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SMPIs and Pensions Dashboards

New rules for benefit projections

November 2022

On 7 October 2022 the Financial Reporting Council (FRC) announced changes to how benefit projections shown in Statutory Money Purchase Illustrations (SMPIs) must be calculated.

As a reminder, all defined contribution (DC) pension arrangements must provide an annual illustration of the benefits members might receive at retirement from their DC fund, including the DC AVC arrangements of defined benefit (DB) pension schemes. These illustrations are known as SMPIs.

The changes announced by the FRC standardise the investment return assumptions used for SMPIs and also how members' projected DC funds are assumed to be converted to income at retirement. This is to ensure consistency between illustrations from different providers and between different types of pension, a key requirement for the soon to be launched pensions dashboards.

Without these changes, there could have been considerable confusion if individuals were to compare different retirement income projections from different schemes or providers on a pensions dashboard. However, the complex and significant nature of the changes mean that for many schemes there will be implementation and member communication challenges.

When will the changes happen?

The changes will apply to all SMPIs issued on or after 1 October 2023 and, once the first new-style SMPI has been issued, to any estimated retirement income illustration shown on pensions dashboards.

Schemes will need to think carefully about when they issue their SMPI statements in 2023 otherwise work could end up being wasted. For example, a scheme with a statement date of, say, 31 March 2023, will need either to issue their statements by 30 September 2023 under the current rules or issue their statements after this date under the new rules – it is not possible to early adopt the new rules. If work commences based on the current rules but the 30 September 2023 deadline for issuing is missed, the SMPI production will need to be repeated based on the new rules.

How LCP can help: Although the changes are complex, the FRC has given sufficient time for the work to be carried out. But schemes (including any DB schemes with AVC arrangements) and providers will need to start work promptly, scheduling the sytem changes to ensure that they are ready to make available these projections from October 2023. We can help you plan and manage the project to achieve this.

Investment return assumptions

The most controversial of the FRC's changes is to set a DC fund's assumed investment return according to which of four volatility groups the fund is placed in, this in turn being determined according to the volatility of the fund's monthly returns over the past five years. This concept of past volatility being a guide to future performance came in for widespread criticism from LCP and the wider industry. Currently, there is some flexibility around the setting of the return assumptions, with returns normally being set as the expected future return on the fund's underlying assets.

The prescribed volatility groupings are as follows, with the greater the past volatility, the greater the assumed investment return:

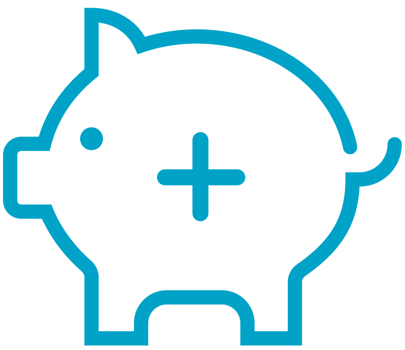
Volatility Group	Assumed investment return
1	1% pa
2	3% pa
3	5% pa
4	7% pa

The FRC has said that a Group 1 designation, a 1% pa return, is likely to be used for cash funds, whilst a Group 4 designation, a 7% pa return, is likely to be used for most equity funds.

However, our analysis shows that this volatility-based approach could lead to misleading return assumptions in some instances. For example, some gilt/bond-based funds may have the same assumed return as some equity/return-seeking type funds. There is a risk that members may make decisions on how to invest their DC funds based on such misleading assumptions, resulting in poor member decisions being made. This is even more of a concern where the SMPI investment return assumptions are also used in an online modeller, as is often the case.

Furthermore, the volatility analysis and calculations required to categorise funds into one of the four volatility groups are not necessarily straightforward. In particular, special consideration will be needed for more complex types of fund, such as with-profits funds and funds holding less liquid assets, and funds without a five-year track record.

How LCP can help: We can help you categorise your scheme's funds into the four volatility groups, taking a proportionate, but compliant, approach. When the new rules are in place, there will then be an annual requirement to review the assumptions. Again, we can assist with this.



Conversion of the projected DC fund to retirement income

The FRC has determined that a member's projected DC fund should be converted into an estimated retirement income by assuming the purchase of a single life non-escalating annuity. The FRC has decided to pursue this approach despite concerns expressed by the pensions industry, due to the fact that few DC members currently purchase annuities with their DC funds at retirement.

Currently schemes have the flexibility to illustrate a single or joint life annuity which can be either escalating or non-escalating.

None of the projected fund at retirement will be assumed to be taken as tax-free cash, so all the projected fund is assumed to be annuitised. Again, this does not reflect actual member behaviour, with members typically taking 25% of their fund as tax-free cash.

How LCP can help: We can liaise with scheme administrators and providers on the actions they need to take to ensure that the calculations are carried out following the correct methodology.

The above changes will also mean that members are likely to receive projections significantly different to those they received previously. Given this we can help you consider the communications you should provide to members and we can draft appropriate materials as required.

The overall impact of the FRC's proposals is that retirement income illustrations are likely to be misleading. This is because of:

- the volatility grouping approach being likely to lead to misleading investment return assumptions in some instances;
- the retirement income illustration being based on an annuitisation assumption which does not mirror what members typically choose at retirement; and
- the erroneous assumption that members will not take any tax-free cash at retirement.

How LCP can help: We expect many schemes will wish to also provide alternative, more realistic, projections to their members. We can help you consider whether alternative projections should be provided and the format of these projections, based on your scheme and members' circumstances.

Want to find out more?

If you would like further information, please contact your usual LCP adviser or one of our experts below.

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