To: All Scheme Actuaries

27 October, 2000

Dear Scheme Actuary

REVIEW OF THE MINIMUM FUNDING REQUIREMENT (MFR)
INTERIM CHANGES

The May 2000 report of the Pensions Board to the Government in relation to the MFR review sets out, at Section 5.1, three 'interim' changes which the profession has recommended should be made to the current MFR test, in advance of any longer term changes that may be introduced by the Government. In seeking views on the Pensions Board report, the Government has indicated that it is considering whether to put in place these interim changes and over the next two months the Pensions Board will be seeking your views on the merits of making these changes.

Section 5.1.3 of the Pensions Board report sets out the change recommended in relation to the Equity Market Value Adjustment. The purpose of this letter is to set out further detail in relation to the other two interim changes described in sections 5.1.1 and 5.1.2 of the Pensions Board report (mortality assumptions and pension increases respectively). It is hoped that this will be helpful to scheme actuaries in assessing the possible impact of these interim changes on the schemes which they advise, thereby informing responses to the Government's consultation on the MFR, comments upon which are sought by 31 January 2001. This information should also assist discussion at the forthcoming discussion and consultation meetings being arranged by the profession in relation to the MFR review.

Mortality assumptions (section 5.1.1)

Paragraph D.1 of Appendix 2 to GN27 specifies that the standard mortality table PA90 rated down two years must generally be used for MFR purposes. Our costing of the interim changes put forward to the DSS was based on reducing this rating by a further two years. However, the Pensions Board is currently considering whether it should recommend that this table should be replaced by the standard table PMA92/PFA92 (C = 2001) – that is, based on the mortality rates applicable to calendar year 2001 according to the PMA92/PFA92 table. Again, your view will be welcome. The scheme actuary will be able to continue to use scheme - specific mortality for large schemes (paragraph D.2, GN27 Appendix 2).

Pension increases (section 5.1.2)

Pensioner liabilities

The Pensions Board proposes that paragraph A of Appendix 2 to GN27 should be replaced by revised guidance along the lines of that set out in the Appendix to this letter. Further explanation will be placed on the profession's website. It should be noted that the attached wording may be subject to some refinement before being formally exposed to the profession as draft guidance under Due Process.

It is proposed that the approach set out in the Appendix would apply irrespective of whether the 'equity easement' applies to the assessment of pensioner liabilities (see paragraph 3.14 of GN27).

Non-pensioner liabilities

Again, our initial proposed changes were limited to the assessment of pensioner liabilities. However, in assessing non-pensioner liabilities, on the basis of the long-term assumptions set out in paragraph B.1, Appendix 2 of GN27, the Pensions Board is currently considering recommending that the pension increase assumptions should be derived as set out in the Appendix to this letter, but using the long-term assumptions set out in paragraph B.1, notably the long-term assumption as to forward inflation of 4% per annum. This will have an effect on schemes with certain types of pension increase.

This may be illustrated in relation to two particular patterns of pension increases which may result in this change impacting on the assessment of non-pensioner liabilities for some schemes as compared with the current MFR:

(a) *pension increase assumption in relation to post 1988 GMPs*: this is currently specified in paragraph B.1 to be 2.75% per annum. This assumption will change to 2.5% per annum, in line with the entry in the attached table under '3% pa cap and zero floor' where forward inflation is 4% per annum; and

(b) *pension increase assumption in relation to pensions which receive guaranteed increases in line with the RPI, subject to a floor of 3% per annum and a cap of 5% per annum*: although not specified explicitly in paragraph A of Appendix 2 of GN27, the pension increase assumption typically used in this situation would be 3.75% per annum. This assumption will change to 4% per annum, in line with the entry in the attached table under '5% pa cap and 3% pa floor' where forward inflation is 4% per annum.

<u>Exposure Draft</u>

In due course, any changes will be formally exposed to the profession through an Exposure Draft on changes to GN27. The DSS/HM Treasury consultation document has indicated that any changes are unlikely to come into effect before the end of 2001.

I hope that this information will be helpful to you.

Yours sincerely,

Peter Tompkins
Chairman, Pensions Board
Faculty and Institute of Actuaries

Encl: Appendix

APPENDIX

Proposed revised approach for GN27, Appendix 2, Paragraph A

Pensioner liabilities must be valued using a discount rate equal to the annualised gross redemption yield on the FTSE Actuaries Government Securities 15 year Yield Index.

The pension increase assumption to be adopted, in cases where the guaranteed increase is dependent on the level of inflation, must be derived using a methodology that takes explicit account of any cap and/or floor to the guaranteed level of pension increase.

The methodology adopted must produce assumed levels of pension increase in line with the following table:

Pension Increase Assumption				
Forward inflation	**3% pa cap and zero floor**	**5% pa cap and zero floor**	**5% pa cap and 3% pa floor**	**No cap and zero floor**
0.0%	0.8%	0.9%	3.1%	0.9%
0.5%	1.0%	1.2%	3.1%	1.2%
1.0%	1.3%	1.5%	3.2%	1.5%
1.5%	1.5%	1.8%	3.3%	1.9%
2.0%	1.7%	2.1%	3.4%	2.3%
2.5%	2.0%	2.5%	3.5%	2.7%
3.0%	2.2%	2.8%	3.7%	3.1%
3.5%	2.4%	3.2%	3.8%	3.6%
4.0%	2.5%	3.5%	4.0%	4.0%

where forward inflation must be derived from the annualised gross redemption yields on the FTSE Actuaries Government Securities 15 year Yield Index, the annualised real redemption yields on the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (0% inflation) Index and the FTSE Actuaries Government Securities Index-linked Real yield Over 5 years (5% inflation) Index. Forward inflation must be calculated as *forward rpi* defined by the following two equations:

forward rpi = [(1 + *gross yield*)/(1 + *real yield*) – 1]

(forward rpi)/0.05 = ((real yield 0% inflation) – (real yield)) / ((real yield 0% inflation) – (real yield 5% inflation))

where

gross yield = the annualised gross redemption yield on the FTSE Actuaries Government Securities 15 year Yield Index

real yield 0% inflation = the annualised real redemption yield on the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (0% inflation) Index

real yield 5% inflation = the annualised real redemption yield on the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (5% inflation) Index

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