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Elston Insights

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Understanding SMPI rates

- Refreshed rates were overdue
- Linkage to volatility is welcome
- Robust assumptions for cashflow modelling

What are SMPI rates and how are they used?

Pension providers use Statutory Money Purchase Illustration (SMPI) rates to illustrate the potential return on a pension portfolio. Mandated by the Financial Conduct Authority (FCA), the methodology behind SMPI is overseen by the Financial Reporting Council (FRC). While the rates theoretically derive from capital market assumptions, after extensive consultation in 2023, the FRC evolved the approach. The key changes are 1) there are now four growth rates defined, rather than three, and 2) the growth rates are linked to volatility.

What are the implications for advisers?

Financial advisers have to use an assumed growth rate when undertaking any kind of cash-flow planning. Whilst financial advisers are not obliged to use the same rates as a pension provider, we consider it good practice to use them in cashflow modelling assumptions so that growth rates are 1) reasonable, 2) consistent with regulatory guidance for pension providers and 3) evidence-based.

Whilst growth rate assumptions are never certain and assumptions are open to challenge, the fact that there are now volatility bands for each SMPI rate means advisers can apply rates that map to an asset allocation framework, thereby de-risking their growth rate assumptions by relying on the FRC approach.

SMPI rate history

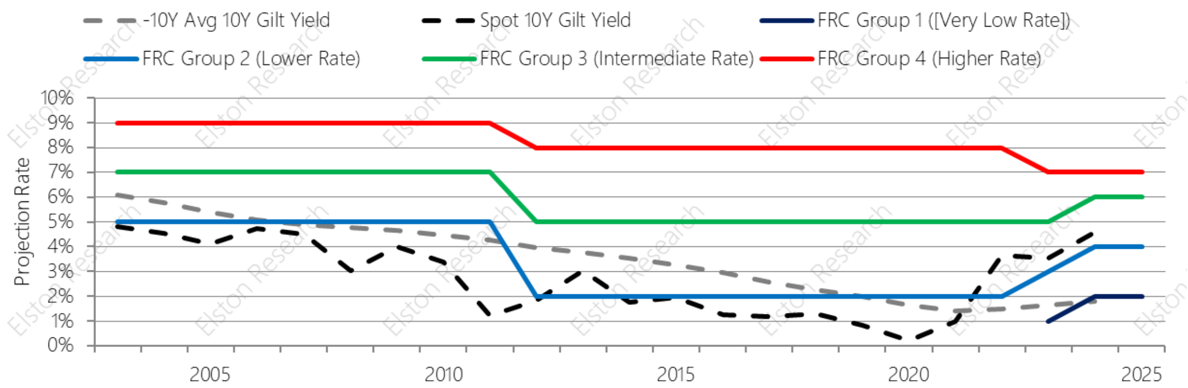
The history of the SMPI rates is summarised below:

	2003-12	2012-22	From Oct-23	From Apr-24
Group 1	n.a.	n.a.	1%	2%
Group 2 (Lower Rate)	5%	2%	4%	4%
Group 3 (Intermediate Rate)	7%	5%	5%	6%
Group 4 (Higher Rate)	9%	8%	7%	7%

Note: returns are nominal gross. Source: Elston summary, FCA and FRS data

Since April 2024, the SMPI rates are 2%, 4%, 6% and 7% for volatility Groups 1,2,3 and 4 respectively. This was a change from 1%, 4%, 5% and 7% from October 2023. For the decade prior to then, the SMPI rates were 2%, 5%, and 8% for the Lower, Intermediate and Higher Rate.

The evolution of regulatory SMPI is summarised in the chart below. As the methodology considers capital market returns and risk premia, the reduction in rates was linked to compressed yield following the financial crisis (plotted with spot gilt yields and rolling 10-year gilt yields for reference).



Source: Elston research, FCA data, FRC data, Bloomberg data

What is the methodology to setting the rates

A huge amount of asset class performance analysis around long-run gilts returns and risk premia was conducted by PWC in March 2012 to assist the FCA and the FRC in their review of statutory projection rates. From 2003 to 2012, these rates were 5%, 7% and 9% for the lower, intermediate and higher growth rates. Broadly speaking this inherently represented a "risk free" bond portfolio of 5%, an all-equity portfolio of 9% (assuming 4% equity risk premium), and a balanced multi-asset portfolio in the middle of 7%. The PWC study of 2012 (when gilt yields were suppressed following the financial crisis) supported the FCA decision to reduce the rates to 2%, 5% and 8%.

What does the new methodology look like and how has it been calculated?

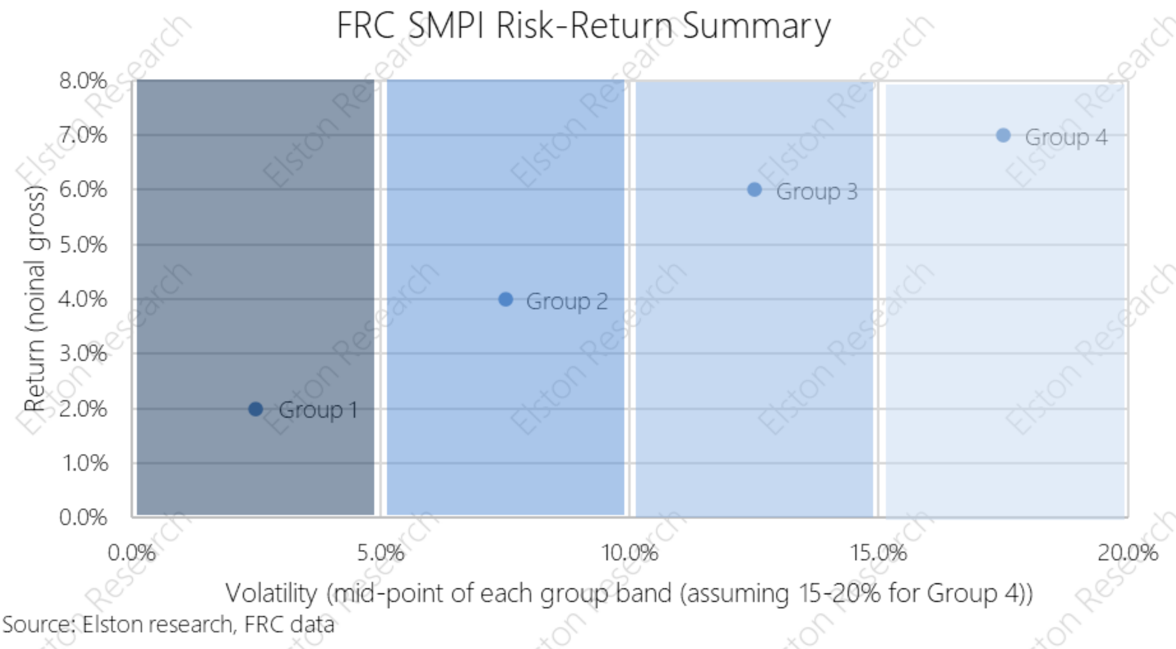
In addition to creating a new low fourth rate, and tweaking the other rates, the SMPI rates are now also been defined by 5-year volatility bands (across 4 bands), which is a similar (and more pragmatic) methodology to ESMA SRRI definitions (7 bands). Both the FRC and ESMA methodologies face the challenge of using static volatility bands (when volatility is itself dynamic), but introducing the linkage between risk and return is good progress and consistent with theory and practice. The volatility bands used by the FRC to create the groups are summarised below:

	Volatility Band
Group 1	Greater than 0, less than 5%

Group 2 (formerly Lower Rate)	Greater than 5%, less than 10%
Group 3 (formerly Intermediate Rate)	Greater than 10%, less than 15%
Group 4 (formerly Higher Rate)	Greater than 15%

Based on the FRC's technical analysis[1] (looking at the median volatility of 1,075 pension funds over rolling 5-year periods), Group 1 volatility (0-5%) would capture money market funds, Group 2 volatility would capture bond funds, Group 3 would capture multi-asset funds, and Group 4 would capture equity funds (based on an analysis of pension funds).

By looking at the mid-point of those volatility bands, it is now possible to link SMPI returns with volatility assumptions to create a traditional capital markets framework. The SMPI risk-return is summarised below.



What could FRC do to improve the methodology?

1) Use index, not fund data

The current volatility bands are based on pension fund performance aggregates for different asset classes. This requires data aggregation and inherently captures how those funds are managed, not just their asset classes. We think a potential improvement would be to use index data for each asset class and derive SMPI rates that are expressly linked to asset allocations, rather than samples

[1] https://media.frc.org.uk/documents/AS_TM1_-_Accumulation_Rate_Assumptions.pdf

of funds. This would enable consultants and scheme providers to model the SMPI rate of different asset allocation strategies and be a more useful assumption for cashflow modelling tools.

2) Relative, not absolute, volatility bands

The other drawback, in our view, is using absolute volatility bands. Because market volatility is itself volatile, a "balanced" 60/40 mandate could be >10% for one 5-year period and <10% for another 5-year period. The risk classification of KIID documentation has the same problem.

We think "relative risk" is more useful. This is where a portfolio can be defined as having x% of Global Equity volatility. Relative risk is relatively stable as it captures fluctuations in the level of volatility over any 5-year period. By contrast absolute risk cannot.

Conclusion

Growth rates in pensions illustrations are highly governed by the FCA and FRC.

By contrast there are no constraints on what financial advisers use as illustration rates in cashflow models.

We think it prudent that advisers use the FRC growth rates in their cashflow planning tools.

Henry Cobbe, CFA

Head of Research, Elston Consulting

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