Institute and Faculty of Actuaries

GC17/1 – Changes to the way firms calculate redress for unsuitable defined benefit pension transfers

IFoA response to Financial Conduct Authority

09 June 2017

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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.

Institute and Faculty of Actuaries

Racquel Thomas-Smith
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9 June 2017

Dear Ms Thomas-Smith

IFoA response to FCA Consultation: GC17/1 – Changes to the way firms calculate redress for unsuitable defined benefit pension transfers

1. The Institute and Faculty of Actuaries (IFoA) welcomes the publication of this consultation. Members of our Pensions Board have led the drafting of this response.

2. Given the current concern about inappropriate transfers from Defined Benefit (DB) schemes, it is right to review the redress methodology. Our members have suggested there has been a marked increase in the number of transfer requests in recent months. Evidence is emerging that this increase in requests is now leading to actual payments.

3. We are supportive of the aim of redress (Paragraph 1.9) which is to put the consumer into the position they would have been had they remained in the defined benefit scheme. We also welcome the FCA's view that hindsight should not require a more demanding standard. Current market conditions would mean (in many cases) consumers receiving higher redress than if calculations were performed at the date of transfer. However, separation of the redress calculation from the assessment of advice given should mean hindsight is applied only in cases where the reason for the member seeking redress is not purely the unexpected changes in market conditions.

4. In principle, we are supportive of the approach set out in the consultation paper. Consequently, we have provided answers to questions only where we have comments or concerns about the proposed methodology.

5. There is merit in adopting simplified assumptions, where values used by DB schemes would vary. Such an approach makes the calculations easier. However, one area where scheme practice varies significantly is in commutation. This difference can be more significant than some of the benefit differences which are reflected in the calculations. We have commented in more detail about commutation issues in the response.

Q1: Do you agree with our proposal for the basis of the redress calculation methodology? If not, what approach do you consider we should take and why?

6. We support the rationale given in the consultation paper for the methodology (3.1 to 3.6). Cash compensation will be the most practical and appropriate means of redress, as is basing the compensation calculation on what the DB scheme would have expected to provide. Any other approach is either unworkable or would result in delays or more complex work.

Q2: Do you agree with our approach to valuing the DB pension scheme benefits? If not, do you agree with the alternative approach or do you consider a different method would work better?

7. The Pension Review approach suggested is the better of the two given. Transfer value bases may vary significantly between schemes and over time. We also consider it would be very difficult to set an appropriate basis for schemes no longer in existence. The transfer value basis is determined by a scheme's trustees, based on their best estimate of providing benefits. Aspects such as the returns on the underlying scheme assets cannot be fairly determined in such an aggregate fashion. Using transfer values could be less transparent and would be less consistent between cases.

8. As the FCA suggests, it is unlikely that schemes which are still in existence would bear the costs of calculating a transfer value for the purposes of redress. Using this approach would likely lead to delays and additional costs.

9. Finally, we note there will remain a difference between redress calculated under this method and compensation calculated using the "Ogden Tables" for assessing lump sum compensation suitable to cover future loss, and assume that the FCA remains comfortable with this. We believe the proposed approach represents a better estimate of the value lost,

Q3: Do you agree with our proposal for the inflation rate assumption to be used in the methodology? If not, what rate should be applied and why?

10. The approach suggested is reasonable, although we note that the Bank of England has currently suspended publication of its inflation yield curves. There might need to be an alternative if this were to happen again in future, such as FTSE Actuaries Gilts Indices.

Q4: Do you agree with our proposal for the pre-retirement discount rate to be used in the methodology? If not, what approach do you consider should be used and why?

11. We agree with the methodology adopting a diversified investment approach. This would be consistent with most DB schemes' investment strategies and not guaranteed in all circumstances. The range of investment strategies implemented by DB schemes is significant, so adopting this methodology may not reflect what would have happened in specific schemes.

12. There are two specific areas where the methodology may not have adopted the best approach. Most DB schemes and insurers will invest globally in equities rather than concentrating on UK equities. Using the dividend yield based on a FTSE Index is not comparable to the average dividend yield for a global equity portfolio. If the dividend discount model is used to derive expected equity returns, then consideration could be given to whether a global dividend index is appropriate.

13. Given the global investment approach and the complication of selecting the “correct” index, there may be merit in exploring other approaches for deriving the expected return in equities. One example could be to set the return as a margin over the gilt yield curve which is periodically reviewed by the FCA in the light of changes in market conditions.

Q5: Do you agree that there should be one approach to the pre-retirement discount rate applied to all consumers? If not, how should the other rates be determined?

14. As noted previously, the single approach to the discount rate will mask the variations in schemes’ investment strategies.

Q6: Do you agree that the same pre-retirement discount rate proposed for DB pension scheme benefits should be used for PPF benefits? If not, what rate should be applied and why?

15. No. PPF benefits are lower than would have applied in the member’s original scheme, but are arguably more secure. It would make sense to reflect this in the discount rate.

Q7: Do you agree with our proposal for valuing personal pension charges in the methodology? If not, what approach should be taken and why?

16. We note that this approach has been suggested on the grounds of simplicity; however its effect could be as great as that from moving to the complex approach of using the yield curve to set the discount rate. If the intention is that the methodology should reflect the individual’s ability to make up the value of their pension then we believe it should reflect the actual charges on the personal pension at the date of calculation.

Q8: Do you agree with our proposal for the post retirement discount rate to be used in the methodology? If not, what approach should be applied and why?

17. We agree with the approach to use an approach based on the risk-free gilt yield. We believe that using an annuity pricing basis is not consistent with the intention to replicate the benefits that would have been available from a DB scheme, since they would not have had the same level of guarantee.

Q9: Do you agree with the 0.6% deduction to reflect pricing models used by annuity providers?

18. As noted above, we do not entirely follow the rationale for using individual annuity pricing as the basis for deriving an adjustment. For a DB scheme, it would be less common to secure the pension at retirement by an annuity, but more common to secure through bulk annuity pricing, which is typically rather better than that available on individual scheme annuities. In our view, the post retirement assumption could be equal to the gilt yield curve without adjustment, as being a reasonable way to take account of the lack of full guarantee even for

pensions in payment in a DB scheme. More work may be required to determine the size of any adjustment.

Q10: Do you agree that the pension methodology should take account of the pension commencement lump sum?

19. Yes, this is appropriate as in our experience almost all members take the maximum pension commencement lump sum.

Q11: If so, do you agree with the approach and the rate proposed to account for this? If not, what approach should be applied and why?

20. There is significant variation in DB schemes for setting commutation factors. We believe that such variation should not be ignored. It is possible to view them as benefit differences between schemes, in much the same way different pension increases between schemes are reflected in the calculations. As a principle we would prefer, if possible, for redress to reflect the actual practice of the specific scheme in respect of commutation factors.

Q12: Do you agree with our proposal to use PxA08 mortality tables adjusted for future mortality improvements? If not, what approach should be used and why?

21. The SAPS tables could be viewed as equally, if not more, appropriate for this group. Given most schemes use SAPS tables and would typically be on what the transfer values had been based, we would ask the FCA to consider whether SAPS tables were not more appropriate.

Q13: Do you agree with our gender-neutral approach to mortality in the methodology? If not, what approach should be used and why?

22. While we accept this approach as a reflection of the annuity market, most pension schemes will use gender-specific mortality assumptions in their transfer value calculations.

Q14: Do you agree with our proposal to assume that consumers are the same age as their spouse? If not, what approach do you think should be used and why?

23. For consistency with Q13, most schemes will use different age assumptions for spouses in their calculations. However, we note this proposal is consistent with gender-neutral mortality.

Q17: Do you agree that firms should update the relevant assumptions on a quarterly basis? If not, please tell us why.

24. As most calculation systems cope with regular changes to market values, we would suggest assumptions could be updated monthly. This is relevant given how sensitive the calculations will be to gilt yields and the relatively large movements in gilt yields seen, even on a monthly basis, in recent years.

Q19: Do you think that our proposed redress methodology should be applied to complaints relating to non-joiners, opt-outs and FSAVC cases? If yes, why? If not, how should

redress for these cases be calculated and why? For example, should any adjustments be made so that the proposed methodology can be used for these cases? Should the current methodology continue to be used for these cases?

25. In the case of opt-outs it may be necessary to consider making an adjustment to the methodology for the potential for the member's salary increases to have out-paced, or lagged, inflationary increases.

Should you wish to discuss any of the points raised in further detail please contact Philip Doggart, Technical Policy Manager (Philip.doggart@actuaries.org.uk / 0131 240 1319) in the first instance.

Yours sincerely

Fiona Morrison
Immediate Past President, Institute and Faculty of Actuaries

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