Consultation Paper

CP12/4**

Financial Services Authority

Pension Transfer Value Analysis Assumptions

FSA®

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 27 March 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12_04_response.shtml.

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Abbreviations used in this paper

BAS	Board for Actuarial Standards
CMI	Continuous Mortality Investigation
COBS	Conduct of Business sourcebook
CP	Consultation Paper
CPI	Consumer Prices Index
DB	Defined Benefit
DWP	Department for Work and Pensions
ECJ	European Court of Justice
FSMA	Financial Services and Markets Act 2000
KFI	Key Features Illustration
LPI	Limited Price Indexation
PSD	Product Sales Data
RPI	Retail Prices Index
SMPI	Statutory Money Purchase Illustration
TPR	The Pensions Regulator
TVA	Transfer Value Analysis
TVAS	Transfer Value Analysis System

1 Overview

Introduction

1.1 This consultation paper (CP) presents proposals for changes to our rules and guidance on pension transfer value analysis assumptions in the Conduct of Business sourcebook (COBS) 19.1, *Pensions supplementary provisions: pension transfers and opt-outs*. The proposed changes outlined in this paper are intended to clarify and update the assumptions and guidance to be used when a firm compares the benefits likely to be paid under a defined benefit (DB) pensions scheme with the benefits provided by a personal pension scheme or stakeholder pension scheme (COBS 19.1.2 R (1)).

1.2 We intend that the proposed Handbook rules (see Appendix) will come into force when the instrument is made and published. This Overview sets out information relevant to the proposed changes outlined in this CP.

Background

1.3 The last few years have seen a trend in employers moving away from offering DB pension schemes to defined contribution. The main reason for this is the increasing cost to the employer of maintaining DB schemes as investment returns have dropped and life expectancies improved.

1.4 As a result, some employers with DB schemes are offering members the opportunity to transfer their benefits out of a DB scheme to a personal pension by offering a transfer value that reflects the value of the benefits given up and, in many cases, an incentive above that amount. COBS lay out a basis for the calculation of the benefits given up when members transfer to a personal pension (referred to in this paper as 'the basis').

1.5 Transfer value analysis (TVA) is the advisory process of comparing the benefits being given up from a DB pension scheme with those that could be offered by a personal pension scheme. It is regarded as a complex, high risk area and so recommendations require sign-off

from a pension transfer specialist: we have extra rules in COBS 19.1 that pension firms advising in this area must comply with.

1.6 The rules in COBS 19.1 require a pension transfer specialist to compare (on reasonable assumptions) the benefits likely to be paid under a DB scheme with the benefits possible from a personal pension scheme, before it advises a retail client to transfer out of the DB scheme. We would expect the starting point to be that a transfer will not be in the client's best interests.

1.7 The financial advisory firms undertaking the analysis mostly use an automated Transfer Value Analysis System (TVAS) which, given a monetary transfer value, calculates the return required from the personal pension fund for it to provide the same benefits as those given up in the DB scheme.

1.8 The quantitative analysis in a TVA is dependent on a number of economic and demographic assumptions for which the values are laid out in COBS. We review the economic assumptions for their continuing validity in line with other assumptions used for projecting benefits (i.e. for point of sale illustrations) and demographic assumptions are reviewed as needed. Where assumptions are being misused or are out of date, it will result in unrealistic outputs from the analysis and the potential for consumer detriment if members are advised to transfer inappropriately.

1.9 From time to time, ad hoc changes may be required, e.g. to reflect other regulatory changes, or where we become aware of market abuse of policy intent. In recent months, we have been advised of potential misuse of the existing assumptions, particularly in valuing pension increases in retirement. Feedback from the industry suggests that the basis is being interpreted in different ways and that clarification is required. In addition, there have been other regulatory changes (i.e. the Test Achats gender discrimination judgement and the use of Consumer Price Index (CPI) rather than Retail Price Index (RPI) in many occupational DB pension schemes) which now require us to review our assumptions for TVA.

Summary of the proposals

1.10 The TVA assumptions that have created concern in the market and will be addressed in the consultation, are:

i. the mortality assumption for TVAS when placing a value on annuity benefits. We propose to update the mortality basis to be consistent with the Board for Actuarial Standards' (BAS) Statutory Money Purchase Illustration (SMPI) mortality basis, such that the cost of replicating benefits in a personal pension scheme will allow for both general updating of the basis and implementation of gender equal rates;

ii. the introduction of an explicit CPI assumption for revaluation of pensions in deferment, at a rate to be determined when we next consider the continuing validity of our projection rates;

iii. valuing CPI-linked pension increases. We propose to require CPI-linked benefits to be valued using the same interest rate assumption as is used for RPI-linked annuities; and

iv. the assumption for valuing pension increases that have Limited Price Indexation (LPI). We propose that LPI annuities be valued on the same assumptions as RPI annuities.

1.11 We also propose a requirement for TVA comparisons to be illustrated using a growth assumption that takes account of the member's attitude to risk and the recommended personal pension assets, as well as being conservative enough to reflect that the member has taken on the investment and longevity risks.

1.12 The following questions are asked in the CP:

Q1: Do you agree with the revised mortality basis? If not, please explain what alternative basis you think is more appropriate and why you consider that alternative basis would be more appropriate.

Q2: Do you agree with our proposals for CPI-linked revaluation in deferment? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

Q3: Do you agree with our proposals for CPI-linked pension increases? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

Q4: Do you agree with our approach to LPI pension increases? If not, please explain how your alternative solution would operate from a practical perspective.

Q5: Do you agree that the annuity interest rate should continue to be reviewed annually? If not, describe the approach you believe should be taken and why you believe it would be more suitable.

Q6: Do you agree that there is a need for the proposed guidance? If not, please indicate why you disagree.

Q7: Do you have any comments on the cost benefit analysis?

Next steps

1.13 This consultation period closes on 27 March 2012. We will then finalise any changes to the Handbook in light of responses to this Consultation Paper. After this, we intend to publish a Policy Statement providing feedback and setting out the finalised rules and guidance.

1.14 We intend that the final Handbook rules will come into force when the instrument is made and published.

Equality and diversity

1.15 We have considered the likely equality and diversity impact of our proposals. Specifically for the updated mortality assumption, the assessment shows that new gender equality factors add 4% to the cost of annuity purchase for single males, and similarly reduce it by about 4% for single females. The change to the gender equal factors reflects the decision of the European Court of Justice (ECJ) in the Test Achats judgement which looks to promote equality between men and women by removing recognition of the sex of policyholders as a risk factor in calculating premiums and benefits. Any comments from respondents on this assessment are welcome.

Pre-consultation

1.16 We have discussed our proposals with a range of stakeholders, including relevant trade bodies, representatives of the actuarial profession, consumer groups and individual firms. We have also consulted the Consumer Panel, the Practitioner Panel and the Small Business Practitioner Panel. We have worked closely with the Department for Work and Pensions (DWP) and have also discussed the proposals with the Pensions Regulator (TPR). We would like to thank all who have contributed to these discussions and helped form our proposals.

Who should read this Consultation Paper?

1.17 This paper will be of interest to:

Regulated firms:

- financial advisory firms advising on pension transfers; and
- pension providers receiving transfer business.

Non-regulated firms:

- software providers specialising in pension transfer software for advisory firms;
- employer sponsors of defined benefit pension schemes; and
- employee benefit consultancies.

CONSUMERS

This paper focuses on meeting our consumer protection objectives by reducing the risks of consumer detriment if consumers are advised to transfer their pension benefits inappropriately.

The proposals in this paper will affect members of a DB pension scheme who are considering a transfer to a personal or stakeholder pension. This paper will, therefore, be of interest to consumers and their representative groups.

2

Proposed changes to TVA assumptions

2.1 In this chapter, we provide our views on TVA and discuss our proposed changes to the rules and guidance on the TVA assumptions in COBS 19. These changes result from both external regulatory changes and general market intelligence acquired by talking to firms (regulated and non-regulated) that are active in this market as well as our supervisory reviews of TVA.

2.2 These proposals do not include changes that may arise from the regular review of our projection rates. Any changes arising from that review will be consulted on separately.

Our position on TVA

2.3 The regulatory responsibilities for transfer exercises extend beyond the FSA, so we continue to work closely with the government and with other regulators to minimise detriment to members of DB schemes who are considering a transfer to a personal pension scheme.

2.4 We regard advice on TVA as a high risk area and we have been, and will continue to be, active in supervising it. We have become particularly concerned at the mechanistic approach taken to some corporate TVA exercises. Such an approach depersonalises the advice process with consequent risks to the suitability of the recommendation for the person concerned.

2.5 In particular, we have seen a number of cases where advisory firms are not providing sufficient justification for recommending a transfer, or where the reasons given are not specific to the member in question. Frequently in the files we review there is too much reliance on the member's attitude to risk relative to the 'critical yield'.[1] We also see members with different attitudes to risk being advised to invest in the same fund with little or no justification other than that it is the 'default'. Firms should consider their risk

1 COBS 19.3.3G(3) provides guidance that the comparison should explain the rates of return that would have to be achieved to replicate the benefits being given up. In this paper, we use the commonly-used industry phrase 'critical yield' to describe these rates.

profiling procedures in the light of the good practice identified in our guidance on 'Assessing Suitability'.[2]

2.6 We have also seen a lack of clarity about the limitations of the advice, for example the advice only relates to the transfer recommendation. Even where the limited nature of the service is disclosed, the advice needs to be suitable. If there is no suitable course of action, then no personal recommendation should be given to the member. Our rules do not prevent advisers from providing other services at the same time as they provide advice on the transfer, or from combining the recommendations, subject to the client agreements that have been put in place.

2.7 We also have concerns about the way in which some advisers promote their services to employers undertaking transfer exercises, for example, on the basis of a 'successful' take-up rate. Successful advice is suitable advice – this does not necessarily result in a high proportion of members transferring. We subscribe to TPR's view that a transfer offer is likely to be suitable for a minority '*and, very possibly, a small minority*' of members.[3]

2.8 Adviser firms must think more about how the comparison and the recommendation are presented to members, as well as members' ability to understand the long documents that they are being given. We have seen very little evidence that firms consider how well members are able to comprehend the information that is supposed to help them make an informed decision. We strongly urge firms to reconsider the style and length of such documents which, when presented poorly, increase the risk of the documents not being read.

2.9 We have often seen tick-box style compliance with the assumptions laid out in COBS 19 1.4R. There is evidence that firms are not thinking about these assumptions or their ability to vary the assumptions to be more cautious. There is a heavy dependence on software and, in some cases, advisers are lulled into a false sense of security. Firms need to reassess their practices.

Mortality basis

2.10 When preparing a TVA, an annuity factor is determined to place a value on the annuity that may be purchased from the vesting personal pension fund. Currently, the mortality basis used for the annuity factor is based on the PA92 year of birth tables with medium cohort improvements, as laid out in COBS 13 Annex 2. However, the 92 series of mortality tables are generally no longer used by insurers for pricing annuities as they now understate longevity.

2 *Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*, March 2011 (www.fsa.gov.uk/pubs/guidance/fg11_05.pdf)

3 The Pensions Regulator: Regulatory Guidance on Incentive Exercise (www.thepensionregulator.gov.uk/guidance/incentive- exercises.aspx)

2.11 In reviewing this aspect of the basis, we have spoken with the BAS who recently reviewed the mortality basis for Technical Memorandum 1 (TM1)[4], the standard that lays out the assumptions for annual pension statements (SMPIs). A member who transfers to a personal pension scheme will receive a SMPI each year, so it would be sensible for the basis on which the transfer is assessed to be consistent with the basis on which the individual would receive projections of their benefits.

2.12 During the course of discussions in 2011, the ECJ published its ruling on the Test Achats case.[5] The ruling bans the use of gender as a rating factor in insurance contracts from 21 December 2012. As this will affect the cost of the annuity that may be purchased by transferring members in due course, it follows that the TVA should be based on gender equal mortality rates.

2.13 We are proposing that the mortality basis should use the 2000 series of tables with future improvements based on the latest Continuous Mortality Investigation (CMI) model, as follows:

- Base table: 50% of PCMA00 + 50% of PCFA00, on a year of birth basis;
- Improvements: 50% of CMI_(20yy-1)_M[1.25%] + 50% of CMI_(20yy-1)_F[1.25%] where 20yy is the 12 month period starting 6 April 20yy.

This is the same as the basis for SMPIs in TM1.

2.14 For a single male, currently aged 45 and with approximately 20 years to retirement, we estimate that the effect of the updated basis, including the gender equality factor, will be to increase the value of the annuity benefits by approximately 11%, of which some 7% is attributable to the updated basis and 4% to the application of gender equal rates. The impact is lower for females as, while the general updating of the mortality basis increases the cost, the impact of the gender equality factor will reduce it again. For joint life annuities, the general updating of the basis will increase the cost but the impact of the gender equality factor will be small.

2.15 This means that, if the basis did not change, the cost of replicating the benefits of the DB scheme in the personal pension scheme for a transferring member could fall short by 11% for a single male. Although the effect of the Test Achats case has been known for a year, we have no evidence to suggest that any advisory firms are taking it into account when making recommendations on TVA despite the fact that most transferred members will not purchase annuities until after 21 December 2012. This is despite COBS 19.1.4R being clear that more cautious assumptions than those stated may be used when undertaking TVA.

2.16 In due course, we also expect to consult on implementing the same mortality basis for personal pension Key Features Illustrations (KFIs). However, the very specific targeting of personal pension benefits to replicate those in the DB scheme as part of a TVA makes the

4 Board for Actuarial Standards, Technical Memorandum 1 v2.0, December 2011 (www.frc.org.uk/images/uploaded/documents/TM1%20v2%200%20final.pdf)

5 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62009CJ0236:EN:HTML

need for change more urgent. We accept that, in the meantime, there will be an inconsistency in the comparison report and the KFI received by the transferring member.

Q1: Do you agree with the revised mortality basis? If not, please explain what alternative basis you think is more appropriate and why you consider that alternative basis would be more appropriate.

Consumer Price Indexation

2.17 As a result of changes in legislation in 2011, many occupational pension schemes are now using the CPI rather than the RPI as a measure of price increases. This impacts in two areas when considering TVA:

- revaluation in deferment; and
- pension increases.

2.18 While our rules contain a specific assumption for limited price revaluation and pension increases linked to RPI, there are no such assumptions based on CPI and we consider the implication of introducing explicit CPI assumptions here.

CPI-linked revaluation in deferment

2.19 When an active scheme member becomes a deferred scheme member, their accrued pension benefit (subject to when it was first accrued) is increased (revalued) each year up to their normal retirement date to protect the value from being eroded by inflation. So when the member is considering transferring their benefits out of the scheme, an assumption on the rate of revaluation is necessary to try and replicate the value of the benefits being given up.

2.20 Our rules currently define a rate of pre-retirement limited price indexation revaluation that is set to the same value as the RPI assumption. In light of the introduction of CPI-linked revaluation, we have considered the need for an explicit limited price indexation assumption based on CPI.

2.21 The introduction of CPI rather than RPI for revaluation is expected to reduce the costs of a DB scheme for the sponsoring employer. CPI has usually been lower than RPI since it was introduced in 1996 and it is generally expected that this will continue. The two measures are also calculated differently, which contributes to part of the difference, with variation in the other components of the indices making up the difference.

2.22 The introduction of a revaluation rate based on CPI rather than RPI would place a lower value on the benefits being transferred, which is consistent with the concept of CPI being less costly. For a transferring member with 20 years to retirement, a CPI-based revaluation

assumption set, for example, at 0.75% below the current RPI assumption would reduce the transfer value required to replicate the benefits by about 15% (7% for 10 years).

2.23 From a practical perspective, we believe that the implementation of a revaluation rate based on CPI would be relatively straightforward.

2.24 We have not yet drafted a rule in respect of this change, but plan to consult on it in our review of the continuing validity of our projection rates. In the meantime, firms should not anticipate the introduction of the CPI-linked revaluation rate.

2.25 We also take this opportunity to remind firms that the revaluation rate in COBS 19.1.4R(1)(d) is fixed. Whereas the read across to COBS 13 Annex 2 3.1R for the annuity interest rate indicates that the annuity interest rate can be illustrated at low, intermediate and high rates, there is no such variability indicated for pre-retirement revaluation. Using a low, intermediate and high rate of revaluation with a low, intermediate and high rate of growth where the gaps between each rate are the same (e.g. +/- 2%) effectively illustrates the same outcome, all other things remaining equal. This dilutes the effect of demonstrating the potential variability of the personal pension and, in particular, the investment risk that the member would carry, if they transferred.

Q2: Do you agree with our proposals for CPI-linked revaluation in deferment? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

CPI-linked pension increases

2.26 Our rules currently define an annuity interest rate for RPI-linked annuities. This is adjusted to derive an annuity rate that is suitable for valuing level or fixed increase annuities. We currently have no assumption for valuing a CPI-linked annuity.

2.27 There are a variety of approaches being used by the industry to value CPI-linked benefits. We are concerned that some of the approaches may not be sufficiently conservative to prevent consumer detriment.

2.28 Determining an annuity rate for a CPI-linked annuity is not straightforward. The RPI-linked annuity rate is based on the yields of indices for RPI-linked government bonds. However, there are no CPI-linked government bonds and the Debt Management Office confirmed in December 2011[6] that there is no intention to start issuing CPI-linked gilts within the next 12 months, although they acknowledged that they may do so in future if there is sufficient demand. While an arbitrary adjustment could be applied to the RPI-linked annuity rate, the level of the adjustment would be difficult to determine without a market in CPI-linked assets.

6 Debt Management Office: CPI-linked gilts: response to consultation, November 2011 (www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons20111129.pdf&page=Gilts/Consultation)

2.29 We have reviewed the practice of other regulatory bodies. The legislation governing SMPIs is based on the assumption that all future benefits will be RPI-linked. Consequently, TM1 has a single annuity rate for valuing only RPI-linked benefits. We understand that the underlying premise of assuming that all benefits will be taken with inflation increases is currently under review by the DWP.

2.30 Following discussions with insurers in early 2011, the Pension Protection Fund found that insurers did not differentiate pricing for CPI-linked and RPI-linked annuities on a bulk buyout basis and that there had not been any bulk buyouts on a CPI basis. We believe this is still the case. They determined that there was no need to value CPI- and RPI-linked benefits on different assumptions for buyout valuations. For a scheme looking to reduce its liabilities, a bulk buyout is an alternative to offering the membership a chance to transfer out so provides a reasonable basis for comparison with the TVA assumptions.

2.31 Similarly, we have seen no evidence that insurers are offering CPI-linked annuities yet in the individual retail market. The implication of this is that a transferring member requiring any form of inflation-linked benefits would have to opt for RPI-linked benefits.

2.32 In light of this and the practical issues of determining a suitable CPI-linked annuity rate, we do not believe it is appropriate at present to determine a differentiated CPI-linked annuity rate. Given that the CPI-linked benefits cannot yet be replicated by insurance company products, we believe it is more appropriate for CPI-linked benefits to be valued using a RPI-linked annuity rate as this is what the member would have to purchase to have any form of inflation-linked annuity benefits. We recognise that this overstates the true cost of the benefits being transferred from the DB scheme.

2.33 However, firms should not rule out that different assumptions may be introduced in future for CPI-linked and RPI-linked increases if a market in CPI-linked annuities develops.

2.34 It follows that firms should take the approach set out in COBS 13, Annex 2 3.1R for CPI-linked annuities. Accordingly, we propose a rule amendment to COBS 19 to this effect.

> **Q3:** Do you agree with our proposals for CPI-linked pension increases? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

Limited Price Indexation

2.35 In some occupational schemes, while the pension increases may be linked to RPI, these may be subject to minimum underpins or schemes may impose ceilings on the pension increases awarded. These 'caps and collars' may be different for different layers of the benefit or those accrued at different times. Further, each scheme may apply increases in excess of the

minimum which, from a practical perspective, means that there are a vast number of cap and collar combinations. Any restriction of RPI pension increases is typically referred to as Limited Price Indexation (LPI).

2.36 Firms have told us that the assumptions in the rules for valuing LPI pension increases are being interpreted in different ways. This confusion seems to result from the interaction of the COBS 19 rules with those in COBS 13 Annex 2, which largely lays down the basis for KFIs. We understand that three scenarios are used to value LPI-linked benefits:

a) the RPI-linked annuity rate, *y*, from COBS 13 Annex 2;

b) the annuity rate from COBS 13 Annex 2 for level of fixed increase (y+3.5%) in conjunction with the explicit LPI assumption (2.5%) in COBS 19; and

c) the annuity rate from COBS 13 Annex 2 for level or fixed annuities (y+3.5%), following a determination by the user of the likely level of LPI if it were a fixed increase.

2.37 The different approaches clearly indicate that COBS 19 is not well understood. Firms should take into account the general requirement to use the assumptions unless they use a more cautious approach.

2.38 Our view is that a) above is suitably cautious. It values inflation-linked benefits using an inflation-linked interest rate. It potentially overstates the value of the benefits. Everything else being equal, this approach would result in a higher yield to retirement being required for the transfer for a given transfer value.

2.39 We can understand, given the wording in COBS 19, why b) above may have been considered. However, with the current assumptions and current market conditions, the real yield derived is unlikely to be attainable, much less guaranteed. On the current assumptions, it would result in a value of annuity benefit approximately 15% lower than a) above. For an individual with 20 years to retirement, this results in a difference of about 1% a year in the growth rate required to replicate the benefits of the DB scheme. Everything else being equal, there is significant potential for a transferring member to suffer detriment under this approach.

2.40 The approach shown in c) above is unsuitable. Inflation-linked benefits should not be valued using an annuity rate intended to value level or fixed increase benefits.

2.41 The impact of using approaches b) and c) could result in transfer values that are around 15% too low to purchase the benefits being given up unless the assets in which the consumer invests yield an extra 1% (over 20 years) over what might be considered reasonable. We understand that the use of different approaches has created friction in the marketplace between the different parties involved in transfer exercises.

2.42 Given the vast number of combinations of possible LPI pension increases, we do not believe it is appropriate for us to try and define an LPI assumption for each possible combination. Our discussions with the industry have led us to believe that it is more important that we clarify

the rules to state which of the existing approaches should be used by all parties. We propose that all LPI pension increases should be valued in the same way as RPI pension increases.

Q4: Do you agree with our approach to LPI pension increases? If not, please explain how your alternative solution would operate from a practical perspective.

Annual change of the annuity interest rate

2.43 The annuity interest rate used for TVA is the same as that used for point-of-sale KFIs. The current methodology for determining the TVA annuity interest rate was introduced in April 2003, following consultation. Respondents to that consultation agreed that the TVA annuity interest rate should be aligned with the illustration annuity interest rate and, similarly, that it should be determined once a year. However, there has been recent debate in the industry on whether the annual change is still appropriate or if a more frequent change should be considered.

2.44 The annual review means that long-term trends in the cost of annuity purchase are picked up in the annuity interest rate, rather than short-term fluctuations faced by those who are already at the stage of purchasing an annuity. We recognise that current rates are no indication of the annuity rate that may be in force at the time an individual comes to vest their pension fund.

2.45 In recent years, there has been a significant downward trend in the value of the annuity interest rate, defined as y in the sourcebook:

Year	Annuity interest rate (y)
2005	1.2%
2006	0.6%
2007	0.8%
2008	0.6%
2009	0.6%
2010	0.4%
2011	0.2%

2.46 The movement in y has mirrored the downward movement in market annuity rates over the period (as it should). The effect is to make the purchase of annuities more expensive. Therefore, for a given transfer value, a higher yield in the period to retirement would be required to purchase a given set of annuity benefits.

2.47 More specifically, since 2005, the fall in *y* has increased the typical cost of purchasing a RPI-linked annuity by about 15%. For someone transferring out of a DB scheme with 40 years to retirement, this would require an additional yield of approximately 0.3% a year. However, for someone with only 20 years to retirement, the additional yield would be close to 1% a year and for 10 years to retirement, about 1.4% a year. In practical terms, therefore, the level of *y* is often seen as key as to whether the 'green light' can be given for proceeding with a recommendation to transfer.

2.48 It is useful to consider the sensitivity of the annuity interest rate to smaller changes. Under the current formula, the smallest possible change in the rate is 0.2% as happened from 2010 to 2011. This increased the cost of purchasing benefits at age 65 by about 3%. The additional yield required in deferment would have been:

40 years to retirement	0.07%
20 years to retirement	0.15%
10 years to retirement	0.3%

2.49 If the annuity interest rate was calculated more frequently, these figures indicate the changes in the 'critical yield' that could result for small changes in *y*. They are significantly smaller than the changes resulting from the long-term trend.

2.50 Since the annuity interest rate was derived at the start of the 2011/2012 tax year, there has been a significant downward movement in the yields of the indices used to derive *y*. This seems to have been mirrored by market annuity rates and it appears that the formula itself remains a good indicator of current annuity rates.

2.51 However, for TVA, the movement in market annuity rates relative to *y* has created an inconsistency between the basis used by the scheme to calculate the transfer value offered to the member and that used by the adviser to determine whether or not the transfer is suitable. As market annuity rates fall, the cash equivalent transfer value increases. Everything else being equal, if advice is given on a TVA using *y* where *y* is higher than the rate used to determine the cash equivalent transfer value, the 'critical yield' will appear lower (than if the interest rates had been equal) making a recommendation to transfer more likely.

2.52 Since the current methodology for determining the annuity interest rate was introduced, such a rate of change in the indices underlying the calculation of *y* has been unprecedented in a single year. However, the economic situation has also been unprecedented. Such uncertainty also reduces the arguments in favour of trying to specify what the annuity rate might be at specific point in the future.

2.53 Irrespective of the rate of change in the indices over the last year, firms have told us that the annual change in the annuity interest rate has given rise to gaming the timing of corporate transfer exercises. We are concerned that changing the annuity interest rate more frequently may lead to an increase in such strategies.

2.54 We are also wary of introducing an inconsistency between the TVA basis and the KFI basis. When the annuity interest rate is the same for both, a KFI produced on the transfer value using a growth rate equivalent to the 'critical yield' should illustrate the same benefits as those from the DB scheme. Consistent assumptions are important for the member's understanding in making an informed decision (see next section) to transfer or not. If the TVA annuity interest rate is reviewed more frequently than that for KFIs, this consistency will be lost. We do not currently intend to review the annuity interest rate more frequently for KFIs.

2.55 Given the recent economic situation, the risk of gaming strategies being used in transfer exercises, and the importance of consistent consumer information, we do not intend, at this stage, to review the annuity interest rate basis more frequently, especially given COBS 19.1.4R(1) permits advisory firms to use more cautious assumptions. However, we will continue to monitor market interest rates inbetween annual reviews.

> **Q5:** Do you agree that the annuity interest rate should continue to be reviewed annually? If not, describe the approach you believe should be taken and why you believe it would be more suitable.

Illustrating the comparison

2.56 COBS 19 requires that the likely benefits under the DB scheme are compared with those that could be afforded by the personal pension scheme on reasonable assumptions. Further, the comparison must be given to the member and must contain sufficient information for the member to be able to make an informed decision about their continued participation in the DB scheme.

2.57 Over the last three years, we have undertaken a number of file reviews and have become increasingly concerned at the quality of the comparison provided to the member. Typically containing over 20 pages, the comparisons present a number of figures and charts to illustrate to the consumer the effect of different growth assumptions and the impact of retiring at different times. Firms appear to have done little over time to improve the quality of the comparison to ensure that it is meaningful to the member.

2.58 In the huge majority of comparisons provided to the member, the comparison has been illustrated, on a deterministic basis, both numerically and graphically at growth rates of 5%, 7% and 9%. These are the maximum growth rates for deterministic projections for pension KFIs in COBS 13. Whilst COBS 19 requires the comparison to be undertaken on reasonable assumptions, it does not state that it should necessarily be illustrated using these rates.

2.59 Alongside the comparison, the client may also receive a KFI. Our rules require that KFIs are prepared using deterministic growth rates, which do not overstate the investment potential

of the product, subject to the standardised maximums that are reviewed from time to time. This means that the client could receive a KFI that may be presented on one set of growth assumptions and a TVA comparison report that may be done on a different set of growth assumptions – but often higher.

2.60 We do not consider that providing a TVA comparison on a more optimistic set of assumptions than the KFI is reasonable. We believe that members will be confused by the different projections, making it even more difficult for them to make an informed decision on the transfer itself.

2.61 In the past, we have made it clear that using the maximum growth rates to prepare KFIs is inappropriate where the product is unlikely to achieve such rates. Similarly, firms providing TVA comparisons should not use those same maximum growth rates to illustrate the comparison where the product is unlikely to achieve those rates. However, neither is it appropriate simply to use the rates on the underlying KFI without considering further whether these are reasonable for each member's individual circumstances.

2.62 We have noted that a minority of firms are using stochastic techniques to illustrate the comparison. Typically, the graphical output from stochastic modelling shows a range of outcomes as well as an indication of the likelihood of these outcomes occurring. The stochastic projections of the personal pension within the comparison are prepared with regard to the rules on alternative projections of a packaged product in COBS 13 Annex 2 1.5R(3).

2.63 A key feature of an employer-sponsored transfer exercise is that the employer is undertaking a de-risking exercise, by trying to reduce the investment and longevity risk that they carry. The nature of any transfer is such that the investment and mortality risk is passed over to the transferring member. COBS 19 provides guidance to firms on advising clients of the advantages and disadvantages of the recommendation and we would expect, amongst others, that the transfer of investment and mortality risks would be explained.

2.64 Further, COBS 19 provides guidance to firms to consider the client's attitude to risk. It appears that, for most firms involved in advising on employer-sponsored transfer exercises, this is addressed by asking participating members to complete a questionnaire. Such questionnaires differ significantly and firms may find it useful to refer to the guidance document 'Assessing Suitability', mentioned earlier. It is clear to us that some questionnaires focus more on the potential upside of investment flexibility rather than on features such as the member's capacity to withstand loss. When considering moving from a DB scheme with fixed benefits, the consideration of the client's attitude to a capital loss must be a key consideration.

2.65 We have seen little indication, especially in deterministic comparisons, that the transfer of risk to the member and the member's capacity for carrying that risk are being considered when illustrating the comparison. Certainly, for a member who is relatively close to retirement,

cautious in their attitude to risk, and with little experience of investing, it is arguable that it should be illustrated using something more akin to a risk-free rate of growth.

2.66 We considered whether firms should be required to use stochastic techniques to determine a suitable adjustment to the growth rate, similar to those used to value investment and mortality guarantees. As the value placed on investment and mortality guarantees would vary for individuals of different ages and with different periods to retirement, such models could be helpful in determining adjustments to the growth rate. However, we recognise that the fixed benefits offered by the scheme are not guaranteed in this way as there may be uncertainty around the continued support of the employer, which may also be a factor for consideration. Having said that, we do believe that there is a place, in TVA, for stochastic illustrations that can convey these risks in a way that consumers can understand.

2.67 Our view is that firms should be using the existing guidance and incorporating the principles of attitude to risk and transfer of risk in the illustration of the comparison. We are proposing to include additional guidance in COBS 19 to emphasise this point.

2.68 This guidance reinforces the need to consider:

a) the growth rates likely to be achieved by the underlying assets; and

b) the need to assess whether any further reduction in the growth rate is necessary to reflect the transfer of risk.

> **Q6:** Do you agree that there is a need for the proposed guidance? If not, please indicate why you disagree.

Annex 1

Cost benefit analysis

1. 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.

The market

2. Our internal Products Sales Data (PSD) shows us that approximately 2,600 advisory firms are actively advising on pension transfers. We know that 12 to 15 of these are active in corporate transfer exercises that typically involve enhanced transfer values, although PSD does not indicate these separately. Transfer business is received by approximately 115 pension providers.

3. A 2011 KPMG survey[1], based on data from 10 national IFA firms that are active in the enhanced transfer market, indicated that enhanced transfers were offered to over 90,000 employees in the 39-month period from 2008 Q1 to 2011 Q1 inclusive. KPMG estimate that around half of all DB schemes are considering such exercises - that would cover 2.5 million individuals. If current take-up rates are maintained, KPMG estimate that around 750,000 transfers could be instituted that would release £100 billion of liability from DB schemes.

4. The potential detriment identified in this paper is calculated by reference to the figures given in the KPMG report although we have not verified them. However, other sources have told us privately that they believe the KPMG figures may underestimate future transfer business.

1 KPMG, August 2011: Enhanced Transfer Values, KPMG Pensions Survey

Compliance costs to firms

5. Advisory firms that are active in the transfer market typically use TVA software when assessing the merits of moving from a DB scheme to a personal pension scheme. The market for TVA software is dominated by two companies, both of which provide deterministic software. We are aware of one company providing stochastic modelling software for undertaking the analysis. In all cases, adviser firms pay a licence fee for use of the software. The licence fee includes the cost of updating the software and the assumptions as required. We have always made it clear that the assumptions could be reviewed from time to time.

6. From our discussions with the software companies, it appears that the software used for TVA is modern and flexible and the majority of changes proposed in this would be relatively simple for software providers to implement:

a) LPI pension increases

Typically, the software allows the user to choose from a number of options including our proposal that LPI pension increases should be valued at the RPI rate. Therefore, there would be no additional cost to providing this option, although software providers may choose to turn off the options that we have specified as not suitable.

b) CPI in deferment

The software already allows for an inflation rate in deferment. An option for CPI in addition to the existing RPI option will be required. However, the rate to use has not yet been determined. Based on information from software providers, we estimate that this is a relatively minor task, which requires minimal time for implementation and testing.

c) CPI pension increase

As with LPI, the software already allows for users to select from a number of options for valuing pension increases, including our proposed option of valuing them using the RPI-linked annuity rate. Therefore, we estimate that there would be no additional cost to providing this functionality although software providers may wish to remove other options from their software.

d) Mortality

We have always made it clear to the marketplace that we would review the mortality assumption from time to time. The basis we propose now uses a similar structure to the current basis in that it uses year of birth tables with an improvement factor. An additional weighting is applied to each of these to take account of the gender equality factor. However, in contrast to the existing basis, there would be ongoing costs in updating the improvement factors each year in line with the latest factors published by the CMI. Based on discussions with software providers, time would be needed to implement and test the new mortality basis. There would be additional costs incurred in updating the improvement factors each year although the timing of this is consistent

with the current timings for updating the annuity interest rate, which will make the process more efficient.

e) Illustrating the comparison

It is our understanding that the deterministic software enables advisers to choose between illustrating the comparison at the standardised maximum rates or at the rates used in the accompanying product provider's KFI. In order to comply with our new guidance that requires firms to consider the likely return on the assets in the personal pension scheme and the extent to which the transfer of risk from the DB scheme to the member should be reflected in the illustration, depending on the customer's appetite for risk, changes would be required that enable advisers to select the rates on which the comparison is illustrated. However, once the rates are selected, the functionality for the projection should be unchanged. As firms should already be considering the transfer of risk from the DB scheme to the consumer in conjunction with the member's attitude to risk, we believe that the costs to advisory firms associated with the additional guidance would be minimal.

Overall, we estimate that the changes to software can be done in under one month with a cost of no more than £20,000[2] for each of the three main software providers, or £60,000 in total. We would expect the ongoing costs associated with the annual update of the mortality basis to be around a quarter of the initial cost, or £15,000 in total.

Direct costs to the FSA

7. We do not expect any additional costs to be incurred by regulators as a result of these changes.

Market impacts

8. Our proposals will apply to all advisory firms undertaking TVA and should not impact unfairly on any specific type of firm. We recognise that the new guidance on illustrating the comparison may be less onerous for firms using software based on stochastic modelling than for those using deterministic projection software.

9. We recognise that, in some cases, the overall impact of our proposals would be to raise the 'critical yield', which is required in order to recommend the transfer. This may reduce the number of individual transfers if transfer values on offer are not increased. To demonstrate their independence from the employer, adviser remuneration is normally based on the provision of advice on TVA rather than on the number of transfers implemented. Consequently, any fall in the number of transfers should not impact significantly on their income, everything else being equal.

2 4 people full time for 1 month at £60,000 per annum = £20,000

10. However, our proposals may deter some employers who sponsor DB schemes from undertaking transfer exercises. This could reduce the quantity of TVA work for advisory firms, which could impact on their income.

11. Any reduction in the number of transfers could also reduce new business for pension product providers.

Benefits

12. While in most cases a transfer out of a DB scheme will not be in the members' interests, there will be a small minority of cases where it could be in the client's interests to transfer. Our rules aim to provide a fair basis for the comparison and to ensure individual members receive suitable advice that assists their decision. Our rules do not consider the wider issue of the continued ongoing existence of the DB scheme and/or the employer.

13. In the majority of cases, these proposals should increase the 'critical yield' necessary to recommend a transfer. As a result, fewer members should be transferring out of the DB scheme which should be in the members' interest. For those who choose to transfer out, the transfer value offered would have to be sufficiently high for a personal recommendation to transfer to continue to be suitable following these changes. The scale of benefits will depend on how many transfers currently take place below the resultant level under these proposals.

14. We consider that the changes proposed would deliver the following benefits for members:

a) LPI pension increases

Our proposals would clarify the annuity rate to be used for valuing LPI pension increases. Without this, there is a risk that firms may use a rate that undervalues the pension benefits by about 15%. The scale of benefits will depend on how many transfers currently take place below the proposed RPI annuity rate. If all firms used this unsuitable approach, it could undervalue LPI annuities by up to £15 billion.[3] Therefore, this proposal suggests that transfer value offers may have to be increased by up to £15 billion for a positive transfer recommendation and/or lead to fewer employees to transfer out of the DB scheme.

b) CPI in deferment

Our proposals to introduce an explicit rate for CPI in deferment, in response to revised government revaluation orders, would distinguish between members considering transferring from schemes with RPI revaluation and those considering transferring from schemes with CPI revaluation. In particular, it would ensure that members in schemes with CPI revaluation receive a comparison that is fair and does not overvalue their pension benefits. For a given transfer value, the growth rate required on the transfer value under this proposal would result in a lower value than if an RPI-linked revaluation rate was used.

3 Based on KPMG's estimate that £100 billion of enhanced transfers could be implemented over the next five years.

c) CPI pension increases

Currently, it is not possible for members moving from DB schemes with CPI-linked pension increases to personal pension schemes to replicate their benefits as there are no insurers offering CPI-linked annuities. Therefore, they would have to purchase an RPI-linked annuity to have any form of inflation-linked income. Our proposals would benefit members by ensuring that the TVA takes this into account when the comparison is prepared.

d) Mortality

The mortality basis needs to be reasonably reflective of the mortality pricing assumptions used by annuity providers to ensure that the TVA provides a fair representation of the average costs of purchasing an annuity. In particular, if the basis is not updated to reflect improvements in longevity, there is a risk that the TVA would undervalue the annuity benefits, potentially resulting in an unsuitable recommendation to transfer. In addition, the changes in annuity pricing that will be implemented by 21 December 2012 as a result of the Test Achats ruling need to be fairly represented in the mortality basis. For males, gender equal annuity rates would increase the cost of annuity purchase although for females, it should reduce. Overall, we estimate that our changes to the mortality basis would increase the value placed on annuity benefits in TVA by about £5 billion to £6 billion.[4]

e) Illustrating the comparison

Currently, most members receive a TVA comparison illustrated on one set of deterministic growth rates and a KFI that may be illustrated on another, often lower, set of deterministic growth rates. We consider that this is confusing for members and not conducive to making an informed decision about whether or not to transfer. Further, our supervision has indicated that few firms, particularly those using deterministic software to illustrate the comparison, consider whether the illustration adequately reflects the transfer of risk, in association with the customer's attitude to risk. We revisited some past file reviews to assess the benefit of our proposals and looked at cases where a transfer had been recommended but we had subsequently assessed it as unsuitable. There was some evidence that, where the KFI was illustrated on lower rates than the maximum, a lower growth rate on the TVA would have helped the advisory firm identify unsuitability more easily and so prevent consumer detriment. The proposed additional guidance on the growth rate for the illustration and being upfront on the fact that employees will give up the investment and mortality guarantees when accepting the transfer is consistent with the guidance that already exists in COBS 19 on explaining the advantages and disadvantages of the recommendation. Therefore we expect the benefits from the additional consideration of these factors in the illustration of the comparison to be limited for consumers (at minimum cost).

Q7: Do you have any comments on the cost benefit analysis?

4 Based on KPMG's estimate that £100 billion of enhanced transfers could be effected over the next five years.

Annex 2

Compatibility statement

1. In this section we set out how the approach on which we are consulting is compatible with our general duties under Section 2 of FSMA and with the regulatory objectives set out in Sections 3-6 of FSMA. We also outline how our proposals are consistent with our principles of good regulation to which we must have regard.

Compatibility with our statutory objectives

2. The proposals in Chapter 2 of this CP are consistent with our statutory objectives of securing the appropriate degree of protection for consumers and improving confidence in the financial system. Our proposals are designed to ensure consumers are not advised to transfer their pension when it is not in their best interests to do so. Overall, we believe our proposals will lead to higher standards for pension transfer advisory firms and will improve the quality of advice and consumer confidence in the market.

Compatibility with the principles of good regulation

3. Section 2(3) of FSMA requires us to consider certain principles when discharging our general functions. We set out below how our approach supports these principles.

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

4. As indicated in Annex 1, we do not expect any additional costs to be incurred by the FSA as a result of these changes.

The responsibilities of those who manage the affairs of authorised persons

5. The proposals do not have an effect on the responsibilities of the senior management of authorised firms beyond those currently required by our Principles for Business and Senior Management arrangements. Our proposals form rules and guidance in the Handbook and

it remains the responsibility of senior management to ensure the rules are effectively implemented, whether by using this guidance or by other means.

The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions

6. We believe the benefits of consumer protection outweigh the compliance costs to firms stated in the CBA.

The desirability of facilitating innovation

7. As stated in the CBA we recognise the effect of our proposals may reduce individual pension transfer activity and may deter some employers who sponsor DB schemes from undertaking transfer exercises. However, to the extent that this is the result of more appropriate advice and decision-making, there are benefits.

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

8. The proposals update and clarify transfer value analysis assumptions in COBS 19.1 and provide additional guidance on illustration of the comparison. We do not believe our proposals will have a material impact on the competitive position of the UK.

The need to minimise the adverse effects on competition

9. We believe that there are no adverse effects on competition as a result of our proposals.

Annex 3

List of questions

Q1: Do you agree with the revised mortality basis? If not, please explain what alternative basis you think is more appropriate and why you consider that alternative basis would be more appropriate.

Q2: Do you agree with our proposals for CPI-linked revaluation in deferment? If not please describe the approach you believe should be taken and why you believe it would be more suitable.

Q3: Do you agree with our proposals for CPI-linked pension increases? If not, please describe the approach you believe should be taken and why you believe it would be more suitable.

Q4: Do you agree with our approach to LPI pension increases? If not, please explain how your alternative solution would operate from a practical perspective.

Q5: Do you agree that the annuity interest rate should continue to be reviewed annually? If not, describe the approach you believe should be taken and why you believe it would be more suitable.

Q6: Do you agree that there is a need for the proposed guidance? If not, please indicate why you disagree.

Q7: Do you have any comments on the cost benefit analysis?

Appendix 1

Draft Handbook text

PENSIONS (TRANSFER VALUE ANALYSIS ASSUMPTIONS) INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 156 (General supplementary powers); and
(3) section 157(1) (Guidance).

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

Commencement

C. This instrument comes into force on [ ] 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 Pensions (Transfer Value Analysis Assumptions) Instrument 2012.

By order of the Board
[ ] 2012

Annex

Amendments to the Conduct of Business sourcebook (COBS)

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

19.1 Pension transfers and opt-outs

…

19.1.3 G In particular, the comparison should:

…

(2) have regard to the benefits and options available under the ceding scheme and the effect of replacing them with the benefits and options under the proposed scheme; ~~and~~

(3) explain the assumptions on which it is based and the rates of return that would have to be achieved to replicate the benefits being given up; and

(4) be illustrated on rates of return which:

(a) take into account the likely expected returns of the assets in which the *retail client's* funds will be invested; and

(b) are sufficiently conservative to take account of the loss of the fixed benefits and the consequent transfer of risk from the *defined benefits pension scheme* to the *retail client*.

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:

…	
(e) ~~the post-retirement limited price increases at~~ [deleted]	~~2.5%~~
(f) the index linked pensions rate is the intermediate rate of return in *COBS* 13 Annex 2 3.1R(6) for annuities linked to the retail prices index, the consumer prices index or with limited price indexation~~;~~ (g) the mortality rate used to determine the annuity is not based on the mortality tables referred to in *COBS* 13 Annex 2.3.1R(2) but is instead based on 50% of each of the tables PCFA00 and PCMA00, using each person's year of birth, with mortality improvements derived as a blend of 50% of	

each of CMI_(20YY-1)_F[1.25%] and CMI_(20YY-1)_M([1.25%], updated every 6 April 20YY;	

or use more cautious assumptions;

…

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