



Institute  
and Faculty  
of Actuaries

# Pensions Conference 2015

24 – 26 June

Hilton Hotel, Glasgow





Institute  
and Faculty  
of Actuaries

# Update on research by the IFoA Pensions General Working Party

Speakers: Hilary Salt & Richard Gibson

25 June 2015

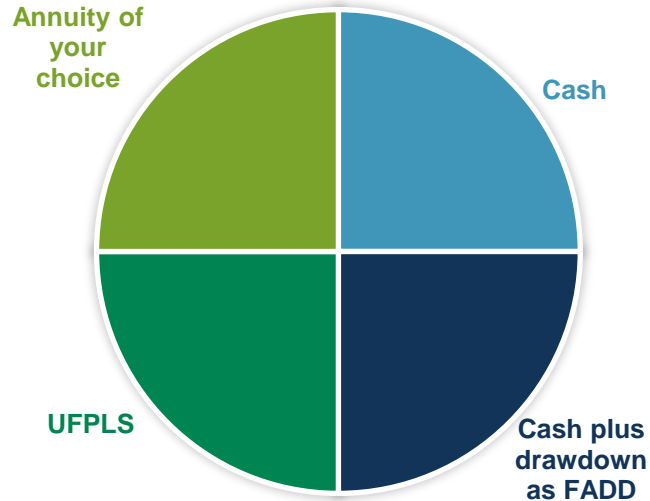
# Introduction

- The Pensions General Working Party
- Open to new members.... and to accrual of further work!
- Recent and Current work:
  - Idiosyncratic mortality risk
  - The effect of DC flexibilities on DB scheme
  - Explaining longevity in the individual drawdown market
  - Treatment of Inflation in UK pensions

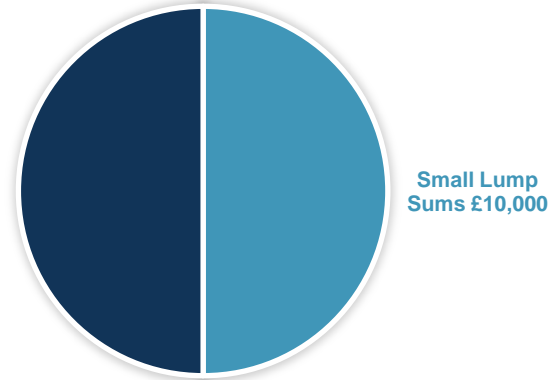


# Effect of DC Flexibilities on DB Schemes

DC: Definitely Changing!



Trivial  
Commutation  
£30,000



Institute  
and Faculty  
of Actuaries

# Immediate Effects on DB Schemes

- Trivial commutation and small lump sum exercises:
  - For existing pensioners and deferreds above 55
  - Debate on whether the incentive code applies
- Transfer values
  - Significant increase in transfer value requests
  - Increase in transfer value requests at, near or after normal retirement age
- Does it matter? Need to consider:
  - Consistency of factors
  - Appropriateness of CETVs at retirement age



# Background to different factors

## Transfer Values

- Best estimate cost of providing benefits in the scheme
- No allowance for options which reduce value of benefits
- Trustees must consider discretionary benefits
- Can reduce TVs (overall) with insufficiency report

## Trivial Commutation Factors

- No regulatory control
- Trust Deed and Rules may cover
- “Normal” commutation plus partner or best estimate approach

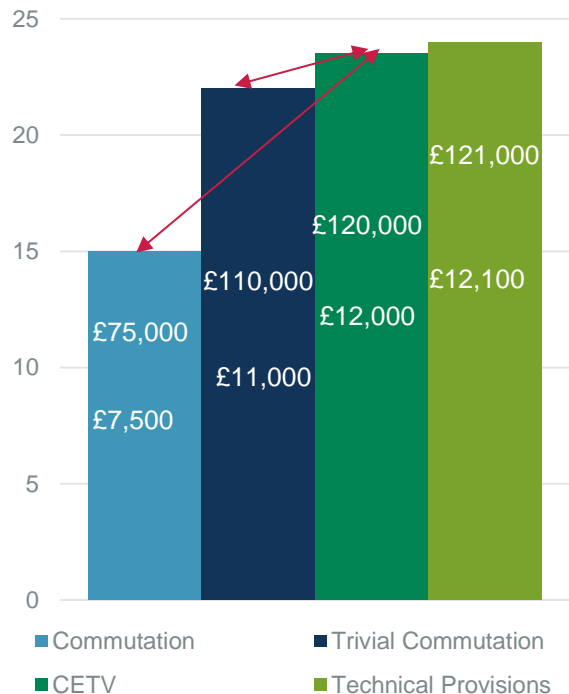
## “Normal” Commutation Factors

- No regulatory control
- Trust Deed and Rules may cover
- Often significantly below best estimate
- 2006 Member options working party and letter to scheme actuaries



Institute  
and Faculty  
of Actuaries

# Comparison between factors



- Higher figures are for £5,000pa pension, lower figures for £500 pa pension
- This example scheme uses a single commutation factor at all ages – so effects pronounced at young ages
- Gap between trivial commutation amount and CETV – member can have more cash if they transfer somewhere else first
- Gap between commutation and CETV may well appear unfair to members (although disguised by maximum cash calculation)
- Partial transfer to take maximum cash can be better than taking cash from the scheme
- Note also closeness of CETV and TP levels – especially likely with low commutation factors are allowed for in TPs



# Cash Alternatives

## Single vehicle

- In scheme:
  - Commute £1,538 for maximum tax-free cash **£23,077**
  - Remaining pension: **£3,462pa**
- Transfer all to DC vehicle:
  - CETV: £120,000
  - Tax-free cash **£30,000**
  - **Drawdown from £90,000**

# How tax free is tax-free cash?

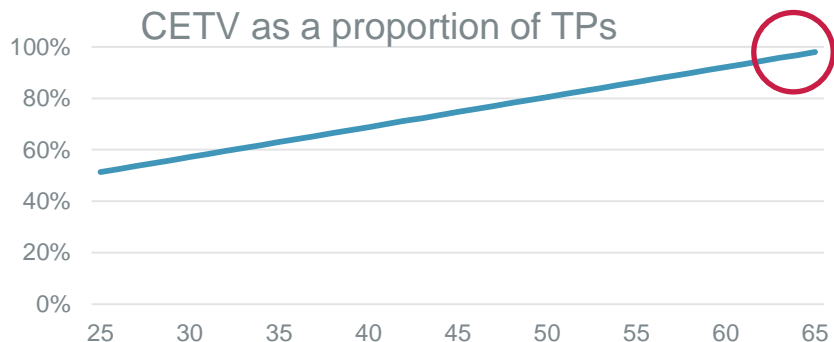
## Partial Transfer

- Transfer £1,538 of pension
- CETV = £1,538 x 24 = £36,912
- Take one quarter as tax free cash: £9,228
- Take remainder of £27,684 taxed:
  - At 20% = £22,147 + £9,228 = **£31,375**
  - At 40% = £16,610 + £9,228 = £25,838
  - Residual pension in scheme **£3,462pa**
  - Partner's pension lost on £1,538pa





# CETVs very close to TPs at retirement?



- Dual discount rates so TPs and CETVs bond based post retirement
- Small gap in allowance for mortality improvement
- Advance allowance in TPs for commutation

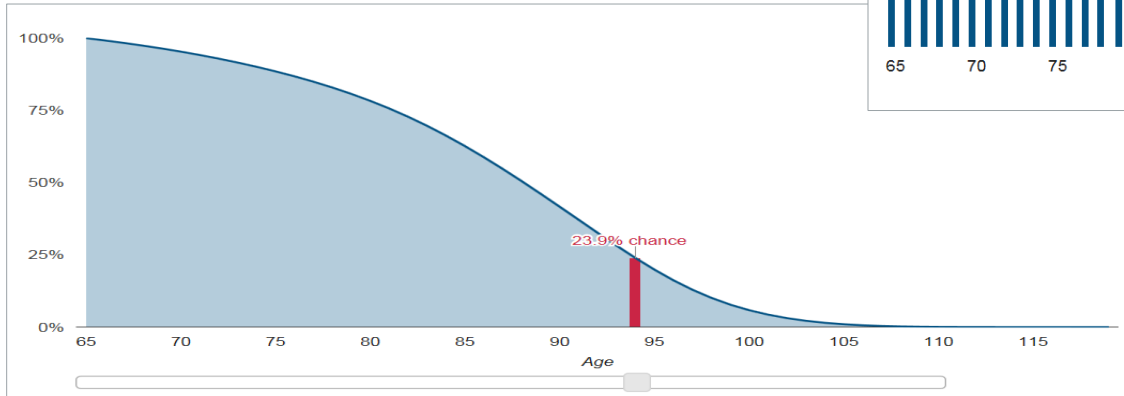
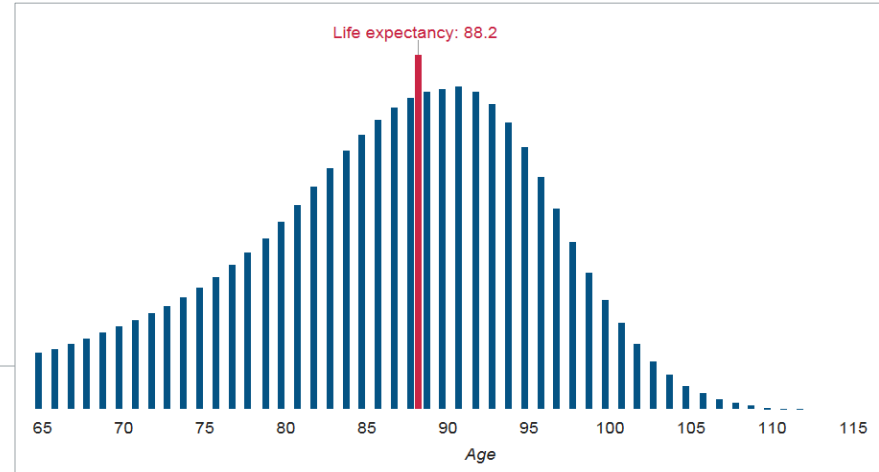
- Concern for trustees if large numbers of transfers take place
- Selection against the scheme – increased or decreased?
- Underwrite transfer values?
- Insufficiency report is across all members
- Protecting members from themselves?



Institute  
and Faculty  
of Actuaries

# Helping Members Understand DIY Annuitisation

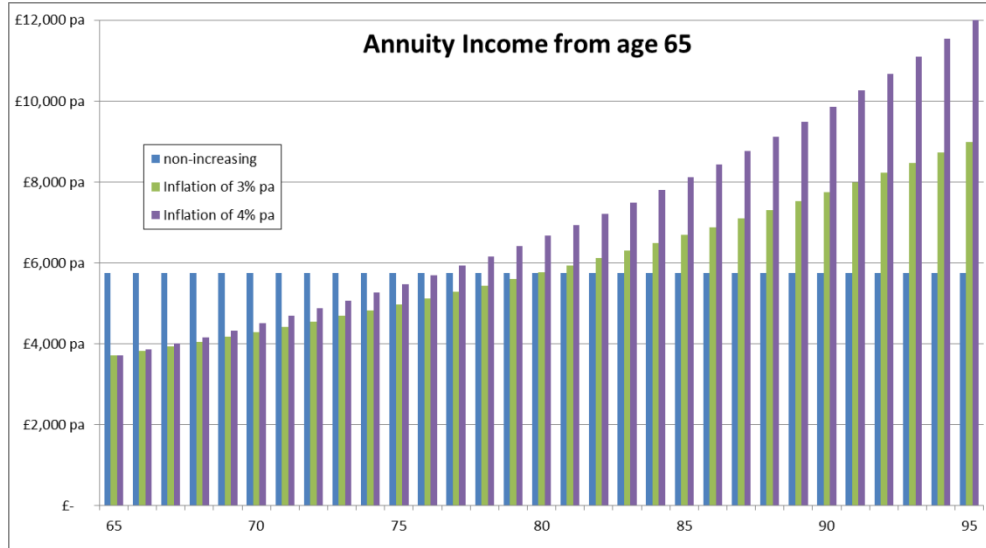
- Life expectancy – not mortality or longevity
- You – not your parents or grandparents
- Population life expectancy?
- How many known factors to allow for?



Institute  
and Faculty  
of Actuaries

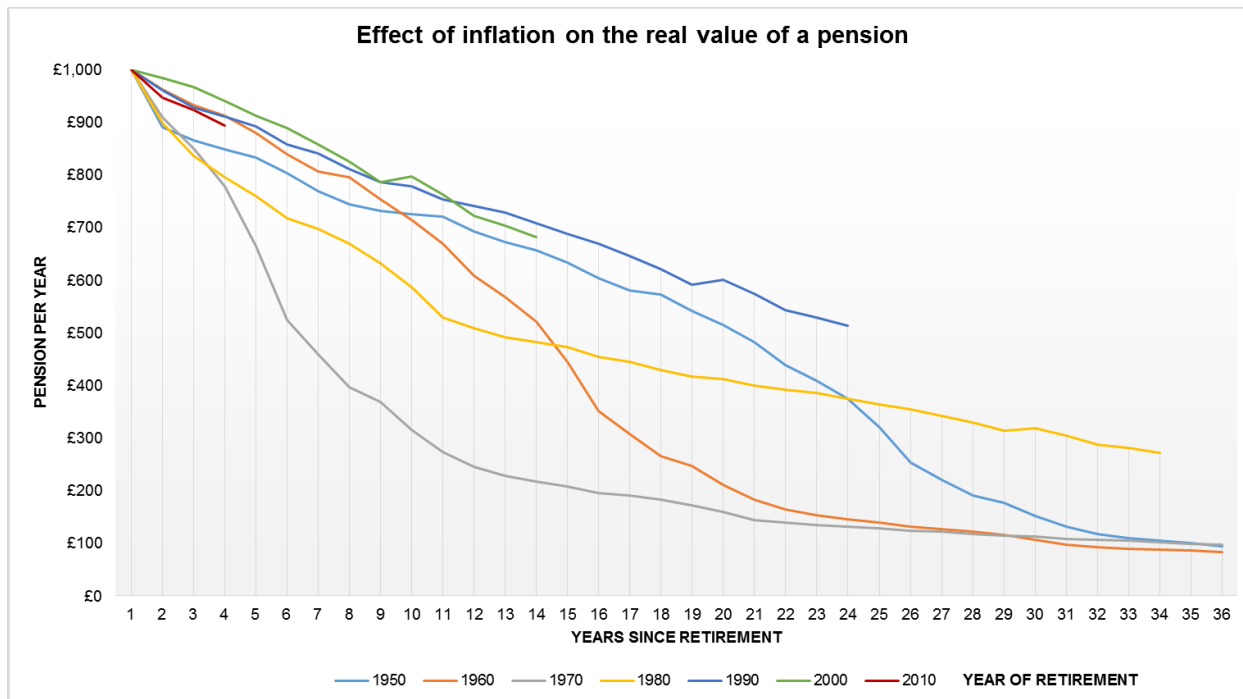
# How long to pay for inflation protection?

- Annuity bought for £100,000 for a male aged 65 on 1 June 2015
  - £5,749 pa non-increasing
  - £3,699 pa RPI-linked



	Crossover point	Breakeven point
Inflation of 2% pa	88	>100
Inflation of 3% pa	80	93
Inflation of 4% pa	77	86

# The effect of caps and floors

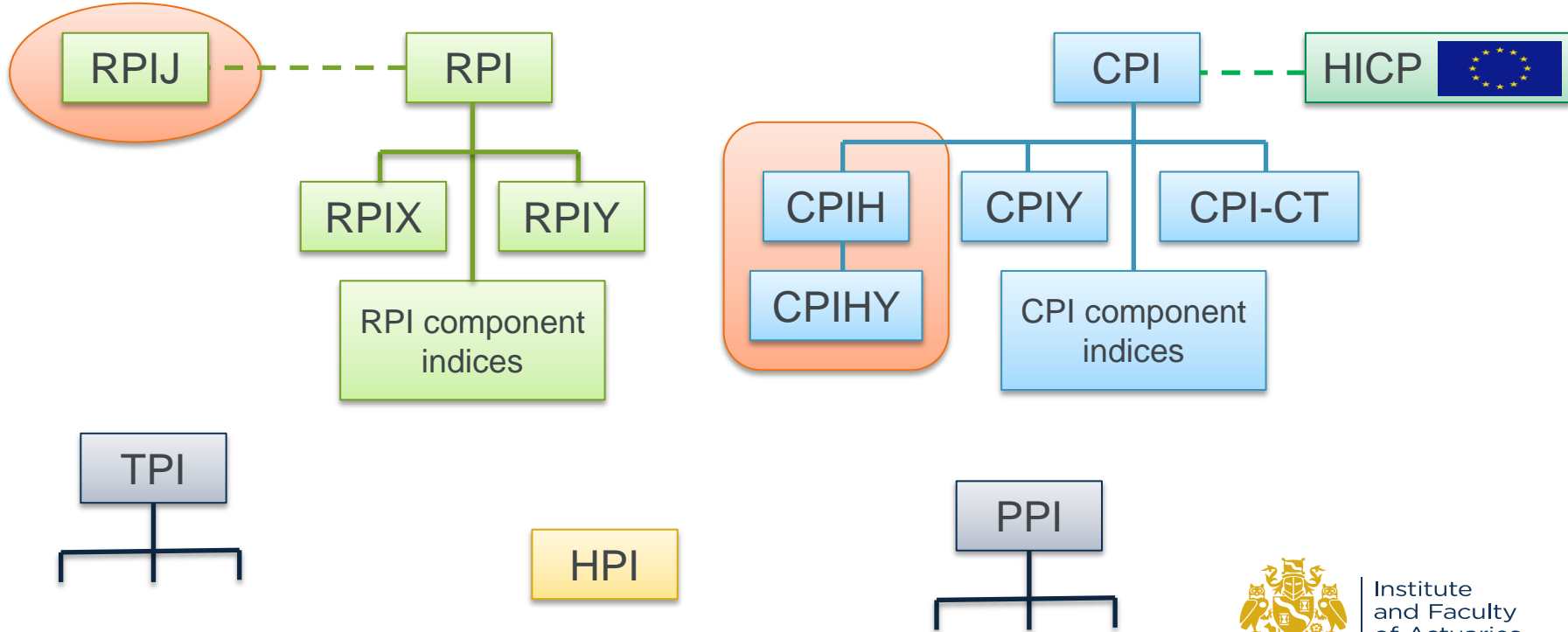


- Inflation erodes benefit differently over differing time periods
- Impact of correlation between years (periods of high/low inflation) is significant
- Outcomes for members are actually more volatile with LPI(0,5) than if no indexation had been granted



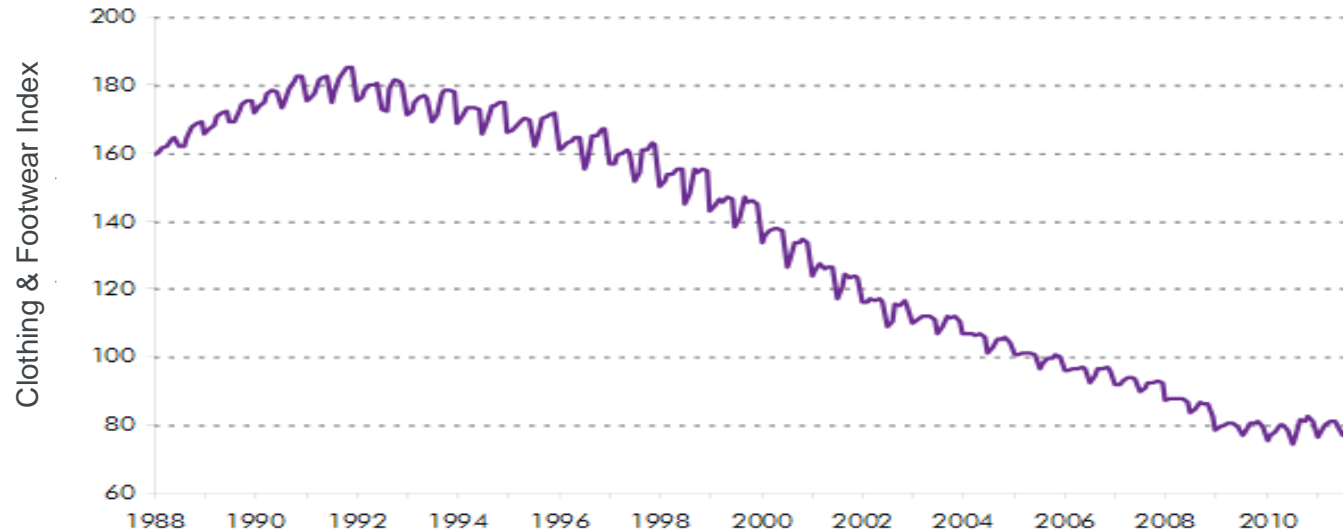
Institute  
and Faculty  
of Actuaries

# The Inflation Family



# The clothing & footwear mistake

- Clothing & footwear prices in decline until corrected in 2010
  - Data previously terminated when out of stock
  - Small changes counted as new items



Source: ONS



Institute  
and Faculty  
of Actuaries

# The RPI-CPI Wedge - Breakdown

	OBR 2011 estimate	BoE central long-term estimate	OBR 2015 estimate
<i>Council tax</i>	0.10		0.10
Housing			
<i>MIPs</i>	0.15	-	0.15
<i>Council tax</i>	0.10		0.10
<i>Other (incl. depreciation)</i>	0.25	0.60	0.25
Other coverage	-		

Direct wealth tax  
excluded from HICP

Scales

Eurostat aim to  
alter coverage  
of housing after  
2018

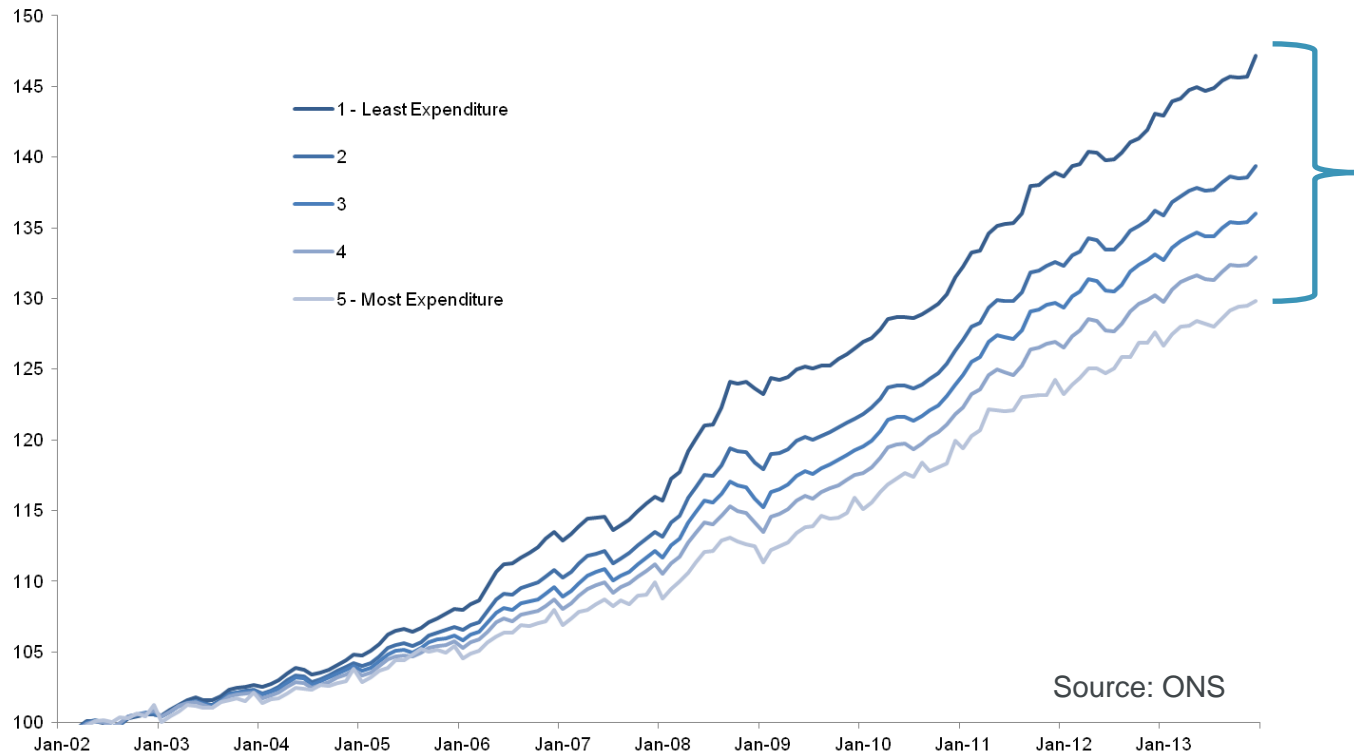
- It is generally assumed that only the formula effect will persist
  - CPI coverage of housing may change in a few years but not necessarily in a way consistent with RPI
  - Council tax distinction likely to persist



Institute  
and Faculty  
of Actuaries

# Inflation reflects household costs

Index 2002=100



Differences between income groups more important than any RPI/CPI distinction



Institute  
and Faculty  
of Actuaries



# Pricing an inflation assumption

- Various common methods for pricing an inflationary assumption:

- 1) Direct mark-to-market

- e.g. based on bonds or swaps

- 2) Constituent Method

- RPI-CPI gap

- 3) Modelling based on long-term distributional assumptions

- e.g. Black-Scholes caplets using assumed volatility

- 4) Modelling based on market-derived volatility surface



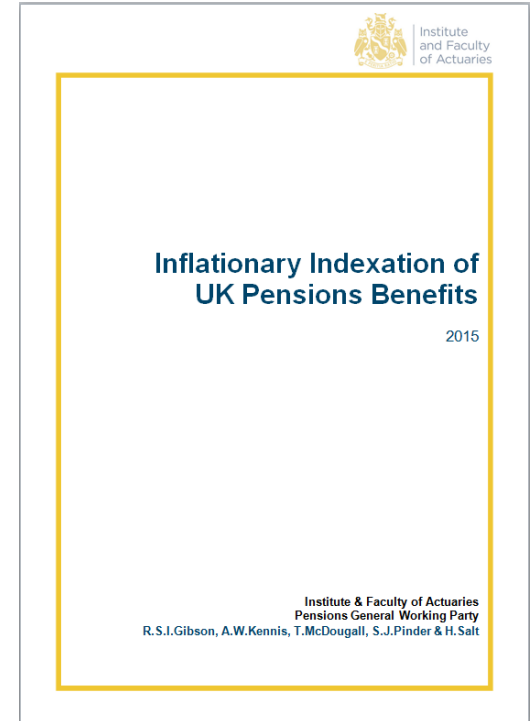
# The future for inflation

- Johnson Review 2015
  - Recommended CPIH be adopted as the general measure of inflation
    - Stronger governance measures
  - RPI to be supported only as a legacy index
    - Would require CPIH-linked debt to be issued
  - Publish a Cost of Living Index
  - Many other technical changes
- UKSA Consultation...



# Pensions General Working Party

- Richard Gibson – Barnett Waddingham LLP
- Alistair Kennis – Aon Hewitt Limited
- Tom McDougall – Scottish Widows plc
- Scott Pinder – Towers Watson Limited
- Hilary Salt – First Actuarial LLP



Institute  
and Faculty  
of Actuaries

# Questions

# Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



Institute  
and Faculty  
of Actuaries