The response to the 2021 consultation on assumptions to be used for valuations under section 143 and section 179 of the Pensions Act 2004

April 2021

1 Introduction

1.1 In February 2021 the PPF began a consultation on changes 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 thirteen responses. The PPF would like to thank all those who took the time to respond.

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 with the exception of the base table mortality assumptions where a slight amendment has been made. The changes come into effect from 1 May 2021 for both section 179 and section 143 valuations.

1.3 The updated assumptions guidance documents are now available on our website (version B9 for section 143 and version A10 for section 179). This document provides a summary of the responses that were given to the consultation.

2 Overview

2.1 The February 2021 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 adopt the Self-Administered Pension Scheme (SAPS) “S3” mortality series and to adopt the amounts weighted dependant SAPS S3 tables for both current dependants and contingent lives,
- to adopt the 2019 version of the CMI’s model for the projection of mortality improvements with an initial addition of 0% and a smoothing parameter of 7.5,
- to amend the components of the post-retirement post-97 discount rates to better reflect current CPI pricing,
- to amend the formula for calculating wind-up expenses resulting in an increase to expenses for smaller schemes and a decrease to expenses for larger schemes so they are capped at £3 million, and
- to slightly reduce the benefit installation/payment expenses.

2.3 The Board proposed to introduce these changes for valuations with an effective date on or after 1 May 2021.

2.4 The response to the proposed changes was generally positive and there was acceptance that bulk annuity prices had altered sufficiently as to merit a change to the assumptions at the present time. There were some suggestions as to how we might amend the way we construct our basis, which we will continue to investigate in our next review of

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

assumptions. On the whole, the responses were sufficiently supportive that we have decided to proceed with the majority of our proposed set of assumptions but with an amendment to the mortality assumptions.

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

3 Responses to the five 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 are reasonable? If not, what would you propose as an alternative set of assumptions?"

3.1.1 There was general agreement that our current assumptions had moved out of line with insurance pricing and our changes were a move in the right direction and satisfied the PPF's aim of deliberately understating liabilities. One respondent believed the basis was too prudent for pensioners and two respondents concluded it was too optimistic for non-pensioners, but there was a general consensus that the proposed assumptions were reasonable and pragmatic for the purpose they were intended.

3.1.2 Many respondents explicitly mentioned that they favoured moving to the S3 base tables and CMI 2019 future improvements, although one suggested early adoption of the CMI 2020 tables. Two respondents commented that the proposed allocation of the Light and Very Light S3 mortality base tables was inconsistent with the way the tables had been produced. Three questioned whether the S3 tables should be adjusted to reflect the fact that there is a significant proportion of public sector data in the S3 dataset.

3.1.3 One respondent felt that the proposed assumptions may imply a higher proportion married assumption than their demographic models suggests.

3.1.4 Five respondents explicitly agreed that the proposed wind-up expenses better reflects the larger relative costs experienced by smaller schemes, although one respondent commented that the expenses were still lower than they expected. The proposed cap on expenses was an area of discussion with one respondent indicating £3m was an appropriate level but two indicating it might be too low when considering projects like GMP equalisation and in circumstances where complex issues arise. One respondent was concerned about the impact the change would have on the distribution of the levy, in particular they noted this will result in higher levy bills for smaller schemes.

3.1.5 One respondent discussed the predicament that some smaller schemes may find themselves in where they are over 100 per cent funded on a s143 measure but find themselves unable to secure a buy-out quote in practice. One suggested that we should consider adopting an adjustment to the liabilities for smaller schemes, or allowing some discretion for the Appointed Actuary to do so, to reflect pricing available in the market.

3.1.6 Four respondents commented that the proposed changes to CPI-linked discount rates better reflected insurer pricing. Three were concerned that the changes did not fully reflect the RPI reform and suggested that we monitor CPI pricing to ensure the assumptions remain appropriate.

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

3.2.1 Of the thirteen responses, eight were from pension consultancies, two were from professional bodies, one was a trustee and one was a consolidator. The final respondent was an individual with a broader interest in the pensions industry. They therefore have likely had insight into indicative insurer pricing assumptions and/or practical experience from buy-out quotation exercises.

3.3 *Question 3:* "Is it appropriate to introduce the new section 143 and section 179 assumptions with effect from 1 May 2021?"

3.3.1 The majority of respondents agreed that 1 May was an appropriate date. Three respondents rejected our proposal to introduce the assumptions from 1 May 2021. One respondent suggested that we could backdate the section 143 assumptions to an earlier date, the other two did not suggest an alternative.

3.4 *Question 4*: "Do you agree that the current basis strikes the correct balance between precision and complexity? If not, how do you think it could be improved?"

3.4.1 Eight respondents explicitly answered yes to this question, with the remaining suggesting ways that we could better balance our two objectives.

3.4.2 Four respondents felt that there would be a benefit in moving towards a yield curve approach, with many highlighting that many systems are now set up to use yield-curve assumptions. One of the respondents commented that they only felt a yield curve approach was appropriate for s143 valuations. Another commented that they felt the additional complexities of a yield curve valuation outweighed the benefits.

3.4.3 Two respondents suggested we consider extending the existing flexibilities within our valuation guidance to enable the actuary to use bespoke assumptions for s143 valuations. Another asked us to consider circumstances when the s179 guidance could be less prescriptive, for example where the basis is used for non-levy purposes.

3.4.4 Two respondents suggested that we adopt a scheme-specific adjustment to the liabilities to capture the fact that pricing can be less competitive for smaller schemes.

3.4.5 Two respondents suggested additional flexibility could be given to schemes to reflect known regional or demographic variations to base table mortality assumptions.

3.4.6 One respondent suggested we include in a future update a credit spread component that moves in line with market indices.

3.4.7 Another suggested we specify an RPI/CPI gap for use in valuations of insured assets with RPI-linked increases.

3.4.8 Finally, one respondent suggested including a contingency reserve for additional unknown liabilities which could be discovered prior to buy out.

3.5 *Question 5:* "Other than discussions with market participants, what sources of information do you think the PPF should be using to ensure that section 143 assumptions remain broadly in line with buy-out pricing?"

3.5.1 There was general agreement that the current approach continues to be appropriate.

3.5.2 Additional sources of information proposed by respondents included:

- reinsurers,
- regulators, such as the PRA, as insurer pricing is directly impacted by changes to these regulations,

- risk transfer teams of advisory firms, and
- trustees who have undertaken recent buy-out or buy-in transactions and in time 'bridge to buy-out consolidators'.

3.5.3 One respondent suggested utilising a buy-out tracker offered by some insurers as an alternative method to monitor if indicative buyout pricing has changed.

3.6 Any further comments

3.6.1 When we speak with insurance companies to decide our basis they each give us a range of different assumptions. One of our principles is to err towards the optimistic side of the range of assumptions (in the sense of leading to lower liabilities). In this connection we received two comments about the broader use of our assumptions:

- One respondent questioned whether the principles should be reviewed based on the increased scope of the s179 basis given it is now being used as a regulatory tool in the supervision of consolidators.
- One respondent highlighted that these bases are sometimes used as an objective reference point for valuations carried out for different purposes, e.g. share of fund of s75 debt calcs.

4 Our decisions in response to the consultation

4.1 We have concluded that we will adopt the proposals set out in our consultation document, with one exception: we have decided to amend the mortality assumptions for the s143 valuations to better reflect the original construction of the S3 tables.

4.2 This change reflects an inconsistency between our proposed use of the Light and Very Light tables and the way the tables had been produced as noted by two respondents. In particular, the populations used to generate the Very Light tables were subsets of the populations used to generate the Light tables rather than separate groups, and our proposal double-counted the lighter mortality experienced by the richer individuals included in the Very Light tables.

4.3 To reflect this in the s143 basis we have decided to remove the Very Light tables from the basis and instead use Light tables for all individuals with pensions above £22,500 for males and £9,000 for females. This will only impact schemes with very high earners and these schemes can request bespoke scheme specific mortality assumptions if necessary. These changes will reduce a scheme's s143 liabilities relative to our proposed assumptions, with the exact impact based on the composition of the scheme.

4.4 There were a number of other comments on mortality and expense assumptions that we considered but on balance we have decided not to implement. In particular:

- Three respondents commented on whether we should adjust the SAPS S3 tables to reflect the fact that there is a significant proportion of public sector data in the S3 dataset. We considered this carefully prior to the consultation and we concluded then and continue to believe that on balance the unadjusted tables are fit for purpose, especially as schemes have the ability to adopt bespoke mortality assumptions in s143 valuations. Also, we gained comfort from the fact that the unadjusted tables better aligned with the overall strength of the assumptions adopted by insurers.

- One respondent suggested that we adopt the latest CMI tables (CMI_2020) published in March 2021. However, we have seen that insurance companies will generally not adopt the new tables immediately and will submit them to considerable scrutiny before incorporating into their pricing basis. As we have to reflect current assumptions rather than anticipate the direction in which they are going, we incorporate new mortality tables only after discussion with insurance companies.
- There were some conflicting views on the changes to the expense allowance, mainly around the level of the cap on wind up expenses for larger schemes. The actual wind-up expenses can vary significantly between schemes based on the complexities they face. Based on our experience we are comfortable that the proposed expenses, including the cap, are set at a reasonable level for most schemes. Schemes have the option to request a bespoke expense assumption for a s143 valuation to reflect their specific circumstances.

4.5 As initially proposed, we have decided to bring both the s143 and s179 assumptions in with effect from 1 May 2021. This approach was endorsed by most respondents and we feel is proportionate given the proposed assumption changes for both bases have a relatively small overall impact for an average scheme.

4.6 We considered backdating the s143 assumptions to the time that we spoke with the insurance companies (mid-December), but we do not believe that doing so would influence the conclusion as to whether any of the schemes currently in assessment will transfer to us or not.

4.7 A number of the other suggestions raised were ways to enhance our approach and would need further consultation with both insurers and stakeholders if we were to implement them. Given the general consensus that the basis was appropriate, we do not see the benefit in delaying the implementation to investigate these at this time and will consider these points again as part of our next review. In particular:

- We agree with the respondent that the pricing for smaller schemes may be more expensive and we will continue to explore ways that this could be reflected in the s143 basis as part of future reviews. If such schemes are unable to secure a buy-out in practice, they can apply for re-entry to the PPF.
- We will also keep under review the flexibilities within our current approach to setting bespoke assumptions. In particular we will continue to review how these flexibilities help schemes that are more marginally funded obtain the right outcome. At present only the demographic and expense assumptions can be amended. In practice only a small number of schemes use the bespoke assumptions and our experience to date has been that the current guidance has provided the required flexibilities.
- We note the general optimism regarding the feasibility of using yield curves for s143 valuations, with only one respondent suggesting that such functionality would take time to introduce. While we do not propose to introduce changes at this stage, we will continue to give consideration in future reviews.
- We also note and agree the need to keep gilt yields and inflation assumptions under review. We have processes to do this throughout the year, not just as part of our biannual discussions with insurers.

4.8 One respondent questioned whether a contingency reserve should be included to allow for unknown liabilities that may be discovered prior to buy-out. We do not feel a reserve is necessary for s143 valuations, which are only signed off once a data review has been completed and therefore we expect the majority of data uncertainties to already be quantified and valued. For s179 valuations we favour a proportionate approach given the primary purpose of the valuation is to allocate PPF levy to the eligible universe.

4.9 The final few comments are relevant for wider PPF policy setting. We have therefore passed on to other teams within the PPF for consideration.

- The consequence of changing the expense assumptions could result in a re-distribution of levy from smaller to larger schemes.
- The impacts of broadening of the purpose of the s179 valuation, with its new additional purpose as a regulatory tool to supervise consolidators.

4.10 Finally, we would like to thank again the insurance companies that informed our consultation proposal, and the thirteen respondents to the consultation whose input we greatly appreciate.

5 Feedback on the consultation

5.1 The Board 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 around setting 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 (see Appendix 1). In particular, the assumptions are required to reflect insurance company buy-out pricing terms for PPF compensation.
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.