Consultation Paper

CP12/10**

Financial Services Authority and

the Financial Reporting Council

Product projections and transfer value analysis – consultation by the Financial Services Authority

Statutory Money Purchase Illustrations – consultation by the Financial Reporting Council

May 2012

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The Financial Services Authority and the Financial Reporting Council invite comments on this Consultation Paper, to be submitted by the following deadlines:

FSA consultation:
Chapter 2 – mortality assumptions – by 29 June 2012
Chapter 3 – transfer value analysis – by 31 August 2012
Chapter 4 – investment return assumptions – by 31 August 2012

FRC consultation:
Chapter 5 – Statutory Money Purchase Illustrations – by 31 August 2012

FSA consultation
Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/library/policy/cp/2012/12-10-response.shtml

Alternatively, please send comments in writing to:
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FRC consultation:
For ease of handling, the FRC prefer comments to be sent electronically to TM1@frc.org.uk
Comments may also be sent in hard copy to:

The Director of Actuarial Policy
The Financial Reporting Council
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It is the FSA and FRC's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

AS TM1	Actuarial Standard Technical Memorandum 1
CMI	Continuous Mortality Investigation
COBS	Conduct of Business sourcebook
CP	Consultation Paper
CPI	Consumer Prices Index
DB	Defined benefit
ECJ	European Court of Justice
FRC	Financial Reporting Council
FSMA	Financial Services and Markets Act 2000 (as amended)
KFI	Key Features Illustration
LPI	Limited Price Indexation
OBR	Office for Budget Responsibility
RDR	Retail Distribution Review
RPI	Retail Prices Index
SMPI	Statutory Money Purchase Illustrations
TVA	Transfer Value Analysis

1 Overview

Introduction

1.1 This Consultation Paper (CP) is a joint consultation between the FSA and the Financial Reporting Council (FRC).

FSA

1.2 The FSA consultation covers:

- proposals for updating the mortality assumption to be used when illustrating a personal pension, including implementation of the European Court of Justice (ECJ) ruling on gender equality in insurance;
- introduction of a separate Consumer Prices Index (CPI) assumption for transfer value analysis (TVA) when benefits under a defined benefit (DB) pension scheme are compared with the possible benefits under a personal pension scheme; and
- changes to the investment return assumptions (projection rates) in Chapter 13 Annex 2 of the Conduct of Business sourcebook (COBS).

FRC

1.3 The FRC consultation covers:

- possible changes to the assumptions used for Statutory Money Purchase Illustrations (SMPIs) to make them consistent with the FSA assumptions in COBS (amended as proposed in Chapter 4).

Background

FSA consultation

1.4 In April this year, we made rules that updated the mortality basis for pension TVA.[1] This updating took account of the ECJ's ruling on gender equality[2] and respondents to the consultation on that updating urged us to introduce the same mortality basis for Key Features Illustrations (KFIs); Chapter 2 of this CP sets out our proposals for making this change. The changes will also make our rules more consistent with the FRC assumptions used for SMPIs, which are covered in Chapter 5.

1.5 Our proposals in Chapter 3 also follow on from the consultation on TVA. We accepted, in principle, during that consultation that defined benefit scheme benefits linked to the CPI should be valued on an explicit CPI assumption. The effect of our proposals is that there would be separate explicit assumptions for benefits linked to the Retail Prices Index (RPI) and those linked to the CPI. Chapter 3 lays out our proposals for both CPI benefits that are revalued in deferment as well as CPI-linked pension increases. It should be noted that we are not, at this stage, proposing any changes to the existing RPI inflation rate.

1.6 Chapter 4 proposes changes to the projection rates in COBS 13 Annex 2 for non-MiFID packaged products, and follows a report published on 10 April[3], consisting of a review by PricewaterhouseCoopers (PwC) and peer reviewers' comments (the PwC report). That report supported a reduction in our current intermediate projection rate and in the adjustment for tax-disadvantaged products.

FRC consultation

1.7 Chapter 5 sets out a consultation by the FRC on the assumptions used for SMPIs. Their proposals tie in with our proposals in Chapters 2 and 4, and aim to make the assumptions used for SMPIs more consistent with those in our rules.

Equality and diversity issues

1.8 The implications of our proposals in Chapters 2 to 4 for equality and diversity are set out separately in each chapter.

1 Policy Statement 12/8 *Pension transfer value analysis assumptions – Feedback to CP12/14 and final rules* (April 2012)
2 ECJ Test Achats case, March 2011
3 www.fsa.gov.uk/static/pubs/other/projection-rates12.pdf

Timetable

1.9 Please note the differing consultation periods for the different chapters:

Chapter	Consultation period
2	Four weeks – ending on 29 June.
3	Three months – ending on 31 August.
4	Three months – ending on 31 August.
5	Three months – ending on 31 August. Responses to this chapter should be sent direct to the FRC, as explained at the end of the chapter.

Who should read this paper?

1.10 All the chapters will interest life insurers and other providers of personal pensions and also firms that advise on personal pensions. Chapter 3, on the introduction of explicit CPI-linked assumptions, will also interest TVA software providers and employee benefit consultancies as well as employer sponsors of DB schemes. Chapter 4, on changes to the projection rates in COBS 13 Annex 2, affects all non-MiFID packaged products, not just pensions, so will interest providers of these products and firms that advise on them, including firms advising on TVA. Chapter 5 will also be of interest to administrators and trustees of occupational pension schemes and firms that advise on occupational pensions.

1.11 Consumers will be interested in the implications of the proposals in all the chapters for pension information and in the Chapter 4 proposals for other products.

2

Personal pensions – mortality assumption for Key Features Illustrations

Introduction

2.1 In this chapter, we propose changes to update the mortality assumption to be used when illustrating a personal pension. The proposed changes include a general updating to reflect improved longevity and also gender equalisation of male and female rates to take account of the ECJ ruling in 2011.

2.2 Earlier this year, we made rules that introduced the mortality basis proposed here for pension TVA assumptions. In the feedback to that consultation, respondents urged us to introduce the same basis for KFIs as soon as possible. So we are restricting the consultation on the mortality assumption changes to four weeks (closing date 29 June).

Background

2.3 Our rules on pension illustrations require the potential retirement income that could be achieved from a personal pension to be illustrated using an annuity basis designed to reflect current market annuity rates. COBS sets out the interest rate, mortality basis and expenses to be assumed in projecting the future annuity income.

2.4 Historically, the basis has been consistent with the one used in annual pension statements, known as Statutory Money Purchase Illustrations (SMPIs). The technical detail of SMPIs is governed by Actuarial Standard Technical Memorandum 1 (AS TM1) published by the FRC, under delegation from the Department for Work and Pensions. In general, we think it

is sensible that an individual who purchases a personal pension and receives a projection of the potential benefits at point of sale should continue to receive annual statements indicating future benefits determined on a consistent basis.

2.5 During 2011, we discussed the mortality basis with the FRC with a view to updating it. We recognised that the existing basis, based on the Continuous Mortality Investigation's (CMI) 92 series of mortality tables, is generally no longer used by annuity providers for pricing annuities, as it understates longevity.

2.6 European law prohibits discrimination based on sex in the supply of goods and services. There was a limited exemption in respect of actuarial factors in insurance and related financial services. This was in effect removed by the ECJ's judgment in the *Test Achats* case in March 2011, and accordingly rating factors in insurance contracts based on sex are not permissible after 21 December 2012. This will change the annuity rates available in the market, and we and the FRC agreed that the basis we were considering would need to be amended further to allow for equal male and female rates, to reflect the terms that may be available in practice.

2.7 During discussions with insurers during 2011, it became apparent that they had not reached any conclusions on how gender equal rates would be determined in practice for annuity pricing. Even now, amongst industry practitioners, there are expectations that annuity pricing may be volatile in the months following implementation of the ECJ ruling.

2.8 However, it became clear during discussions that insurers expect future pricing practices to be based on a blend of male and female rates, and not simply to reflect the most conservative approach.

2.9 In December 2011, the FRC published a new version of AS TM1. This included an annuity mortality basis based on updated mortality tables and improvement factors as well as introducing a gender equal rate based on an equal blend of male and female mortality rates.

2.10 Earlier this year, we consulted and then made rules on applying the same basis for pension TVA assumptions. In the consultation, we indicated our intention of applying the same basis to KFIs. Respondents to the consultation supported the basis overall and also urged us to apply it as soon as possible for KFIs, to reduce the discrepancy between TVA comparison reports and KFIs, and ensure that all consumers purchasing personal pensions would receive a realistic assessment of their potential retirement income.

The change in the mortality basis

2.11 We are proposing that the mortality basis for KFIs should use the 2000 series of tables, with future improvements based on the most recent CMI model, as follows:

50% of PCMA00 including improvements based on CMI(20yy-1)_M[1.25%] +

50% of PCFA00 including improvements based on CMI(20yy-1)_F[1.25%]

where 20yy is the 12-month period starting 6 April 20yy

2.12 This basis is the same as the basis introduced for TVA, as well as being consistent with the basis introduced by AS TM1 for SMPIs at the end of 2011 (but see further comments by the FRC in Chapter 5).

2.13 Putting aside gender equal rates, the general updating of the mortality basis has a different impact on people of different ages. Generally, the further a person is from retirement, the higher the impact due to the expected future improvements in mortality that they will experience. So, for two individuals of different ages but the same intended annuitisation age, with the same level of projected pension fund, the illustrative value of the annuity that could be purchased at that age would be lower for the younger person than for the older person.

2.14 The introduction of gender equal rates by blending male and female rates as proposed has the further effect of reducing the annuity income illustrated for single men, while increasing it for single women. For single men, the overall fall in illustrated annuities, including both the revised mortality basis and gender neutrality, will vary from 10% to 17%, depending on age. For single women the fall in illustrated income from updating the mortality basis generally outweighs the increase caused by the gender equality effect; for the youngest women, the overall illustrated annuity income could fall by up to 8%, although there will be a marginal increase in the annuity illustrated for those nearest to retirement.

2.15 The effect of gender equality is less pronounced for joint annuities, as the decrease in male annuity rates is offset by the improvement in female annuity rates. However, this depends on the age difference between the annuitant and the spouse as well as the relative value of the spouse's payment, as a percentage of the full annuity.

2.16 The proposed mortality basis is similar in structure to the existing basis in that it consists of a base mortality table with improvement factors. However, it differs in that the improvement factors need to be updated each year. We are proposing that the updating should be undertaken annually on 6 April, at the same time as firms update their systems for the automatic change to the annuity interest rate.

2.17 We have considered carefully when firms should be required to implement the revised mortality basis. We understand that, for the most part, firms will not be changing pricing practices to comply with the ECJ ruling before 21 December 2012. We are also aware that

firms are already undertaking substantial changes to illustration systems for the Retail Distribution Review (RDR). Further, a number of firms use the same systems for both SMPIs and KFIs and are already working towards an implementation date of 21 December 2012 for the new AS TM1 mortality basis.

2.18 On the other hand, consumers intending to annuitise after 21 December 2012 are currently receiving illustrations of future benefits that may overstate the projected retirement income they may receive. Taking into consideration all of the factors, including the cost benefit analysis (see below), we will only be requiring firms to alter their illustration systems by the time the ruling comes into effect on 21 December 2012.

2.19 From our work on TVA, we know that firms are keen to start making the required systems changes alongside their development work on RDR and SMPIs. So we are reducing the consultation period for the changes in this chapter to four weeks. The draft rules for these changes are contained in the first instrument in Appendix 1.

Q1: Do you agree with the new revised mortality basis? If not, please explain what alternative basis you think is more appropriate.

Q2: Do you agree with the timing for the introduction of the new mortality basis? If not, please describe the approach you believe should be taken.

Cost benefit analysis

2.20 When proposing new rules, or amendments to rules, we are obliged (under section 155 of the Financial Services and Markets Act 2000 (FSMA)) to publish a cost benefit analysis, unless we consider that the proposals will give rise to no costs or to an increase of minimal significance.

Impacted population

2.21 Our proposals will apply to all product providers providing individual or group personal and stakeholder pension schemes. It should also be noted that we have consulted on extending the KFI regime to operators of Self-Invested Personal Pensions (SIPPs), with effect from 31 December 2012. If those rules are made, SIPP operators would also be affected by the proposals in this chapter from that date. Using figures from Product Sales Data, we estimate that up to 200 pension providers (including SIPP operators) will be affected by our proposals.

Direct costs to the FSA

2.22 We do not expect the FSA to incur any additional costs as a result of these changes.

Compliance costs to firms

2.23 For the purpose of costing these proposals, we approached a number of organisations and asked them to provide estimates of the costs if we were to introduce the same mortality basis as the FRC. We received figures for a variety of different sized firms, including firms open and closed to new business, although these were not always consistent. The average one-off costs were between £20,000 and £410,000 per firm. The annual ongoing costs were estimated at one-fifth of the level of one-off costs.

2.24 The population of firms affected is the same as that affected by our rules on Retail Distribution Review (RDR) disclosure. So, to get an indication of the overall industry cost, we split the affected firms according to their size, as we did for RDR disclosure. We estimate that the total one-off costs for the industry would be around £7.9m. Feedback from the organisations we contacted suggested that the total ongoing costs would be one-fifth of this at £1.6m. Table 1 shows how we estimated the total one-off costs.

Table 1: Total one-off costs to the industry

Firm size	No. of firms	Cost per firm £	Total £m
Large	6	410,000	2.5
Medium	15	124,600	1.9
Small	179	20,000	3.6
Total	200		7.9

2.25 For these cost estimates to be met, the development work would need to coincide with the timetable laid down by the FRC for SMPIs (as noted earlier, some firms use the same systems). It was suggested that the figures would double if the implementation date was different, as our requirements would then be additional to those already implemented by the FRC.

2.26 Provider firms are currently changing their illustration systems to comply with new RDR disclosure requirements by the end of 2012. Some firms noted favourably that all the changes could be made simultaneously. However, others were concerned about the resources required to implement everything at the same time.

Indirect impact

2.27 Some individuals may be deterred from purchasing a pension contract if they perceive the benefits to be poor value for money, which may reduce new business for pension providers. There may also be a similar reduction in the number seeking advice on pensions, which could impact on advisory firms. On the other hand, lower illustrated benefits may

encourage consumers to focus more on the impact of charges and increase the pressure on providers to reduce these.

2.28 There is also a chance that the reduction in illustrated benefits may act to encourage consumers to increase their pension savings to prevent their intended retirement income from being reduced. Advisers, in particular, could use this opportunity to review levels of pension savings with their customers, with a view to increasing contribution levels.

Benefits

2.29 Changing the mortality rates will ensure that KFIs are up-to-date and still useful for consumers and their advisers to compare pension illustrations from different companies on a consistent basis.

2.30 If the mortality basis was not changed, potential pension purchasers might have misleading expectations of the potential benefits that the contract could provide. Further, existing policyholders requesting ad hoc benefit projections might receive very different projections of their contracts compared to the automatic annual pension statements they receive. If we changed the basis but did not adopt the same basis as the FRC, this would also be true (despite other differences).

> **Q3:** Do you have any comments on the cost benefit analysis for our proposals in Chapter 2?

Equality and diversity issues

2.31 We have considered the likely equality and diversity impact of our proposals. Our assessment shows that applying gender equal rates for males and females will reduce the level of annuity illustrated for single males and increase it for single females. Introducing gender equal mortality rates in illustrations reflects the ruling from the ECJ, which looks to promote equality between men and women by removing the use of gender as a risk factor in calculating premiums and benefits for insurance contracts. Any comments from respondents on this assessment are welcome.

Responses to this chapter

2.32 Responses should reach us by 29 June and should be sent to Sandra Graham using the electronic or postal addresses given at the start of this CP.

3

Consumer Prices Index assumption for pension transfer value analysis

Introduction

3.1 In this chapter, we propose changes to introduce an assumption for pension Transfer Value Analysis (TVA) for benefits linked to the CPI. This follows on from our consultation on TVA assumptions earlier this year, where we accepted, in principle, that benefits linked to the CPI should be valued using an explicit CPI assumption.

3.2 The rules we propose here lay out the assumptions to be used both for CPI revaluation in deferment and CPI-related pension increases. The effect of this is to have separate, explicit assumptions for benefits linked to the RPI and those linked to the CPI for the purposes of TVA. The draft rules for these changees are contained in the scond instrument in Appendix 1.

Background

3.3 TVA is the process of comparing the benefits being given up from a DB scheme with those that could be offered by a personal pension scheme. Our rules, in COBS 19.1, require a pension transfer specialist to compare the benefits likely to be paid under a DB scheme with the benefits possible from a personal pension scheme. For the quantitative analysis, advisory firms mostly use automated Transfer Value Analysis Software which, given a monetary transfer value, calculates the rate of return required from the personal pension scheme for it to provide the same benefits as those given up in the DB scheme.

3.4 The quantitative analysis in a TVA is dependent on a number of economic and demographic assumptions for which the assumptions are laid out in COBS. From time to time we review these assumptions to ensure they remain valid and do not result in unrealistic analysis that could adversely affect the advice process and result in consumer detriment.

3.5 As a result of legislation in 2011, many occupational schemes are now using CPI rather than RPI as a measure of price increases. Following our consultation on TVA earlier this year, we committed to introducing an explicit assumption both for CPI-linked revaluation in deferment and CPI-linked pension increases. We said we would consult on the rates at the same time as we consulted on changes to projection rates, and this is the subject of this chapter.

CPI-linked revaluation in deferment

3.6 Deferred DB scheme benefits are increased (revalued) each year until normal retirement date to protect the value from being eroded by inflation. Currently, COBS 19.1 states a single rate for limited price indexation revaluation pre-retirement. At the time that rate was first introduced, all revaluation was based on RPI. So, to ensure that firms can differentiate between the RPI and CPI revaluation in deferment going forward, the existing rate will be relabelled to make clear that it is the rate to be used for revaluation based on the RPI. We are then introducing a further revaluation rate that will be used for all forms of revaluation based on the CPI.

3.7 We have considered carefully the discussion in the PwC report on the absolute level of CPI, as well as the gap between CPI and RPI. We do not intend to make changes to the rate of inflation in COBS 13 Annex 2 at this time. That rate will remain the same as the rate we have now relabelled RPI-linked revaluation in COBS 19.

3.8 While the PwC report indicates that industry economists have different views on the size of the CPI-RPI gap, the Office for Budget Responsibility (OBR) uses an assumption that the gap between the GDP deflator[4] and CPI is 0.5%. PwC estimates that the GDP deflator will remain at the OBR assumption of 2.5% in the medium term. This suggests that a CPI rate of 2% would not be unreasonable. This is consistent with the government target for CPI inflation.

3.9 We have drafted a rule that sets the assumption for revaluation based on CPI at 2%.

> **Q4:** Do you agree with the assumption for CPI-linked revaluation in deferment? If not, please state the level at which you believe the assumption should be set and why you believe it is more suitable.

4 The GDP deflator is a measure of inflation in the domestic economy.

CPI-linked pension increases

3.10 Historically, DB schemes have offered pensions which were level, increased at a fixed rate or increased in line with the RPI (within bounds). Consequently, our rules defined annuity interest rates which were appropriate for valuing these types of increases. In accepting the principle that CPI-linked pension increases should also be valued using an appropriate annuity interest rate, it is necessary to define what that rate should be.

3.11 The annuity interest rate for RPI-linked pension increases is based on the yields of indices for RPI-linked government bonds. However, there are no CPI-linked government bonds, and there is no intention for any to be issued in the near future. We consider that the most pragmatic way to determine a suitable rate is by a simple adjustment to the annuity interest rate used for valuing RPI-linked pension increases.

3.12 Given the 0.5% difference between the CPI and RPI rates for revaluation, we consider the most appropriate approach to set a CPI-linked annuity interest rate is by adding 0.5% to the RPI-linked annuity interest rate. This approach will be applied both when the RPI-linked rate is set each 6 April and on any subsequent application of the rolling average annuity interest rate. The effect will be to place a lower value on full CPI pension increases than on full RPI pension increases, which is consistent with the aim of introducing CPI as a measure of price increases.

3.13 In PS12/8 on TVA, we made rules that distinguished between different collars and caps for Limited Price Indexation (LPI) pension increases based on the RPI. The approach taken was based on the differential between the RPI-linked annuity interest rate and the annuity interest rate for level or fixed increase annuities. We propose to take the same approach for LPI increases based on CPI.

3.14 The difference between the proposed CPI-linked annuity interest rate and the level or fixed increase rate will be 3%. The effect of this is that for caps of 3% or below, or for collars of 3% or above, fixed rate escalation based on the cap (if there is one) should be used. In all other cases of LPI based on CPI, the CPI-linked annuity interest rate should be used.

3.15 We recognise that this approach can give rise to some apparent inconsistencies. For example, where there are two otherwise identical schemes, one offering LPI based on RPI and one offering LPI based on CPI, this methodology will value the benefits from the schemes at the same level where the cap is at or below 3%, despite the inherent difference in the indices. On the other hand, it can be considered that this outcome reflects the expected long-term CPI rate, which is implicit in the annuity rate. On balance, we consider it is preferable to use consistent methodology for pension increases with collars and caps, whether these are based on RPI or CPI.

Q5: Do you agree with the approach and level of the assumptions for pension increases based on CPI? If not, please explain what alternative basis you think is more appropriate.

Cost benefit analysis

3.16 The principle of introducing assumptions for CPI-linked benefits was considered in CP12/4 and PS12/8 earlier this year. The cost benefit analysis (CBA) in CP12/4 took into account the costs associated with introducing an explicit CPI assumption for revaluation in deferment. Respondents made it clear during the consultation process that the costs associated with an explicit CPI-linked annuity rate could also be absorbed within the original analysis. The benefits of doing so were laid out in PS12/8.

3.17 We do not expect the proposals in this chapter to yield any additional costs and benefits other than those discussed in CP12/4 and PS12/8.

> **Q6:** Do you have any comments on the cost benefit analysis for our proposals in chapter 3?

Equality and diversity issues

3.18 We do not consider that our proposals have any impact on equality or diversity, but would welcome comments from respondents on this.

Responses to this chapter

3.19 Responses to this chapter should reach us by 31 August 2012. Please send them to Sandra Graham using the electronic or postal addresses given at the start of this CP.

4

COBS 13 Annex 2 – changes to investment return assumptions

Introduction

4.1 We periodically review the appropriateness of the investment return assumptions (projection rates) that appear in COBS 13 Annex 2.

4.2 The PwC report (the latest such review) supports a reduction in our current intermediate projection rate and in the adjustment for tax-disadvantaged products. Our proposals are:

- to reduce our intermediate projection rate from 7% to 5%; and
- to reduce the adjustment for tax-disadvantaged products from 1% to 0.5%.

4.3 We also propose to increase the span of the explicit flanking rates either side of the intermediate rate from ±2% to ±3%, and to change the wording of COBS 13 Annex 2 R 2.4 from saying that providers should use our standard rates, but revise them downwards where appropriate, to saying that providers should always use appropriate rates, subject to the maxima represented by our standard rates. The draft rules making these changes are contained in the second instrument in Appendix 1.

Proposed changes

Background

4.4 Our COBS 13 projection rules relate to products that are not financial instruments – life investments and pensions. They require firms to:

- project on three different rates of return – 5%, 7% and 9% (or 4%, 6% and 8% for products with a greater tax liability); and
- revise these rates downwards where a product is unlikely to achieve returns in line with these rates.

4.5 Historically, these projection rates have been based on an asset mix of 67% equities and 33% bond investments and a time horizon of 10 to15 years, because this reflects a standard investment period for many of the products in scope.

4.6 The explicit flanking rates either side of the central rates (the ±2%) are intended to illustrate the uncertainty of potential outcomes. They are not derived from an explicit quantification of these products' likely variability, and a range of ±2% is a significant underestimate of historic volatility for shorter terms (e.g. negative returns may well be experienced).

Compliance issues

4.7 Our 2008 thematic review of the quality of advice on pension switching[5] and the thematic work that preceded our 2009 'Dear Compliance Officer' letter[6] indicated that providers often failed to comply with our requirement that they revise our standard projection rates downwards where a product is unlikely to achieve returns in line with these rates.

4.8 To further emphasise this requirement we now propose to change the wording of the relevant rule – COBS 13 Annex 2 R 2.4 – from saying that providers should use our standard rates, but revise them downwards where appropriate, to saying that providers should always use appropriate rates, subject to the maxima represented by our standard rates.

> **Q7:** Do you agree that this change of wording provides sufficient additional emphasis for providers regarding our longstanding requirement that they use appropriate projection rates?

Projection rates

4.9 PwC's report concludes that:

- the best estimate for the single intermediate rate of return is 6%, in nominal terms, with a range around this figure of 5.25% to 6.5%; and
- for a 6% intermediate rate of return an appropriate single adjustment figure for tax-disadvantaged products would be 0.5%.

4.10 However, in respect of the former, PwC explicitly note that:

> '…it could be argued that risks for these forecasts are to the downside, at least in the short term…"

5 www.fsa.gov.uk/static/pubs/other/pensions_switch.pdf
6 www.fsa.gov.uk/static/pubs/other/co_letter_projections.pdf

4.11 PwC and all three peer reviewers also emphasise the greater element of uncertainty around, and volatility in, both estimates compared to those in the 2007 review.[7]

4.12 PwC goes on to conclude that pension funds and insurance products have very different asset allocations. The main asset class for pension fund investment remains equities, which still comprise on average around 60% of the investment. Insurance products such as with-profits funds now commonly invest anywhere between 50% and 100% in bonds. PwC retains the portfolio compositions used in its 2007 report for estimating intermediate rates of return, but includes a portfolio of 50% equities, 30% government bonds and 10% in both corporate bonds and property to show the potential impact of a shift towards fixed income investments away from equities.

4.13 We are determined that our updated projection rates should reflect the findings of the review. In the absence of any change in the asset mixes observed for in-scope products, the preponderance of downside risks would have led us to settle on a rate at the bottom end of the range set out by PwC. However, the observed changes in asset mixes away from equities – particularly for insurance products – combined with our desire to avoid spurious accuracy, has led us to conclude that we should reduce our intermediate rate from 7% to 5% (from 6% to 4% for products with a heavier tax liability). We will also reduce the adjustment for tax-disadvantaged products from 1% to 0.5%.

4.14 We have considered a number of ways that information about future variability might be presented, e.g. stochastic projections. However, none of these approaches offers a quantifiable gain in consumer benefit or understanding that would justify the cost to providers of implementing the change. So, we believe that the greater element of uncertainty identified by the review should be reflected in an increase in the span of the flanking rates from ±2% to ±3%.

> **Q8:** Do you agree that the proposed changes to these assumptions are appropriate? If not, what changes would you propose? Please explain why you would make other proposals.

Cost benefit analysis

4.15 When proposing new rules, or amendments to rules, we are obliged (under section 155 of the Financial Services and Markets Act 2000 (FSMA)) to publish a cost benefit analysis, unless we consider that the proposals will give rise to no costs or to an increase of minimal significance.

7 www.fsa.gov.uk/pubs/other/projection_rates07.pdf

Impacted Population

4.16 Our proposals relate to the providers and distributors of products that are not financial instruments.

Direct costs to the FSA

4.17 We do not expect the FSA to incur any additional costs as a result of these changes.

Compliance costs to providers

4.18 We do not believe the proposed changes will result in significant costs to providers.

4.19 Providers should already have the capacity to change their systems and processes to reflect updated projection rate assumptions without incurring any significant incremental costs.

4.20 The rewording of COBS 13 Annex 2 R 2.4 does not alter the meaning or purpose of this rule.

Indirect impact

4.21 Consumers can react in a variety of ways on being presented with lower projected returns, and a reduction in the overall level of investment will not automatically follow. A reduction in projected returns may deter some consumers from investing, equally it may encourage others to invest more, e.g. increase their pension savings.

4.22 Lower projected returns may also encourage consumers to focus more on the impact of charges and increase the pressure on providers to reduce these.

Benefits

4.23 Our proposals mitigate the risk that inappropriate projection rates will mislead consumers on potential future returns, thereby distorting the process of comparing and analysing product choices and increasing the risk that they will purchase unsuitable products.

> **Q9:** Do you agree with the cost benefit analysis for our proposals in Chapter 4?

Equality and diversity

4.24 We have concluded that our proposals do not give rise to discrimination and are of low relevance to the equality agenda. Nevertheless, we would welcome any comments respondents may have on any equality issues they believe arise.

Responses to this chapter

4.25 Comments should reach us by 31 August 2012. Please send them to Donald Cranswick using the electronic or postal addresses given at the start of this CP.

Financial Reporting Council

Consultation on assumptions for Statutory Money Purchase Illustrations

5

Assumptions for Statutory Money Purchase Illustrations

Background

5.1 In this chapter, which was written by the FRC, we consider the consistency of assumptions used for Statutory Money Purchase Illustrations (SMPIs) and those in COBS 13 of the FSA Handbook. In particular we consider whether there should continue to be a maximum accumulation rate specified for SMPIs, and, if so whether that rate should be the same as the FSA's intermediate projection rate.

5.2 There has been a requirement for members of certain money purchase pension arrangements to be given annual SMPIs since 6 April 2003. The FRC, through its Board for Actuarial Standards (BAS), sets standards for the actuarial methods and assumptions to be used in SMPIs through its Actuarial Standard Technical Memorandum 1: Statutory Money Purchase Illustrations (AS TM1).

Consistency of projections

5.3 The FRC and the FSA consider that there is merit in using consistent assumptions and methods for SMPIs and FSA-regulated projections. Consistency helps consumers to compare different projections and also makes issuing projections simpler for providers.

5.4 There might, however, be justification for different approaches in some areas, as SMPIs serve a different purpose to some FSA-regulated projections, which are issued before a sale is completed.

5.5 We are therefore seeking views on the benefits of consistency between AS TM1 and the assumptions specified in section 13 of the FSA's Conduct of Business sourcebook (COBS), in the areas discussed below.

Financial assumptions

Maximum accumulation rate

5.6 The accumulation rate for SMPIs must take account of the expected returns from the current and anticipated future investment strategy of the member's funds over the period to the retirement. It is important that providers, and the actuaries advising them, specify an accumulation rate which is justifiable.

5.7 Actuarial Standard TM1 specifies that the maximum accumulation rate of funds before retirement which may be assumed is 7% per annum. This is the same as the FSA's current intermediate rate for pension scheme projections required by COBS 13 Annex 2.

5.8 In March 2010 we consulted on whether the maximum accumulation rate should be reduced from 7% per annum. Nearly all respondents considered that the maximum rate should remain at 7% for consistency with the FSA's intermediate rate. We decided not to change the rate and to revisit the matter when the FSA next reviewed its assumptions.

5.9 We also considered whether AS TM1 should continue to specify a maximum accumulation rate. If a maximum rate was not specified, providers would not be able to use that rate as a default. However, providers should in any event be taking account of the underlying investment strategy when determining the rate before applying the maximum. A maximum prevents speculative returns being assumed, but this is perhaps less likely to happen for SMPIs than for projections made when a product is being sold. We are seeking views on whether AS TM1 should continue to specify a maximum rate.

5.10 We have considered the recommendations in PwC's report and the FSA's rationale in Chapter 4 for reducing the intermediate rate from 7% per annum to 5% per annum. We wish to seek views on two alternative approaches to the maximum accumulation rate in AS TM1. The first is for a maximum of 5% per annum so that there continues to be consistency between the COBS intermediate rate and the AS TM1 maximum rate. The second is to have no maximum, so that the rate could be more than 5% per annum if this is justified by the expected returns from the member's current and anticipated investment strategy.

Inflation

5.11 Actuarial Standard TM1 specifies the rate of inflation used to convert a projected pension at retirement into today's prices. This rate is currently specified as 2.5% per annum, the same as the rate specified in COBS 13 Annex 2 in the FSA Handbook.

5.12 In its report, PwC uses an inflation assumption of 2.5% for the GDP deflator.[8] The justification for this rate is described in section 3 of the report. Having considered the PwC analysis, we do not propose to change the current inflation assumption of 2.5% specified in AS TM1.

Mortality assumptions

5.13 The mortality assumptions to be used in SMPIs were changed in version 2.0 of AS TM1, which was published in December 2011.[9] These mortality assumptions are gender neutral and are based on a blend of male and female mortality tables.

5.14 In chapter 2 the FSA states that it proposes to adopt the same approach, but to be more specific about how the tables are blended. In particular, it is proposed that providers should determine male and female mortality rates inclusive of improvement factors before blending the two resulting rates. We consider that moving to a consistent approach by specifying the same approach in AS TM1 will be helpful to firms. So we are seeking views on whether AS TM1 should include similar wording to the FSA rules for the mortality assumption.

Impact assessment

5.15 The proposals seek to ensure greater consistency between SMPIs and the point-of-sale illustrations required by the FSA. Buyers of FSA-regulated products might find it helpful to have greater consistency between the illustrations they receive at point of sale and the illustrations they receive subsequently. There will be less impact on occupational pension schemes which are not regulated by the FSA, although greater consistency may be helpful for members of such schemes who buy or hold separate personal or stakeholder pensions regulated by the FSA. Providers should already have the capacity to change their systems and processes to reflect any change to the accumulation rate without incurring any significant incremental costs.

5.16 If we remove the maximum accumulation rate, this might lead to inconsistency with FSA-regulated illustrations in some cases, although AS TM1 will still require providers to ensure that the accumulation rate used is justifiable. Providers must also ensure that the method used to set the accumulation rate is consistent from year to year.

8 The GDP deflator is a measure of inflation in the domestic economy.
9 TM1 version 2.0 published December 2011

Next steps

5.17 Subject to consideration of the responses to this consultation we intend to publish an exposure draft of a revised version of AS TM1 (version 2.1) in October 2012. This revised version would include the reduction to the maximum accumulation rate, and would bring the wording for the mortality in line with the proposed approach for chapter 13 of COBS.

5.18 Given the specific nature of the changes that will be reflected in this exposure draft, we propose having a four-week consultation period, with the revised version of AS TM1 being published by the end of 2012. A longer consultation would result in a later publication date. We intend that the changes will be effective for SMPIs with illustration dates on or after 6 April 2013.

5.19 The FRC would be interested in respondents' views on the proposed four-week consultation period.

Questions

5.20 We would welcome views on the following issues:

Q1: Do you agree that the assumptions in AS TM1 should be consistent as far as possible with those specified in COBS 13 Annex 2 of the FSA Handbook?

Q2: a) Should AS TM1 continue to specify a maximum accumulation rate?

b) If AS TM1 continues to specify a maximum accumulation rate, should it be the same as the FSA's intermediate projection rate?

c) If your answer to b) is 'No', what rate should be specified in AS TM1?

Q3: Should the wording for the mortality assumption in AS TM1 be changed along the lines of the wording proposed in Chapter 2?

Q4: Given the proposed nature of the changes to AS TM1, do respondents envisage any difficulties with a four-week consultation period for an exposure draft of a revised version of AS TM1?

Q5: Do you agree with our proposals for the timing of any changes?

Q6: Do you have any comments on the impact assessment for our proposals?

Responses to this chapter

5.21 Responses should reach the FRC by 31 August. For ease of handling, we prefer comments to be sent electronically to TM1@frc.org.uk

5.22 Comments may also be sent in hard copy to:

The Director of Actuarial Policy
The Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Annex 1

Compatibility statement for Chapters 2 to 4

Introduction

1. In this annex we set out our view on how our (FSA) proposals and draft rules in Chapters 2 to 4 of this CP are compatible with our general duties under Section 2 of FSMA and our regulatory objectives set out in Sections 3 to 6 of FSMA. We also outline how our proposals are consistent with the principles of good regulation (also in Section 2 of FSMA), to which we must 'have regard'.

Compatibility with our statutory objectives

2. The proposals outlined in this CP are designed to help us meet our statutory objectives of maintaining confidence in the financial system and securing the appropriate degree of protection for consumers. We do not consider that our proposals have any material impact on our financial crime or financial stability objectives.

Market confidence

3. The proposals in Chapters 2 to 4 are intended to ensure that information provided to consumers is on a basis that is consistent with market conditions and does not give rise to unrealistic expectations on the part of consumers who buy, or who already have, pensions or other non-MiFID packaged products.

Consumer protection

4. The amended disclosures for consumers will ensure an appropriate level of information for consumers. They are designed to ensure consumers are not misled on the potential

retirement income or other benefits they may receive when provided with a projection of their potential benefits. Overall, we consider our proposals will provide consumers with a more realistic projection of their potential benefits and will improve consumer confidence in the market for pensions and other packaged products.

Compatibility with the principles of good regulation

5. Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation.

The need to use our resources in the most efficient and economic way

6. Our proposals build on or update existing requirements, and so do not place onerous new requirements on either firms or supervisors.

The responsibility of those who manage the affairs of authorised persons

7. Our proposals do not interfere in any way with the responsibility of firms' senior management, but rather allow firms to adopt an approach that is consistent with their business model and tailored to the needs of their customers.

The principle that a burden or restriction that is imposed should be proportionate to the benefits

8. We have carried out a CBA for all our proposals. We are satisfied that the costs of our proposals are proportionate to the benefits.

The desirability of facilitating innovation

9. Our proposals are not expected to hinder innovation, but allow a flexible approach, subject to firms meeting the overarching requirement for communications to be clear, fair and not misleading.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

10. We do not consider that these proposals will adversely affect the competitive position of the UK.

The need to minimise the adverse effects on competition

11. We do not consider that our proposals will have a material effect on competition.

The desirability of facilitating competition

12. We do not consider that our proposals will have a material effect on competition.

Acting in a way that we consider most appropriate for the purpose of meeting our statutory objectives

13. The proposals in this CP are designed to help us meet our objectives of maintaining confidence in the market and protecting consumers, by ensuring that consumers are not given unrealistic information on potential future benefits. So, we consider the proposals to be the most appropriate for meeting our statutory objectives.

Annex 2

List of questions

Chapters 2 to 4 – FSA consultation

Q1: Do you agree with the new revised mortality basis? If not, please explain what alternative basis you think is more appropriate.

Q2: Do you agree with the timing for the introduction of the new mortality basis? If not, please describe the approach you believe should be taken.

Q3: Do you have any comments on the cost benefit analysis for our proposals in Chapter 2?

Q4: Do you agree with the assumption for CPI-linked revaluation in deferment? If not, please state the level at which you believe the assumption should be set and why you believe it is more suitable.

Q5: Do you agree with the approach and level of the assumptions for pension increases based on CPI? If not, please explain what alternative basis you think is more appropriate.

Q6: Do you have any comments on the cost benefit analysis for our proposals in Chapter 3?

Q7: Do you agree that this change of wording provides sufficient additional emphasis for providers regarding our longstanding requirement that they use appropriate projection rates?

Q8: Do you agree that the proposed changes to these assumptions are appropriate? If not, what changes would you propose? Please explain why you would make other proposals.

Q9: Do you agree with the cost benefit analysis for our proposals in Chapter 4?

Chapter 5 – FRC consultation

Q1: Do you agree that the assumptions in AS TM1 should be consistent as far as possible with those specified in COBS 13 Annex 2 of the FSA Handbook?

Q2:
a) Should AS TM1 continue to specify a maximum accumulation rate?
b) If AS TM1 continues to specify a maximum accumulation rate, should it be the same as the FSA's intermediate projection rate?
c) If your answer to b) is 'No', what rate should be specified in AS TM1?

Q3: Should the wording for the mortality assumption in AS TM1 be changed along the lines of the wording proposed in Chapter 2?

Q4: Given the proposed nature of the changes to AS TM1, do respondents envisage any difficulties with a four-week consultation period for an exposure draft of a revised version of AS TM1?

Q5: Do you agree with our proposals for the timing of any changes?

Q6: Do you have any comments on the impact assessment for our proposals?

Appendix 1

Draft Handbook text for Chapters 2 to 4

Annex 1: Conduct of Business sourcebook (Mortality assumptions for future annuity projections) Instrument 2012

Annex 2: Conduct of Business sourcebook (Projections) Instrument 2013

CONDUCT OF BUSINESS SOURCEBOOK (MORTALITY ASSUMPTIONS FOR FUTURE ANNUITY PROJECTIONS) INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making power);
(b) section 149 (Evidential provisions); and
(c) section 156 (General supplementary powers); and

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 21 December 2012.

Amendments to the Handbook

D. The Conduct of Business sourcebook (COBS) is amended in accordance with the Annex to this Instrument.

Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (Mortality Assumptions for Future Annuity Projections) Instrument 2012.

By order of the Board
[*date*]

Annex

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

13 Annex 2 Projections

…

R			
3	How to calculate a projection for a future annuity		
3.1	A *projection* for a future annuity must:		
	(1)	be calculated by rounding all factors to three decimal places before applying them to the relevant retirement fund;	
	(2)	~~be based on the mortality tables PMA92 and PFA92, using the medium cohort projection based on year of birth mortality rates~~ use a mortality rate based on the year of birth rate derived from each of the Institute and Faculty of Actuaries' Continuous Mortality Investigation tables PCMA00 and PCFA00 and including mortality improvements derived from each of the male and female annual mortality projection models, in equal parts;	
	(3)	[deleted]	
	(4)	(for an annuity where two lives are concerned):	
		(a)	reflect the age difference between the two lives; or
		(b)	be based on the assumption that the male life is three years older than the female (if the genders differ) or the two lives have the same age (if the genders are the same);
	(5)	include an expenses allowance of 4%;	
	(6)	be based on the following rates of return as appropriate:	

…

E	
3.1A	For any year commencing 6 April, the use of the male and female annual CMI Mortality Projections Models in the series CMI(20YY-1)_M_[.25%] and CMI(20YY-1)_F_[1.25%], where YY-1 is the year of the Model used, will tend to show compliance with *COBS* 13 Annex 2 3.1R(2).

CONDUCT OF BUSINESS SOURCEBOOK (PROJECTIONS) INSTRUMENT 2013

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making power); and
(b) section 156 (General supplementary powers); and

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on xxxx 2013.

Amendments to the Handbook

D. The Conduct of Business sourcebook (COBS) is amended in accordance with the Annex to this Instrument.

Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (Projections) Instrument 2013.

By order of the Board
[*date*]

Annex

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

13 Annex 2 Projections

…

R			
Assumptions: rates of return			
2.3	A *standardised deterministic projection* must be calculated using <u>rates that accurately reflect the investment potential of the product and do not exceed</u> the following <u>maximum</u> rates of return:		
Nominal rates	Lower rate	Intermediate rate	Higher rate
tax-exempt business held in a *wrapper* or by a *friendly society* *personal pension schemes*, *stakeholder pension schemes* and investment-linked annuities	~~5%~~ <u>2%</u>	~~7%~~ <u>5%</u>	~~9%~~ <u>8%</u>
all other products	~~4%~~ <u>1½%</u>	~~6%~~ <u>4½%</u>	~~8%~~ <u>7½%</u>

R		
Exception		
2.4	A *standardised deterministic projection*:	
	(1)	~~must be calculated using lower rates of return, if the rates described in this section overstate the investment potential of the product;~~ [deleted]
	(2)	may be calculated using a lower rate of return if a retail client requests it.

…

19.1 Pension transfers and opt-outs

Preparing and providing a transfer analysis

…

19.1.4 R When a *firm* compares the benefits likely to be paid under a *defined benefits pension scheme* with the benefits afforded by a *personal pension scheme* or *stakeholder pension scheme* (*COBS* 19.1.2R(1)), it must:

(1) assume that:

(a) the annuity interest rate is the intermediate rate of return appropriate for a level or fixed rate of increase annuity in ~~(~~*COBS* 13 Annex 2 3.1R(6)~~)~~) unless *COBS* 19.1.4BR applies or the rate for annuities in payment (if less);	
(b) the retail prices index is	2.5%
(c) the average earnings index and the rate for section 21 orders is	4.0%
(d) for benefits based on the retail prices index, the pre-retirement limited price indexation revaluation is	2.5%
(e) the annuity rate for post-retirement limited price increases based on the retail prices index with maximum increases less than or equal to 3.5% or with minimum increases more than or equal to 3.5% is the rate in (a) above; otherwise it is the rate in (f) below;	
(f) the index linked pensions rate for pension benefits linked to the retail prices index is the intermediate rate of return in *COBS* 13 Annex 2 3.1R(6) for annuities linked to the retail prices index unless *COBS* 19.1.4BR applies;	
(g) the mortality rate used to determine the annuity is based on the year of birth rate derived from each of the Institute and Faculty of Actuaries' Continuous Mortality Investigation tables PCMA00 and PCFA00 and including mortality improvements derived from each of the male and female annual mortality projections models, in equal parts;	
(h) for benefits based on the consumer prices index, the pre-retirement limited price indexation revaluation is	2.0%
(i) the index linked pensions rate for pension benefits linked to the consumer prices index is the intermediate rate of return in *COBS* 13 Annex 2 3.1R(6) for annuities linked to the retail prices index plus 0.5% unless *COBS* 19.1.4BR applies in which case it is the annuity interest rate in *COBS* 19.1.4BR plus 0.5%;	
(j) the annuity rate for post-retirement limited price increases based on the consumer prices index with maximum increases less than or equal to 3.0% or with minimum increases more than	

or equal to 3.0% is the rate in (a) above; otherwise it is the rate in (i) above;	

or use more cautious assumptions;

(2) calculate the interest rate in deferment; and

(3) have regard to benefits which commence at difference times.

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