Institute
and Faculty
of Actuaries

CP17/32: Quarterly Consultation Chapter 7: Our Projection Rates – Changes to the Conduct of Business Sourcebook

IFoA response to Financial Conduct Authority

1 November 2017

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.

Institute
and Faculty
of Actuaries

James Tallack
Banking, Lending and Distribution
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

1 November 2017

Dear James,

IFoA response to CP17/32: Quarterly Consultation
Chapter 7: Our Projection Rates – Changes to the Conduct of Business Sourcebook

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's consultation on the proposed changes to the projection basis for packaged products, including personal pension schemes.

2. The IFoA's Life Standards and Consultations sub-Committee and Life Insurance and Finance & Investment Boards have been involved in the drafting of this response. Members of the Committee and Boards work for insurers active in the investment/ pensions product markets.

General Comments

3. As noted in the consultation paper, the Expert Report on which the FCA's proposed changes are based has not yet been published. The comments below are therefore based solely on the rationale given in Section 7 of the consultation paper.

4. We note that the FCA proposes no changes to the 'nominal' projection rates, but with some reductions to the inflation assumptions. Since the inflation assumptions are used to convert 'nominal' projections to 'real' amounts (COBS 13), and to compare alternative benefits under defined benefit pension schemes (COBS 19), the proposed changes result in a projection basis that is less prudent overall than the current approach. Against a background of equity markets close to all-time highs and fixed interest yields close to all-time lows, we would question whether this 'weakening' of the basis is justified.

Q7.1 Do you agree with our proposal to keep the maximum nominal intermediate rate of return in COBS 13 Annex 2 at 5% for tax-exempt products and 4.5% for all other products?

5. The IFoA does not agree with this proposal. Instead, we believe the maximum nominal intermediate rate of return should be reduced to 4.5% for tax-exempt products, and to 4% for all other products. This would preserve the current relationship with the price inflation assumption, rather than weakening the relationship relative to the status quo.

Q7.2: Do you agree with our proposal to base our price inflation assumption in COBS 13 Annex 2 on the CPI (rather than the RPI), resulting in a reduction from 2.5% to 2%?

6. We agree with using CPI rather than RPI as the basis for the price inflation assumption, and also with reducing the price inflation assumption from 2.5% to 2.0%. We note that the 2.0% CPI assumption is consistent with the Bank of England's consumer price inflation target.

Q7.3: Do you agree with our proposal to retain an RPI-based price inflation assumption in COBS 13 Annex 2 for benefits, contributions or charges linked to the RPI, and to set this at 3%?

7. We also agree with the proposal to retain an RPI-based price inflation assumption in the circumstances envisaged. However, consistent with the reduction in the nominal rates of return, we would suggest setting the RPI-based inflation rate assumption to 2.5%.

Q7.4: Do you agree with our proposal to update the RPI and earnings inflation figures in COBS 19.1 to 3% and 3.5% respectively, and leave the current CPI figure of 2% unchanged?

8. We agree with the proposed reduction in the earnings inflation figure from 4% to 3.5%, and as explained in response to Q7.2 above, we also agree with the 2% assumption for CPI. However, as in our response to Q7.3, we would suggest an assumption of 2.5% for RPI inflation.

Q7.5: Do you agree with our proposal to reduce our earnings inflation assumption in COBS 13 Annex 2 from 4% to 3.5%?

9. Consistent with our response to Q7.4, we support the proposal to reduce the earnings inflation assumption to 3.5%.

Q7.6: Do you have any other comments on our proposals, the underlying analysis, or any other related issues (including how we could improve our projections regime in the future)?

10. The IFoA responded to Chapters 3 and 4 of the Financial Services Authority's consultation CP12/10 (dated 30 August 2012), which covered investment return assumptions and the CPI assumption of pension transfer analysis. In our response to that, we made suggestions on how the projections regime could be improved, and in our opinion most of these suggestions remain relevant. In particular, we:

    - consider that a 5% maximum intermediate growth rate is not the most appropriate way of reducing the risk of consumers being misled by speculative projections;
    - are concerned that the current approach does not bring out potential downside risk, including: a high degree of volatility with short-term investments such as equities; long-term investment in fixed interest; investment in income drawdown products;
    - believe that greater guidance on, and flexibility in, application of the current approach can provide materially improved customer information in many circumstances; and
    - believe consistency, as far as possible, between Standard Money Purchase Illustrations (SMPIs), Packaged Retail and Insurance-based Investment Products (PRIIPs) and FCA

illustrations provides considerable value to customers. We think that the FCA could generally have given more consideration to this aspect.

We responded to chapter 6 of this consultation paper (in relation to PRIIPs) on 2 October 2017.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager at Steven.Graham@actuaries.org.uk or on 020 7632 2146 in the first instance.

Yours sincerely,

Marjorie Ngwenya
President, Institute and Faculty of Actuaries