The Actuarial Profession
making financial sense of the future

Consultation Response
Financial Services Authority

Pension Transfer Value Analysis Assumptions

27 March 12

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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27 March 2012

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Dear Sandra

FSA Consultation Paper CP12/4: Pension Transfer Value Analysis Assumptions

Please find below the response from the Institute and Faculty of Actuaries to this consultation on Pension Transfer Value Analysis Assumptions. We welcome the FSA's decision to consult on changes to guidance on pension transfer value assumptions as set out in COBS19.1. We are supportive of many of the proposals and the general desire to revisit assumptions in the area, but in some places we believe the changes could go further. Below we respond to the specific points raised in the consultation.

1) **Do you agree with the revised mortality basis? If not, please explain what alternative basis you think is more appropriate and why you consider that alternative basis would be more appropriate.**

   Yes, given the research already undertaken by the Board for Actuarial Standards in revising TM1, we would view the revised mortality basis as appropriate for this purpose at the current time. It will be appropriate to keep the mortality assumption under review to ensure it does not become out-of-date over time.

2) **Do you agree with our proposals for CPI-linked revaluation in deferment? If not please describe the approach you believe should be taken and why you believe it would be more suitable.**

   We support the proposal to introduce a revaluation rate in deferment based on CPI in COBS 19.1 and agree that this is easy to achieve from a practical perspective (by inserting a new assumption into COBS 19.1.4(1) and clarifying that the existing LPI assumption should be used for increases linked to RPI). However, in our view the consultation paper does not give a compelling reason for delaying consideration of a revaluation rate for CPI in deferment. We consider that the transfer analysis required under COBS 19.1 should seek to replicate scheme benefits as closely as is practical, and in areas of doubt err on the side of prudence. It will be a matter of fact in each case as to the basis of revaluation in deferment, and therefore we believe that the assumptions should explicitly allow for CPI revaluation in deferment at a different rate to RPI revaluation where that is the scheme benefit. Given that this assumption will be set out explicitly in COBS 19.1, we do not believe that this change needs to wait for a further consultation.

   There is no comment in the consultation document on an appropriate approach for determining the appropriate CPI assumption. We do note, however, the difference between the RPI and CPI assumptions is expected to be significant, further reinforcing the need to make the change now rather than delay the decision. In particular, when CPI indexation for pensions was proposed by the Department for Work and Pensions its own impact assessment used an assumption of 0.87% p.a. for the long run average difference between RPI and CPI.

For completeness, we would like to state that in our opinion the arguments put forward against differentiating between RPI and CPI increases in payment do not apply to revaluation in deferment.

3) Do you agree with our proposals for CPI-linked pension increases? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

We agree that COBS 19.1 should be revised to include explicit instructions for the correct approach to take for CPI-linked pension increases. Without explicit rules for CPI-linked pension increases, regulated firms may adopt different approaches.

The proposed approach is to ignore the difference between CPI inflation and RPI inflation, by treating CPI-linked pension as if it receives RPI-linked pension increases. This is despite the fact that it is recognised that there should be a different assumption for the rate of revaluation in deferment based on CPI.

We can understand how the FSA settled on this proposed approach: it is simple to apply and it broadly reflects the current market for annuities. Therefore it is particularly appropriate for individuals who are expected to purchase annuities in the very near future.

However, we do not believe that the alternative arguments are fully explored. Whilst it is true that CPI-linked annuities are not currently available in the market, it may be expected that such annuities will be available in the future. In carrying out the transfer analysis the annuity assumption should reflect expected future annuity pricing, and not be constrained by current annuity prices. We understand that some bulk annuity providers are already providing marginally lower prices for CPI-linked increases compared to RPI-linked increases (although this is not universal). This may increase in the years ahead and may also extend to the individual annuity market. If this is expected then it would be reasonable to reflect this difference in the transfer analysis calculations under COBS 19.1. We do, however, recognise the practical difficulties this would entail – potentially the same assumption for RPI-linked and CPI-linked increases for individuals very close to their expected annuity purchase and different assumptions for individuals where this is expected to be many years into the future.

Having presented some alternative arguments we believe the decision is a balance between:

- A more complex approach whereby the assumption for CPI-increases is linked to the term until the individual is expected to purchase an annuity. Even if this is accepted as the theoretically correct position, it may be deemed too complex for COBS 19.1
- An easier solution whereby the same assumption is used for CPI-linked increases and RPI-linked increases. This is supported by the current annuity market and is simple to adopt.

If your proposal is adopted then we recognise that it is important that this assumption is kept under review and is amended if the annuity market changes.

4) Do you agree with our approach to LPI pension increases? If not, please explain how your alternative solution would operate from a practical perspective.

We agree that there is a need for guidance on the approach to be adopted for LPI pension increases and we are aware from our members that different approaches are being applied in practice. However, we do not believe that the simple approach proposed is an appropriate solution for all types of LPI pension increases which are subject to different minimum and maximum increases each year.

In our response below we use the shorthand LRPI (x%, y%) to refer to a pension increase in payment linked to RPI, subject to a minimum annual increase of x% and a maximum annual increase of y%.

One of the most common types of pension increases is LRPI (0%, 5%). This type of LPI increase is slightly less valuable than an RPI increase. However, we understand that the difference in current bulk annuities markets is relatively small. Given the small difference we believe it can be appropriate, at the current time, to use an approach where the LRPI (0%, 5%) assumption is set to be the same as the RPI assumption. This is approach a) in your consultation document.

We do not, however, believe that this approach is appropriate for other types of LPI pension increase, as the following examples show:

- Consider an LRPI (0%, 2.5%) increase (this is relatively common as it became the statutory minimum pension increase in 2005). Under the proposed approach this type of pension increase would be valued using an annuity rate which is around 15% higher (based on figures in the FSA consultation document) than a pension that increases at a fixed 2.5% p.a. Clearly a pension with a fixed 2.5% p.a. increase is more, not less, valuable than an LRPI (0%, 2.5%) annuity.
- Consider an LRPI (3%, 5%) increase (again, this is a relatively common increase). Under the proposed approach this would be valued in the same way as a LRPI (0%, 5%) increase, even though it is clearly more valuable. This means that the proposed approach **does not** potentially overstate the value of benefits in this scenario. The consultation document stated that one of the reasons for the simple approach was that it was a cautious one from an individual's perspective. As this example shows this is not always the case.

We believe that these two examples show that the proposed approach is not appropriate. In devising a more appropriate solution there is a balance between getting the valuation and actuarial principles more precise and the simplicity of use. Given this balance we suggest three possible options below:

1) Simple alternative which uses the fixed maximum

Under this approach the firm can either value the LRPI increase as an RPI pension or they can value the pension as a fixed pension using the maximum cap (so value the pension as a fixed 2.5% p.a. pension using the first example above). This would remove the anomalies around LPI pensions with relatively low caps, but does nothing to address the potential undervaluation of benefits in the second example above (due to the relatively high collar). We consider this to be the absolute minimum position that could be taken, but we still do not believe it is a good approach because in some circumstances it will undervalue benefits (which is counter to the FSA's general approach in the consultation of overstating benefits in certain areas taking the more cautious approach).

2) Example assumptions with a requirement of consistency

We agree with the consultation document that there are a vast number of combinations of possible LPI pension increases and it will not be appropriate for the FSA to define an LPI assumption for each possible combination. However, the consultation document does not explore the advantage for defining assumptions for a small subset of the possible combinations. Instead the consultation document only considers a single solution for all LPI assumptions. We believe that this leads to a large gap in the consultation process.

In practice there are typical LPI pension increases that are common across many pension schemes. Therefore if a small range of LPI assumptions were specified this would cover a large proportion of the pension increases granted in practice. We believe that it would be appropriate to state approaches for the following types of increase and then require the firm to make a reasonably consistent assumption for increases that are not listed:

- LRPI (0%, 5%)
- LRPI (0%, 3%)
- LRPI (0%, 2.5%)
- LRPI (3%, 5%)

The Actuarial Profession would be happy to work with the FSA to define assumptions for the above types of pension increases which are consistent with the other assumptions and principles of COBS 19.1. We believe that this approach is much more appropriate than the FSA's proposed approach or our alternative solution 1). Taking this approach would also be easy for firms to implement in practice.

We also note that this approach was taken by the FSA for Pension Review (as set out in Pension Review Bulletin 5, published in August 1999 http://www.fsa.gov.uk/pubs/pensions/PRB05.pdf).

3) Black-Scholes approach

A commonly used approach to derive a specific LPI assumption is the Black-Scholes option pricing formula. This approach is well established within the Actuarial Profession, and is used to determine actuarial assumptions for many other purposes.

The Black-Scholes approach requires as inputs assumptions for price inflation (RPI or CPI as appropriate) and for inflation volatility. The RPI assumption is usually derived by reference to market yields on government bonds and the approach can be integrated into COBS by defining implied RPI inflation as the difference between the fixed interest and RPI-linked net discount rates.

Whilst this approach is undoubtedly more complex, it does lead to a defined approach for all LPI pension increases.

Please note that under this approach, the FSA would need to publish assumptions for inflation volatility. If the FSA was minded to adopt this approach, the Actuarial Profession would be happy to discuss it further with you and help determine suitable volatility assumptions.

Considerations for CPI

If it is decided to adopt a different assumption for CPI-linked pension increases compared to RPI-linked pension increases (consultation question 3), then this would need to be reflected in whatever approach is determined for LPI pension increases as well.

5) Do you agree that the annuity interest rate should continue to be reviewed annually? If not, describe the approach you believe should be taken and why you believe it would be more suitable.

We would recommend that the interest rate be reviewed monthly. We say this for two reasons:

a) the past year has highlighted how changes in market conditions can render the analysis basis out of date, and therefore capable of giving misleading messages to firms and clients.

b) defined benefit pension schemes are required to offer transfer values which do vary with current market conditions. Therefore the analysis system should have, to some extent at least, a corresponding variation so as to provide like for like figures.

We do not agree with the statement that increasing the frequency of the change in the annuity interest rate will increase gaming strategies for the timing of corporate transfer exercises. If fact we believe that the reverse will be true and there will be less opportunity for supposed gaming if the market conditions for the transfer analysis and actual transfer value calculation are aligned.

We also recognise a need for the annuity interest rate to be fixed for a reasonable period of time in order for the advice process to be properly conducted. It would be inappropriate to require the rate to be updated on, say, a monthly basis throughout the advice process. This is because the advice process may take in excess of a month to complete and there needs to be stability in the transfer analysis under COBS 19.1 during this process.

Given the above we suggest that the annuity interest rate is updated on a monthly basis. An appropriate updating process could be to use market conditions on the last day of the previous month before the actual transfer value is quoted. This is often the date for market conditions that underlie the actual transfer value. Firms could then be permitted to use this annuity interest rate throughout the advice period, subject to a maximum period of, say, 6 months. We believe this provides an appropriate balance between regular updates, stability for the advice process and removing possible gaming strategies.

6) Do you agree that there is a need for the proposed guidance? If not, please indicate why you disagree.

We agree that there is a need for proposed guidance that reinforces the requirement for firms to provide appropriate advice on the growth rates likely to be achieved following any transfer. We agree that the advice provided to individuals should reflect their particular risk profile and suitability to transfer and the advice should not simply be based on standard assumptions. It is important, however, to note that this may have practical implications on the transfer analysis process. We understand that in practice such transfer analysis calculations are often performed before the member has been assessed for suitability and their risk profile has been obtained. If the growth rates need to be shown on a member specific basis then this may mean that the transfer analysis becomes a two-stage process, which may impact the cost benefit analysis presented in Annex 1 of the Consultation Paper.

Whilst we fully support the need for individuals to be provided with guidance appropriate for their own circumstances, and the growth rates need to reflect this, we do not believe that the same assumptions need to be used that are used for KFIs. KFIs are provided for a different purpose and any requirement for the two to be aligned is likely to lead to a sub-optimal solution overall. In particular, section 2.9 of the consultation document reinforces that firms have the ability to vary the assumptions to be more cautious than those specified under COBS 19.1. We believe that this point should be reinforced through additional guidance as well, rather than the requirement to be consistent with KFIs (which could conflict with this requirement).

We agree that individuals should understand the transfer of risk that occurs when benefits are transferred from a DB arrangement to a DC arrangement, and the potential loss should be demonstrated to members. We do not, however, believe that this is best achieved through a further reduction in the growth rate. We do not believe that this would adequately demonstrate the potential for loss. We would suggest that a more appropriate solution would be for members to be shown possible outcomes under alternative assumptions (which are more likely to be understood by the member).

Overall we fully support that guidance is a vital part of the process for advice on transfers from defined benefit schemes and that firms must continue to be reminded of the need for suitability of advice. We agree they should not just 'turn the handle' on the transfer analysis calculations.

7) Do you have any comments on the cost benefit analysis?

We don't have any comments on the cost benefit analysis except to say that the costs seem to have been defined very narrowly to just the TVA software rather than the wider changes to the advice process that the FSA seems to be trying to achieve through the changes.

We have restricted our comments to the specific questions that have been asked in the consultation. Our hope is that these answers will be helpful to you in formulating a more appropriate basis for the current environment. However, we also think it is important that consideration is given to how the basis can be kept up to date and reflect the latest developments. We believe that developing a process for future reviews is important and if there is any way we can help you with this specifically, please feel free to contact us.

We hope all of the above will be helpful, but if you have any questions or would like to discuss any of these matters further please do not hesitate to contact us. Please contact Kirstin Lambert (0207 632 2168 or via Kirstin.Lambert@actuaries.org.uk) in the first instance.

Yours sincerely,

Martin Lowes

Martin Lowes
On behalf of the Consultations Group, Pensions Practice Executive Committee