The response to the 2016 consultation on assumptions to be used for valuations under section 143 and section 179 of the Pensions Act 2004

November 2016

1 Introduction

1.1 In September 2016 the PPF began a consultation on a possible change to the actuarial assumptions required for valuations carried out under section 143 and section 179 of the Pensions Act 2004. The consultation lasted six weeks and there were eight formal responses. 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 has decided to change the assumptions for section 143 and section 179 valuations in line with the proposals set out in the consultation document. The changes come into effect from 1 December 2016. The changes are being announced at the same time as the publication of this response.

1.3 The updated assumptions guidance documents are now available on our website (version B7 for section 143 and version A8 for section 179). This document provides a summary of the responses that were given to the consultation.

2 Overview

2.1 The November 2016 consultation document contained a reminder of the ten principles that the Board has adopted for setting assumptions for section 143 and section 179 valuations[1]. These have been reproduced in Appendix 1 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 principles described above. The most significant changes are as follows:

- to use separate discount rates for pensioners and non-pensioners post retirement (in all previous versions of the guidance, the post-retirement rates for non-pensioners have been the same as for pensioners),
- to use yield indices that have durations that better match average liability durations, including the introduction of a new index-linked gilt yield, and
- to update the mortality assumptions.

[1] Valuations carried out under sections 152, 156 and 158 will also be affected as they use the same assumptions as section 143 valuations.

2.3 The Board proposed to introduce these changes for valuations with an effective date on or after 1 December 2016.

2.4 The response to the proposed changes was positive and there was acceptance that bulk annuity prices had altered sufficiently as to merit a change to the assumptions at the present time. We were pleased that responses considered the assumptions, both at an individual level and in terms of the overall strength of the basis. We consider all comments and suggestions in light of our ten principles. On the whole, the responses were sufficiently supportive that we have decided to proceed with our proposed set of assumptions.

2.5 The consultation document set out three questions on which we particularly welcomed feedback. The responses to these questions are summarised in the next section.

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

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

3.3.1 The seven responses received to this question stated that the proposed changes to the assumptions were reasonable and appropriate, and would likely result in section 143 and section 179 valuations that are broadly in line with bulk annuity quotations.

3.3.2 There was general support for the principle that section 143 assumptions should err on the side of understating liabilities (principle h in Appendix 1). This reduces the risk of taking schemes into the PPF that, as at the assessment date, could have bought out better benefits in the market.

3.3.3 Respondents agreed that bulk annuity prices have reduced relative to gilts since the last change to assumptions at 1 April 2014 and, therefore, the proposed assumptions move the section 143 and section 179 bases in the right direction. Although, one respondent noted that the changes may lead to an increase in the number of reapplications to the PPF under section 151.

3.3.4 Four respondents commented on the proposed mortality assumption changes. Three stated that it was reasonable to update the mortality assumptions to make use of up to date base tables and improvement models, with the other stating that the proposed mortality assumptions are in general slightly heavier than they would expect to be used by insurers.

3.3.5 Two of these also commented that it was appropriate to remove the 90% scaling factor from the mortality base tables as they would expect that the mortality experience of schemes in the PPF universe as a whole is likely to be in line with that used to construct the SAPS tables.

3.3.6 Four respondents commented on the proposed changes to the individual financial assumptions. They all welcomed the use of separate discount rates for pensioners and non-pensioners post retirement as it should produce fairer outcomes across schemes with different membership profiles. Their responses suggest that most valuation systems should be able to cope with this change.

3.3.7 They also agreed that the changes to the yield indices should lead to a better match against average liability durations.

3.3.8 One respondent commented that, although insurers are willing to provide indicative pricing assumptions, actual quotations will often differ markedly from their own indicative prices because of the following factors: appetite for writing new business, competitive pressures, availability of attractive assets, and scheme specific circumstances. Another respondent added that increased use of medical underwriting in the bulk annuity market, is likely to make pricing harder to predict.

3.3.9 Some alternative approaches for setting discount rates were mooted, including discounting based on the full yield curve, or picking spot rates at a point appropriate a scheme's own duration. However, in general, respondents agreed the chosen approach achieves an appropriate balance between precision and cost. It was noted that in many cases a more precise approach would not likely lead to a materially different outcome (i.e. entry to the PPF / levy payable).

3.3.10 Although we did not propose any changes to the expense assumptions, two respondents submitted comments, on behalf of cash balance schemes, regarding the expense allowance in respect of benefit installation and payment costs (calculated on a per-member basis). Their concern was that the allowance may be excessive, given that such schemes have a benefit structure that is far simpler than that of a traditional DB scheme; in particular, only one payment is made.

3.3.11 As we do not have any evidence on which to assess if a different expense allowance would be appropriate for a cash balance scheme, we have not made any changes to this assumption. We will address this point specifically with insurers at our next review.

3.3.12 We were pleased to receive all suggestions for how our valuation assumptions might better capture individual scheme characteristics and will continue to review whether our assumptions represent the correct trade-off between theoretical accuracy and pragmatism / simplicity of calculation.

3.3.13 On the whole, we felt that there was sufficient consensus for us to proceed with our proposals as laid out in the consultation document.

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

3.4.1 Of the eight responses, seven were from large pension consultancies or professional / industry bodies. As such they have had insight into indicative insurer pricing assumptions and practical experience from buy-out quotation exercises.

3.5 *Question 3:* "Is it appropriate to introduce the new section 143 and section 179 assumptions with effect from 1 December 2016?"

3.5.1 All respondents supported the decision to change the assumptions from 1 December 2016. One noted that it was helpful that the implementation date is prior to the next significant round of section 179 valuations, with effective dates of 31 December 2016 and 31 March 2017.

4 Feedback on the consultation

4.1 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 1 – policy 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.

These principles are not binding but the Board has made a commitment to follow them as far as possible.