

The response to the February 2008 consultation on section 143 and section 179 assumptions

May 2008

1 Introduction

- 1.1 In February 2008 the PPF consulted on a possible change to the actuarial assumptions required for section 143 and section 179 valuations. The consultation period lasted four weeks and there were 16 formal responses to the consultation, in the main but not solely from actuarial consultancies. The PPF would like to thank all those who have taken 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 March 2008. This change was announced in March 2008 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 February 2008 consultation document set out ten principles that, it was proposed, should form the basis for considering what assumptions it is appropriate to adopt 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 actuarial assumptions that the PPF believed to be appropriate taking into account the ten principles described above. These proposed assumptions differed in two respects from the prevailing assumptions: first, the discount rates were 0.3% pa higher, and secondly the mortality assumptions were set on a different base table together with a more conservative allowance for mortality improvements.
- 2.3 The response to the proposed changes was generally positive, with only one respondent not welcoming the review on the grounds that immature schemes would benefit more from the proposals than mature schemes.
- 2.4 One respondent questioned the need to introduce revisions at this particular time, objecting to the cost associated with updating IT systems, but otherwise there was general agreement that bulk annuity prices had altered sufficiently in recent months to merit reviewing the actuarial assumptions.

- 2.5 The consultation document set out six questions on which it particularly welcomed feedback. The answers to these are summarised in the next section.

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

- 3.1 **Question 1:** “do the ten policy principles in section 3.1 of this document (including the rationale for making changes) seem appropriate? If not, what would you add or subtract?”
- 3.1.1 There was general agreement that the ten principles (which are listed in the appendix to this document) were appropriate, although there was some disagreement as to the importance that should be attached to each. No respondent suggested adding or subtracting any principles.
- 3.1.2 The legislation requires that the actuarial assumptions for section 143 and section 179 valuations should be such as to result in a liability that approximates the cost of purchasing PPF compensation with an insurance company. In order to canvass other professionals’ opinions on how best to achieve this, we proposed two sources of information – as set out in principle b (“seeking evidence from confidential dialogue with market participants”) and principle c (“seeking anecdotal evidence from consultants of the state of the market”). There was a difference of opinion between the respondents as to the relative merits of each of these sources of information, with some suggesting that the market providers would be in a more reliable source of information, and others suggesting otherwise on the grounds that profit margins may in practice be squeezed as a result of negotiation. In this connection, we note that one buy-out company has released a price tracking index. This may prove to be a helpful benchmark for our investigations in future.
- 3.1.3 Principle e (“proportionality (balancing the degree of precision with the cost, taking into account the purpose of the valuation)”) was identified by two respondents as being particularly important, and principle g (“reasonable stability in the assumptions over time”) was suggested by three respondents as deserving special emphasis. On the other hand, another respondent suggested that principle g was unimportant as regards section 143 valuations.
- 3.1.4 Principle h (“deliberately erring on the side of optimism”) caused one respondent concern over the prospect of increased professional costs for schemes that are reconsidered for entry to the PPF. However, it was highlighted by another respondent as being of particular importance in order to enable marginal cases to test the market.
- 3.1.5 The PPF welcomed this feedback, and on the strength of it has decided to retain the ten principles summarised in the appendix.

- 3.2 **Question 2:** “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?”
- 3.2.1 There was general agreement that bulk annuity prices have reduced in recent months and that the proposed assumptions moved the section 143 and section 179 bases in the right direction.
- 3.2.2 There was no discussion over whether the adjustments to the discount rates were of the right magnitude, with several respondents noting that they are not privy to buyout company bases.
- 3.2.3 There was considerable discussion of mortality tables, with five respondents noting that the Pensions Regulator’s recent consultation document suggested that scheme funding valuations should have mortality improvements at least as strong as Long Cohort. It was suggested that it would have been desirable for the section 143 and section 179 assumptions to be based upon Long Cohort improvement rates, for example to avoid sending out conflicting messages to scheme trustees and sponsors. While the PPF appreciates that this is an important fact, its conversations with market participants have suggested that moving to Long Cohort would not accurately reflect the market’s general pricing basis. Also, as described in section 5 of the consultation document, it may be that commercial pressures are resulting in less conservative mortality assumptions for pricing purposes compared with those for reserving calculations.
- 3.2.4 There was less comment on the 1% underpin to the annual improvement rate, the one exception being one respondent’s comment that some consultancies’ valuation systems may need to be updated to allow for this.
- 3.2.5 Several respondents noted that moving to the 00 series for the base mortality table would make a negligible difference, with one suggesting that the 92 series be retained on the grounds of practicality. Four respondents suggested that they anticipated a change in section 143 / section 179 assumptions to the CMI SAPS tables in due course, with one noting that two changes in quick succession would be undesirable.
- 3.2.6 Given that there were no strong views expressed in opposition to the proposed assumptions, the PPF adopted these with effect from 31 March 2008, as described above.
- 3.3 **Question 3:** “what evidence do you have, in summary, to support your response to Q2?”

- 3.3.1 Of the 16 respondents, 12 are either pension consultants or insurance companies with practical experience of the buyout market.
- 3.4 **Question 4:** “is it appropriate to introduce the new section 143 and section 179 assumptions with effect from 31 March 2008?”
- 3.4.1 There were no objections to introducing the new assumptions at this time.
- 3.5 **Question 5:** “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)?”
- 3.5.1 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:
- Two respondents opposed the introduction of term-dependent discount rates for both section 143 and section 179 valuations
 - Nine tentatively favoured the introduction in principle for section 143 valuations but not for section 179 valuations
 - One did not object to this for s179 and s143 valuations, but alluded to the potential impracticality for smaller schemes.
- 3.5.2 One respondent noted that a proxy to the term-dependent approach might be to capture a scheme’s duration in the Scheme Return and use this information in the calculation of the discount rate.
- 3.5.3 If readily practicable, the Board would favour term-dependent yields, particularly for s143 valuations. The Board will investigate further the practicability of using term dependent yields, particularly for section 143 valuations. At the same time it will consider options for a simplified approach with a view to offering a more conclusive proposal at the next revision to the assumptions
- 3.6 **Question 6:** “would you think it appropriate, at the next review, to differentiate each member’s mortality by post-code (for either or both of section 143 and section 179 valuations)?”
- 3.6.1 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:
- Six opposed the introduction of postcode rating outright

- Four tentatively favoured in principle the introduction for section 143 but not for section 179 valuations
- Two favoured the introduction for both types of valuation and both noted the impracticality for smaller schemes or schemes with missing data

3.6.2 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.

4 Other observations made by the respondents

- 4.1 One respondent noted that the wording of the regulations places us in the impossible position of placing a value on something that is sometimes incapable of being secured in practice (e.g. schemes which are too small or large to buyout with a bulk annuity provider).
- 4.2 One respondent suggested that the adoption of a single NPA for section 179 valuations would render their valuations more efficient. While the PPF appreciates that this would be the case, it feels that the benefits of obtaining more accurate valuations through the use of multiple tranches of NPA outweigh the calculation costs. As regards the distribution of the levy, we believe that the multiple tranche approach achieves a fairer allocation of the levy among schemes.
- 4.3 One respondent was unsure how non-revaluing deferred compensation would be valued for levy purposes should such a class of compensation be introduced by legislation. The treatment of non-revaluing compensation will be considered as part of the consultation for the 2009/10 levy.
- 4.4 One respondent did not welcome having to carry out calculations on both pre- and post-31 March 2008 assumptions for different clients, and would prefer the previous method were retained whereby the date of signature determined the version of assumptions used. However, the PPF believes that basing the assumptions upon the valuation date is more in line with the requirements of the valuation regulations. Also, taking account of the date of signature of the valuation report would create unwelcome complications for schemes that were in the process of carrying out a valuation at a time during which the assumptions were being reviewed.

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 optimism; 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 optimism 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.