

The response to the July 2009 consultation on section 143 and section 179 assumptions

October 2009

1 Introduction

- 1.1 In July 2009 the PPF began a consultation on a possible change to the actuarial assumptions required for section 143 and section 179 valuations. The consultation period lasted six weeks and there were 17 responses to the consultation. The respondents included actuarial consultancies, insurance companies, industry bodies and others whose comments were made in an individual capacity. The PPF would like to thank all those who took the time to respond, as well as those who provided informal responses to the consultation.
- 1.2 Following consideration of the responses, the PPF decided to change the assumptions for section 143 and section 179 valuations with effect from 31 October 2009. This change is being announced at the same time as the publication of this response and the updated assumptions guidance documents placed on our website at the same time.
- 1.3 This document provides a summary of the responses that were given to the consultation.

2 Overview

- 2.1 The July 2009 consultation document contained a reminder of the ten principles that the Board has adopted to underlie the setting of assumptions for section 143 and section 179 valuations. These have been reproduced in the appendix to this document.
- 2.2 The consultation document also set out specific changes to the actuarial assumptions that the PPF believed to be appropriate taking into account the ten principles described above. In summary the proposed assumptions changes were to:
 - increase the yields used to discount future payments by 0.1% p.a. in deferment;
 - increase the yields used to discount future payments by 0.3% p.a. in payment;
 - change one of the yields used as a reference point to one with a longer duration;
 - increase the assumption about future longevity improvements for males, and
 - reduce the proportion of members who are married or who have relevant partners by 5%.

- 2.3 The response to the proposed changes was generally positive, especially in relation to section 143 valuations.
- 2.4 There was general acceptance that bulk annuity prices had altered sufficiently since the last change to the assumptions as to merit a further change at the present time.
- 2.5 The consultation document set out seven questions on which we particularly welcomed feedback. The answers to these are summarised in the next section.

3 Responses to the seven specific questions raised in the consultation document

3.1 *Question 1: "Do you consider that the proposed new section 143 and section 179 valuation assumptions in Appendix 1 are reasonable? If not, what would you propose as an alternative set of assumptions?"*

- 3.1.1 There was general agreement that bulk annuity prices have reduced since the last change to assumptions and that the proposed assumptions moved the section 143 and section 179 bases in the right direction.
- 3.1.2 There was limited discussion over whether the adjustments to the discount rates were of the right magnitude, with several respondents noting that they are not privy to buy-out company bases. One consultancy responded that, based on recent experience of broking such transactions, buy-out prices had not reduced by as much we were thinking and that the adjustment to discount rates was too great.
- 3.1.3 Another respondent proposed that no changes be made to the discount rates, as favourable trends in market buy-out terms may shortly be reversed because of increased insurer capital constraints. Our intention in this regard would be to adjust our assumptions at the next review if there is evidence then that higher capital requirements are driving up prices.
- 3.1.4 There was no discussion about the proposed changes concerning the reference yield or the longevity assumption.
- 3.1.5 One respondent commented that the assumption regarding the proportion of members who are married or have a relevant partner should be increased to make allowance for potential cases where the spouse or partner is significantly younger than the member. The dependant's pension payable under the scheme would typically be reduced in such circumstances; however no reduction applies to the corresponding PPF compensation levels. When we carry out the next review we will specifically address this matter in the questions

we ask insurers, to see how significant an issue this is for their pricing.

3.1.6 The responses did not overall suggest that there was any significant misinterpretation of the pricing information we have collected from insurers.

3.1.7 The PPF will adopt the proposed assumptions with effect from 31 October 2009, as described above.

3.2 Question 2: "What evidence do you have, in summary, to support your response to Q1?"

3.2.1 Of the 17 respondents, 10 are either pension consultants or insurance companies with practical experience of the buyout market (or individuals employed by such organisations). As such they had some insight into pricing assumptions (even if only by back-solving from buy-out quotes). The remaining seven respondents did not put forward any direct evidence.

3.3 Question 3: "Is it appropriate to introduce the new section 143 and section 179 assumptions with effect from 31 October 2009?"

3.3.1 Two respondents suggested that any changes to the section 179 assumptions should be delayed until the long-term future of the levy is decided. We do not think that this is appropriate because of the requirement to be timely in keeping the assumptions up to date.

3.3.2 One respondent requested a period of 3-4 months notice before the changes are made to the section 179 assumptions. This delay was not requested by other respondents. We think it is important to keep the assumptions as up to date as possible with as small a delay as possible.

3.3.3 Five respondents suggested backdating the changes to the section 143 assumptions. Four of these respondents suggested 1 January 2009 as a suitable effective date.

3.3.4 In our view backdating these changes would be inconsistent with principle (j), which is that we will provide sufficient notification of changes. In our view this principle would generally require an effective date of change to be in the future. We saw some indications in the fourth quarter of 2008 to suggest that a slight increase in yields could potentially be viewed as arguable; however this evidence was tenuous and certainly not as compelling as that currently available and consequently we do not consider it appropriate to backdate the changes. Moreover, we would generally expect section 143 and section 179 assumptions to be kept in step and backdating section 179 assumptions would present serious practical problems.

3.4 Question 4: “Would you support the introduction of term-dependent yields (perhaps based on swaps) at the next review (for either or both of section 143 and section 179 valuations)?”

3.4.1 The near unanimous consensus was that while term-dependent discount rates may be theoretically correct, this needs to be balanced carefully with the principle of proportionality. Given the generic nature of the question, the answers were tentatively expressed. The following is a summary:

- Four respondents opposed the introduction of term-dependent discount rates for both section 143 and section 179 valuations
- Seven tentatively favoured the introduction in principle for section 143 valuations but not for section 179 valuations
- Three did not object to this for section 179 and section 143 valuations
- Three made no comment.

3.4.2 The Board notes that support for the introduction of term-dependent interest rates is still not overwhelmingly strong. The Board will continue to monitor the practicability of using term-dependent yields, particularly for section 143 valuations. At the same time it will consider options for a simplified approach.

3.5 Question 5: “Would you think it appropriate, at the next review, to differentiate each member’s mortality by postcode (for either or both of section 143 and section 179 valuations)?”

3.5.1 Most respondents noted the practical considerations involved with postcode rating, and commented that the precise implementation of postcode rating would need to be carefully considered. The following summary may be drawn:

- Five opposed the introduction of postcode rating outright
- Six tentatively favoured in principle the introduction for section 143 but not for section 179 valuations
- Three favoured the introduction for both types of valuation. Two of these noted the impracticality for smaller schemes or schemes with missing data.
- Three made no comment.

3.5.2 The Board notes the strong opinions and objections based on practical grounds, and recognises that this is an area of development. The Board will be undertaking further work on the applicability of postcode data and will consult with interested parties in future, should this work lead to a firm proposal.

3.6 Question 6: "Would you think it appropriate, at the next review, to introduce a cap on the allowance for winding-up expenses?"

3.6.1 There was general support for a cap, with a number of respondents commenting that the current allowance is too high for large schemes and does not give credit for economies of scale or fixed costs. One respondent suggested introducing a fixed cost in conjunction with lower percentage allowances under the tiered system.

3.6.2 One respondent expressed concern that a cap would distribute the levy away from larger schemes towards smaller ones.

3.6.3 One respondent commented that the current allowance is too low for small schemes and that a fixed underpin or floor should be introduced to address this issue.

3.6.4 The Board will be undertaking further work on the allowance for winding-up expenses.

3.7 Question 7: "If the cap mentioned in Q6 were to be introduced do you have any comments about what an appropriate cap might be?"

3.7.1 There were several suggested approaches, including a zero allowance in respect of liabilities above £150m or £200m, a 'reshaping' of the percentage allowances to give more weight to the lower tiers of liability, and a fixed cap of £20m or £30m.

3.7.2 One respondent noted that, for section 143 valuations, the scheme actuary and PPF caseworker could carry out a "sense check" of the expense allowance, based on the actual experience of the scheme over the assessment period.

4 Other observations made by the respondents

4.1 One respondent questioned why we consulted a smaller number of insurers than at the previous review. The smaller sample size of insurers at this review reflects the number of insurers actively writing business at the time at which the survey was carried out. In accordance with principle (h), we felt that our main investigation and analysis effort should be focused on those companies with the keenest prices.

4.2 One respondent suggested carrying out section 143 valuations at a later date in the assessment period, i.e. not at the start of the assessment period, as legislation presently requires. The consultation was made on the basis of the legislation and the Board has no discretion under the legislation to require the production of a

section 143 valuation at any effective date other than the assessment date.

- 4.3 One respondent asked whether we had considered the impact of the changes on one of the Pensions Regulator's trigger points. In this respect the Board has drawn the attention of the Pensions Regulator to the changes.
- 4.4 One respondent did not welcome the changes resulting from the review on the grounds that immature schemes would benefit more from the proposals than mature schemes. We have sought to reflect insurance company prices for both immature and mature schemes and believe that our assumptions work reasonably for both.

5 Feedback on the consultation

- 5.1 The PPF would value any feedback on the effectiveness of this consultation process. If you have any comments then please contact:

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Appendix – ten principles underlying section 143 and section 179 assumptions

The Board has adopted the following ten principles to underlie the setting of assumptions for section 143 and section 179 valuations:

- a. Compliance with the regulations.
- b. Seeking evidence from confidential dialogue with market participants.
- c. Seeking anecdotal evidence from consultants of the state of the market; a significant shift would indicate the need for a review of assumptions.
- d. If the need for a review under principle (c) has not been invoked, nonetheless reviewing the market by speaking to market participants every year to eighteen months.
- e. Proportionality (balancing the degree of precision with the cost, taking into account the purpose of the valuation).
- f. Adoption of new tables and techniques as appropriate, having regard to the principle of proportionality.
- g. Reasonable stability in the assumptions over time; i.e. frequent changes are undesirable.
- h. Deliberately erring on the side of understating liabilities; i.e. assessing section 143 liabilities at a level that is believed for most schemes to be somewhat below the best market price.
- i. Consulting with the pensions industry to check proposals.
- j. Providing sufficient notification of changes.

Principle (h) needs some further elaboration. Erring on the side of understating liabilities is appropriate given that market prices fluctuate significantly with varying supply and demand, and given principle (g) regarding the desirability of reasonable stability. Erring on the optimistic side therefore means that we mitigate the risk of taking schemes into the PPF that, as at the assessment date, actually could have bought out better benefits in the market. Moreover, the availability of the reconsideration process under section 151 of the Pensions Act 2004 means that a scheme unable to buy at least PPF levels of benefits in the market should generally be able to transfer into the PPF.