The response to the 2018 consultation on assumptions to be used for valuations under section 143 and section 179 of the Pensions Act 2004

November 2018

1 Introduction

1.1 In August 2018 the PPF began a consultation on possible 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 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 with the exception that we will bring in the section 143 assumptions with an earlier effective date than originally proposed. The changes come into effect from 1 November 2018 for section 179 valuations and from 13 June 2018 for section 143 valuations.

1.3 The updated assumptions guidance documents are now available on our website (version B8 for section 143 and version A9 for section 179). This document provides a summary of the responses that were given to the consultation.

2 Overview

2.1 The August 2018 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 2016 version of the CMI's model for the projection of mortality improvements,
- to increase the discount rate for post-5 April 1997 compensation for members currently in payment,
- to increase the post-retirement discount rate for pre-6 April 1997 compensation for members not yet in payment, and

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

- to increase the pre-retirement discount rate for members not yet in payment.

2.3 The Board proposed to introduce these changes for valuations with an effective date on or after 1 November 2018.

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 investigate in our next review of assumptions. 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 six questions on which we particularly welcomed feedback. The responses to these questions are summarised in the next section.

3 Responses to the six 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 overall aim of our assumptions is to give a liability value that is in line with pricing in the bulk buy-out market. There was general agreement that our current assumptions led to a higher liability compared with insurance companies and therefore our changes were a move in the right direction. Indeed, one respondent suggested that even with the proposed changes our basis might remain too prudent.

3.3.2 When we speak with insurance companies to decide our basis they each give us a range of different assumptions. Another of our principles is to err towards the optimistic side of the range of assumptions (in the sense of leading to lower liabilities). Three respondents explicitly endorsed our approach in their response. One, however, suggested that we move towards the middle of the range so as to minimise the chance that a scheme that was over 100 per cent funded on a section 143 measure would find itself unable to secure a buy-out quote in practice.

3.3.3 Other respondents discussed the predicament that such schemes may find themselves in. One suggested that this was a particular problem for smaller schemes, and that we should consider adopting a simple adjustment to the liabilities depending on the scheme size.

3.3.4 Many respondents commented on the need to keep the assumptions under regular review, with one suggesting that we could have been quicker to update the basis since prices had been out of line with our assumptions for around a year.

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

3.4.1 Of the thirteen responses, ten were from pension consultancies and three were from professional bodies. They therefore 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 November 2018?"

3.5.1 With the exception of one respondent, adoption from 1 November 2018 was either explicitly or implicitly supported. The other respondent suggested that we could backdate the proposed section 143 assumptions to the date of the consultation (13 August 2018) whilst leaving the section 179 effective from 1 November.

3.5.2 The rationale behind backdating the assumptions is that it falls in line with our legislative requirement to keep our basis up to date with current buy-out pricing. If we perceive the market to have diverged from our section 143 assumptions, we should remedy that as soon as possible.

3.6 *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?"

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

3.6.2 Two respondents felt that there would be a benefit in moving towards a yield curve approach. We discuss this further in the response to question six.

3.6.3 Three respondents suggested we consider extending the exisiting flexibilities within our valuation guidance to enable the actuary to use bespoke assumptions.

3.6.4 One respondent suggested that we adopt a scheme-specific adjustment to the liabilities to capture the fact that pricing can be more competitive for larger schemes.

3.6.5 Another suggested we include in a future update a credit spread component that moves in line with market indices.

3.6.6 Finally one respondent suggested that the current basis is appropriate for section 143 valuations, but too complex for section 179 valuations, although no specific simplifications were suggested.

3.7 *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?"

3.7.1 There was general agreement that we should analyse buy-out prices obtained by schemes in a PPF assessment period to test the accuracy of the assumptions, and some consultancies offered to investigate sharing their information with us on an anonymised basis.

3.7.2 One respondent suggested discussing with reinsurers as well as insurers, and discussing pending regulatory developments that may affect pricing (such as forthcoming changes in the treatment of equity release mortgages).

3.7.3 One respondent suggested discussing the latest developments in longevity pricing with mortality experience experts.

3.8 *Question 6*: "Do you have any views on whether using a yield curve approach for interest and inflation would cause any material operational issues?"

3.8.1 Only one respondent suggested that the use of a yield curve would not be operationally simple, with the lead-in time to introduce such functionality being around six months. Other respondents were generally optimistic that such an approach could be introduced in short order.

3.8.2 Respondents used this question to offer their wider thoughts on the use of a yield curve, including the theoretical justification and the challenges it would pose to the PPF.

3.8.3 No respondent supported the idea of using a yield curve for section 179 valuations. It was recognised that the purpose of a section 179 valuation is to give the PPF information that can be used to share out the total PPF levy amongst different schemes in a fair way. Therefore the onus is on differentiating risk rather than placing a theoretically correct value on it.

3.8.4 Some respondents pointed out that using a yield curve approach for a section 179 valuation would complicate the levy calculation, particularly with regard to the PPF's roll-forward methodology as set out in the transformation appendix to our levy rules.

3.8.4 There was more support for using a yield curve approach for section 143 purposes, with three respondents appearing to indicate a definite preference for our doing so. One suggested that this could be done by exception, by our permitting bespoke financial assumptions in cases where the actuary felt it was justified. This would be an extension to the existing flexibility within our valuation guidance (part 4 of version H6). Four respondents stated however that at this stage the additional accuracy did not outweigh the additional complexities.

4 Our decisions in response to the consultation

4.1 We have decided to go ahead with the proposals set out in our consultation document, with one exception: we have decided to backdate the s143 assumptions. The effective date of the new s143 asumptions is therefore 13 June 2018. This date represents the date of our last discussions with insurers to inform our view and therefore we are comfortable that the basis is reflective of market pricing at that time.

4.2 In general our preference would be to bring the assumptions in from a date in the future to avoid complexities of a scheme already having commenced their valuation. However in this instance we agree with the rationale that it is better to bring the new s143 assumptions in from an earlier date to reflect the reality of market conditions. We have reviewed schemes with an effective date on or after 13 June and are comfortable that backdating the effective date will not cause any operational issues.

4.3 We have decided to bring the section 179 valuation assumptions in with effect from 1 November, as proposed. We cannot see the benefit of bringing these assumptions into effect sooner, as schemes may well have commenced their valuation and in any event all valuations are converted back onto the same assumption set as part of the levy calculation.

4.4 Turning to the other suggestions raised, we were particularly interested in the commentary around schemes that were assessed as being over-funded at the s143 valuation date but which were unable to secure a buy-out in practice. Such schemes can apply for re-entry to the PPF under either section 151 or section 153 of the Pensions Act 2004. However, such applications do take time and incur investment expenses.

4.5 This may be a particular problem for small schemes because there is little appetite amongst insurance companies for taking on small buy-outs. Some will not quote below a particular size of deal, for example. In our discussions with insurance companies to date, we have acknowledged that the price depends on scheme size, but have not explored ways that this could be reflected in the section 143 basis. This is something we will investigate as part of the next round of discussions.

4.6 We will also consider if introducing further flexibilities within our current approach to setting bespoke assumptions would help schemes that are more marginally funded obtain the right outcome for their scheme.

4.7 We note the general optimism regarding the operational feasibility of using yield curves for s143 valuations, with only one respondent suggesting that such functionality would need to be built. While it would not be appropriate to introduce a yield curve approach at this stage, we will continue to give consideration in future reviews to whether to adopt such an approach, and give serious thought to the option of allowing this as a 'bespoke' rather than standard assumption.

4.8 Central to a yield curve approach is the selection of an appropriate benchmark curve, and we are thankful to the respondent who suggested particular interest and inflation rate curves that might be appropriate starting points for such a calculation.

4.9 We will also give consideration to the suggestion that we might adopt some measure of 'spread' over and above bond yields, to better capture the way that buy-out prices move relative to risk-free assets. As with many of the other suggestions, we would need to find an objective and practical way to incorporate such theoretical refinements, and will consider this idea further as part of our next review of the basis.

4.10 A couple of respondents suggested that we could move automatically to the latest CMI tables (the latest being CMI_2017). 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 prefer to incorporate new mortality tables into our basis only after discussion with insurance companies.

4.11 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 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.