Please also see our response to question 14.

One of the principles underpinning the development of the methodology to determine the accumulation rates was that the *resulting accumulation rate assumption and the resulting statutory illustration should be easy to describe to savers and to be understood by them* (paragraph 3.4). While it can be challenging to clearly explain why a specific accumulation rate has been used this is currently possible. Pension members will accept that equities have a higher growth potential than cash. Having to explain that fund A has a different accumulation rate than fund B due to the monthly volatility over the past five years will not meet this principle.

Another principle is that the *determination of the resulting accumulation rate assumption should not place an undue burden on providers* (paragraph 3.4). In addition, when considering the treatment of with-profit funds it is stated that *We therefore propose to adopt this approach, but we would like to hear from providers whether such an approach would introduce too great a burden either because the data is unavailable or because it will involve extensive calculation* (paragraph 14). As a single pension provider could be required to annually calculate five-year volatility on over 19,000 different pension assets, our view is that this would place an undue burden on pension providers because it will involve extensive calculation. Please see our response to question 14 for further details.

To lessen this burden providers could choose to reduce the investment choice available for engaged pension members. There are different views on the optimum amount of investment choice for pension members, but the undue burden of calculating accumulation rates should not be relevant when a provider is determining how best to achieve good member outcomes.

There are also the related issues of proportionality and creating a spurious impression of accuracy.

When considering proportionality, we have not looked at proportionality as a whole. Instead we have considered whether the additional burden caused by adopting asset specific volatility-based accumulation rates instead of asset class based accumulation rates is proportionate to the benefit gained.

In paragraph 3.11 it is stated that

We have proposed four volatility groups, which we have found to be broadly aligned to a segmentation of funds by asset types based on 5-year volatilities at 31 August 2021. Money-market funds fall into volatility group 1. Lower volatility fixed interest funds fall into group 2, with the remainder in group 3. Equities funds are mainly captured in group 4, with some lower volatility funds in group 3.

To roughly paraphrase, the accumulation rates derived from the volatility groups are broadly aligned to market segmentation by asset type. The benefit of the proposed method must then be that the accumulation rate is more precisely aligned to individual investment volatility. Given the undue burden and extensive calculations required, our view is that this is not a proportionate benefit.

These disproportionate calculations then create a spurious impression of accuracy. This is because any pension member who knows that their pension provider has undertaken complex calculations to determine the individual accumulation rate of each of their pension investments will have a high degree of confidence that the accumulation rate is accurate. This impression is not given if the same accumulation rate is applied to all broadly similar investments as it will be clearer that these investments have performed differently.

This spurious impression of accuracy is then magnified when applied to individual equities as this would be perceived as a prediction of returns and therefore a reason to invest in one specific equity rather than another equity. An alternative approach of assuming zero real growth for non-fund assets, as suggested for non-listed assets, is unlikely to be justifiable and consistent with the assumed inflation rate. Please also see our response to question eight.

If the individual investment volatility-based accumulation rates are not acceptable then an alternative is required.

Although we think it unlikely that a single accumulation rate would be the preferred approach, our view is that it is still worthy of further consideration. The first objection is that *projecting cash funds at the same accumulation rates as equity funds over the long term may be perceived as being too simplistic, or even misleading* (paragraph 3.17). This could be addressed by using the same accumulation rate for all funds except for cash which would assume nil real growth, in a similar way as the proposal for unquoted assets.

More detailed consideration could also be given to whether a single assumed growth rate should be used for all default investment options on the basis that pension scheme members in their workplace default options could expect broadly similar outcomes. This would fit in with the purpose of SMPI being to give pension scheme members as estimate of their total potential retirement income rather than the ability to compare pension providers based on each pension's Estimated Retirement Income.

One issue that both volatility-based and asset-based growth rates share is that there is an implicit assumption that the members investment will remain unchanged until retirement, other than due to Lifestyling. Where a pension member has made an active investment choice it may be reasonable to assume that the member is more engaged with their pension and therefore more likely to use pension calculators and other tools to model their potential returns. Where the member has more than 25% held in cash there is an FCA requirement to issue regular 'cash warnings', a rule specifically designed to encourage pension members to change their investments. It could therefore be argued that excess cash holdings are even more likely to change.

Our preference is that accumulation rates should be prescribed by asset class, with the accumulation rate being determined by the five-year volatility as described in paragraph 3.11. We note the objections to the approach set out in paragraph 3.18 and have attempted to address how these could be overcome.

- The framework does not need to define the prescribed accumulation rate for all available asset classes in the market. Instead, it needs to be possible to assign all available investments to an asset class for which there is a prescribed accumulation rate. Although this sounds similar, it is not the same. For example, if an investment is split between assets classes then appropriately weighted accumulation rates could be used.
- Despite differences in investment philosophy and practice, there are existing fund classifications such as the Investment Association sectors which group similar funds together. We're not suggesting that there should be 50 different accumulation rates to match these sectors, however it should be possible to match these sectors to accumulation rates. This is similar to the suggested approach for funds with insufficient performance history about which it is stated that *Given that funds will be apportioned into 1 of 4 volatility levels we do not believe that this should give rise to significant differences in approach by different providers.* (paragraph 3.26)
- The entire method would not need frequent review and updating to cater for emerging new financial instruments. In the rare event that a new fund is not sufficiently similar to the existing sectors then it is only this fund for which an allocation rate is needed. If such a fund was to be made available for pension investment then we would expect that it would not be made available by a pension provider until the allocation rate had been determined. If this was a non-fund financial instrument then it is unlikely that it will comprise a materially significant proportion of an individual's pension and therefore any impact of allocating an inappropriate accumulation rate should be insignificant.

4. Based on an assumed CPI of 2.5% do you find the accumulation rates proposed for the various volatility groups to be reasonable and suitably prudent?

We have not responded to this question.

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

- *Lifestyling does not necessarily involve a reduction in the accumulation rate*
- *An approximate growth rate assumption should be used to reflect anticipated Lifestyling*

The exposure draft of AS TM1 defines Lifestyling as '*a program whereby the investor is switched into less volatile pooled funds as retirement date approaches.*' This is not necessarily correct. Although we

agree that accumulation rates are adjusted to reflect derisking, this does not necessarily mean a reduction in the accumulation rate.

Before 2006, the vast majority of defined contribution pension members would have taken 25% tax free cash and used the remaining 75% to purchase an annuity. Lifestyling would have reflected this in that the end position would be that 25% would be held as cash with 75% in fixed interest as gilts or corporate bonds. These destinations lowered the risk of a sudden drop in cash and expected retirement income just before retirement. If annuity rates fell just before retirement then this would be broadly offset by an increase in the value of the fixed interest fund, and vice versa.

Since 2015 annuity purchase has become less common, replaced by the ability to take a flexible income. Lifestyling strategies have been adapted to reflect this. This could include Lifestyling into funds which reflect an expectation that income drawdown will be used to provide a sustainable retirement income, withdrawn as a single lump sum or a combination.

When making an adjustment to reflect anticipated Lifestyling it should be possible to do so by calculating an approximate adjustment in the growth rate (up or down) to reflect the anticipated asset allocation. As there are only four possible accumulation rates, such an approximation should be close to that which would exactly follow the Lifestyling arrangement.

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

- *A 1% corridor would significantly increase projection consistency, increasing member understanding and engagement.*

We do not agree that a volatility-based approach should be used for calculating accumulation rates and this is illustrated by the need to consider whether a corridor should be used.

If a 0.5% corridor is used this would increase the average period between funds switching volatility groups from 4.7 years to 5.4 years. It is not clear whether these figures would be materially different in times of higher or lower than average market volatility. This increase does not make a significant difference to the ability to ensure that accumulation rates are consistent from year to year, a current AS TM1 requirement (C.2.3)

A 1% corridor increases the average period from 4.7 years to 7 years. This would more significantly increase the year to year consistency of retirement income projections and may have an even greater affect when general volatility changes.

We accept that a 1% corridor does undermine the structure of assigning volatility groups to funds, however this is offset by the consistency it would achieve leading to increasing member understanding and engagement with their retirement income.

When responding to this question we haven't examined how funds would move between volatility groups due to changes in general market volatility. This factor should also be considered when determining the corridor width.

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

We have not responded to this question, other than to note that the FRC accept that the proposed approach could change if it would require providers to undertake extensive calculations.

8. Do you have experience of unquoted assets held in pension portfolios and what are your views of the proposed approach for unquoted assets? In particular, do you regard a zero real rate of growth to be acceptable and if not, please provide suggested alternatives with evidence to support your views?

- *It is not appropriate to use volatility to determine assumed accumulation rates for unquoted assets*
- *Assuming zero real terms accumulation rates undermines member trust in their Estimated Retirement Income*

Although we do not permit unquoted assets to be purchased within the HL SIPP it is possible for existing assets to become unquoted, for example a share delisting. This then introduces a degree of judgement in calculating the current value.

The specific issue is that unquoted assets tend to have very low volatility until they suddenly don't. Commercial property funds would be one recent example. By the time this response is considered residential property may be another. Assuming zero real terms growth would be a pragmatic solution.

The significant drawback is that assuming no growth is unlikely to be justifiable and consistent with the assumed inflation rate, a current AS TM1 requirement (C.2.6). This then leads to two bad member outcomes.

The first is that members who are invested in illiquid assets could see a substantial fall in their Estimated Retirement Income when they receive their first SMPI on the new basis. This could only be explained by stating that either the old assumption was too optimistic or the new assumption is too pessimistic. Either explanation undermines the member's trust in their Estimated Retirement Income.

The second outcome is that those, including the government, who want to encourage greater investment in illiquid assets will have to explain why zero real growth is being assumed. However carefully this explanation is worded, it will always come down to an explanation of why the assumed growth rate is inappropriately low. This again eats away at trust in Estimated Retirement Incomes.

Any alternative method for determining volatility grouping would need to be consistent with how other assets are assigned to avoid systematic inconsistencies.

The unquoted asset issue further illustrates why volatility should not be used to determine accumulation rates. If this approach is also applied to listed non-fund assets then this further exacerbates the issue. Please also see our response to question three.

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

If volatility is used to determine accumulation rates then we agree that volatility for pooled funds should be calculated using the unit price of the composite fund of funds rather than by aggregating the volatilities of the sub-funds. With the same caveat, we also agree that a policy invested in multiple funds should have volatility calculated by reference to the individual pooled funds rather than the single policy.

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?

- *The illustrated retirement income should be a single life inflation linked annuity shown before the deduction of tax-free cash*
- *Not deducting tax-free cash frames a pension as being primarily to provide a sustainable retirement income*
- *An index-linked income illustrates the effect of inflation over a retirement which could last thirty years*
- *Alternatively, a single annually reviewed prescribed income/withdrawal rate is a simpler way of achieve the same objective.*

The behavioural impact is an extremely important aspect of both SMPI and Pensions Dashboards. It frames how people annually think about their pension until they take benefits. It can be a key behavioural nudge driving good member outcomes.

We agree that the Estimated Retirement Income should be shown before the deduction of tax-free cash. One reason is due to the complications required to avoid illustrating tax-free cash above the tax limits, for example where the Lifetime Allowance restricts tax free cash to below 25% or Lifetime Allowance protection allows for more than 25% tax free cash.

The other reason is that not deducting tax free cash then frames a pension as being primarily to provide an income which can be reduced to obtain a lump sum, rather than an income plus a default lump sum which must be given up if you want to increase income.

Although tax-free cash is commonly taken due to its tax efficiency it is no longer thought of as 'free' money which can be spent on anything. It is often used to supplement retirement income. Even paying off a mortgage with tax free cash reduces outgoings and so increases disposable income.

We agree that there should not be flexibility in how Estimated Retirement Income is illustrated and that it should be consistent across SMPI and Pensions Dashboards.

Although we agree that most annuities purchased are level single life annuities, this does not consider that most members do not buy an annuity. Members are more likely to take their pension fund as an Uncrystallised Funds Pension Lump Sum, Income Drawdown or a combination of the two. The default option is no longer annuity purchase. Using any annuity type would not be aligned with current market practice.

The SMPI should still illustrate an Estimated Retirement Income, in other words an estimate of the sustainable income which the member could receive throughout their retirement. For this purpose, a single life inflation linked annuity is the most appropriate way to illustrate this income, regardless of the income options which a member could choose.

An inflation linked annuity has two advantages over a level annuity.

The first is that it is also (very) broadly representative of a sustainable drawdown income, albeit without accounting for mortality drag. This then makes the Estimated Retirement Income product agnostic.

The second, more important, advantage is that an inflation linked annuity is illustrating the Estimated Retirement Income in real terms. This income may have to be paid for 20 or 30 years, easily long enough for historically low inflation to halve the real value of this income. High inflation of 10% could do this in a

little over seven years. If inflation is not accounted for then the Estimated Retirement Income is as potentially misleading as if the calculations during the accumulation phase ignored inflation.

We do agree that a single life annuity is more appropriate than an annuity with attaching spouse or partner benefits.

A single life annuity reflects a move away from the assumption that a household only has one earner while still allowing household to calculate a joint retirement income by combining two single life annuities. While there will still be situations where a joint life annuity is more appropriate it should be remembered that the purpose of your SMPI is to illustrate your sustainable Estimated Retirement Income, rather than to provide guidance on how you should take your pension benefits.

A simpler alternative would be to use a single annually reviewed income/withdrawal rate, e.g. 4%. It could be explained that this is broadly equivalent to a sustainable retirement income and this figure could change depending on personal circumstances and options chosen at retirement. It would be very clear that this figure is illustrative and not tailored to specific circumstances.

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 have not responded to this question.

12. What are your views on the proposed new mortality basis for determining the annuity rates where the illustration date is more than 2 years from the retirement date?

We have not responded to this question.

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

We agree that the Estimated Retirement Income should be shown annually.

We agree that SMPIs should only contain a single projection rather than including flanking projections.

We would appreciate confirmation that there will be no requirement to provide separate projections for each element of a policy/plan if each element has the same retirement age. For example, a single pension where one element has an age 55 Protected Pension Age and another element with a standard Normal Minimum Pension Age of 57 where the default or chosen retirement age is 65.

We strongly agree that the future is not written and that an illustration is only an illustration. We note that the scope of AS TM1 has not been widened to communicate this uncertainty due to legislative constraints.

We also have one minor additional comment on whether the income drawdown definition should refer to the proportion or the amount of the pension fund which is available for the drawing of income, rather than the income drawn from that fund.

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

- *The impact assessment has not quantified identified costs nor shown any benefit of using individually calculated volatility-based growth rates over asset—based growth rates*
- *The costs or benefits to pension scheme members has not been considered*

We disagree with the impact assessment as this has neither quantified the identified costs nor taken all aspects of the proposed changes into account. It has also failed to show any benefit of using individually calculated volatility-based growth rates instead of mandated asset-based growth rates. We are disappointed that the impact assessment did not consider any of the costs or benefits to pension scheme members, given that SMPs are there for the benefit of members.

There is an incorrect assumption that providers have the data to calculate volatility due to UCITS requirements. Providers will instead have the SRRRI calculated by the fund manager. They will not hold the historic data to calculate individual volatility.

The impact assessment has assumed that the only pension assets held are either unquoted or listed and has not included assets such as individual equities, bonds or derivatives. It has therefore not considered whether historic month end prices can be easily obtained for these assets. We strongly disagree that the ability to assume that unquoted assets have zero real growth eliminates extra costs for SIPP providers.

The cumulative industry cost of each provider undertaking individual annual volatility calculations on tens or, even hundreds, of thousands of assets has not been considered. As an example, Hargreaves Lansdown has over 19,000 different assets available for investment within the HL SIPP which are neither unquoted nor delisted. Other SIPP providers may have more. Many providers will be simultaneously undertaking this calculation on identical assets.

We agree that there is an offsetting in not having to decide on rates used or having to document the rationale, however this offsetting is negligible in comparison with the additional costs imposed. At a very basic level, the determination of asset classes is generally a one-off event unless the investment strategy of a particular fund changes. Volatility will need to be calculated every year for each asset held.

The only benefit listed is that the proposed changes will allow direct comparison between different pension plans. As this could be achieved by mandating asset-based growth rates there is no intrinsic benefit demonstrated for the proposal of using volatility-based growth rates.

We acknowledge that providers were warned to take account of the possibility of change when devising systems to produce statutory illustrations of SMPs. We'd be surprised if providers would have significant difficulties in changing assumed growth rates or the shape of the illustrated Estimated Retirement Income. Systems may also allow for the growth rate of each individual asset, rather than an asset class, to be annually updated. However, these systems and process are unlikely to have included the possibility of undertaking individual calculations on each investment to determine these growth rates. As such we strongly disagree that the cost of making these changes is insignificant.