

PS12/8

Financial Services Authority

Pension transfer value analysis assumptions

Feedback to CP12/4 and final rules

Contents

	Abbreviations used in this paper	3
1	Overview	5
2	Changes to TVA assumptions	8
Annex 1:	List of non-confidential respondents	
Appendix 1:	Made rules (legal instrument)	

This Policy Statement reports on the main issues arising from Consultation Paper 12/4 (*Pension transfer value analysis assumptions*) and publishes final rules.

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Abbreviations used in this paper

AIR	Annuity Interest Rate
BAS	Board for Actuarial Standards
CETV	Cash Equivalent Transfer Value
CMI	Continuous Mortality Improvement
COBS	Conduct of Business sourcebook
CP	Consultation Paper
CPI	Consumer Prices Index
DB	Defined Benefit
ECJ	European Court of Justice
FSMA	Financial Services and Markets Act 2000
KFI	Key Features Illustration
LPI	Limited Price Indexation
PS	Policy Statement
RPI	Retail Prices Index
tPR	the Pensions Regulator
TVA	Transfer Value Analysis
TVAS	Transfer Value Analysis System

1

Overview

- 1.1 In February 2012, we proposed changing the rules and guidance on pension transfer value analysis assumptions in the Conduct of Business Sourcebook (COBS).
- 1.2 This Policy Statement (PS) provides feedback on the responses we received to those proposals in Consultation Paper, CP12/4, and presents the final rules and guidance we have adopted, which are contained in Appendix 1.

Background

- 1.3 Transfer value analysis (TVA) is the process of comparing the benefits being given up from a defined benefit (DB) pension scheme with those that could be offered by a personal pension scheme, using reasonable assumptions. We regard pension transfer advice as a complex, high-risk area and recommendations need to be signed off by a pension transfer specialist. So firms advising in this area must comply with additional rules and guidance in COBS 19.1, along with the general suitability rules in COBS 9. Given the high level of risk attached to giving up the fixed benefits associated with a DB scheme, the starting point for pension transfer advice is that a transfer will not be in the member's best interests.
- 1.4 Typically, financial advisory firms undertaking TVA use an automated Transfer Value Analysis System (TVAS) which, given a monetary transfer value, calculates the return required from the personal pension fund in order for a future annuity to provide the same benefits as the DB scheme.
- 1.5 The economic assumptions used for TVA are reviewed by the FSA in line with those used for projecting benefits (i.e. for point of sale illustrations). However, from time to time, it becomes necessary to review the assumptions for other reasons, for example, due to other regulatory change.
- 1.6 In CP12/4, we proposed changing the assumptions:
 - to update the rules for calculating mortality to be aligned with those used by the Board for Actuarial Standards (BAS), making them consistent with annual pension statements;

- to calculate annuities on a gender equal mortality rate, in line with the European Court of Justice's decision in March 2011;
- to introduce a Consumer Prices Index (CPI) assumption for revaluing pensions in deferment;
- to require CPI-linked benefits to be valued using the Retail Prices Index (RPI)-linked annuity interest rate;
- so that Limited Price Indexation (LPI) annuities should be valued on the same assumptions as RPI-linked annuities; and
- so that the comparison provided to the member is illustrated on growth rates that take into account the likely returns of the pension fund assets, as well as the transfer of risk from the DB scheme to the member.

1.7 These proposals addressed both regulatory changes and the need to update the demographic assumptions. It also addressed concerns market participants raised that the wording of the assumptions needed to be made even clearer. This is because firms were interpreting them in different ways which could potentially give rise to abuse and consumer detriment for DB scheme members. CP12/4 also made proposals in relation to the way in which the TVA comparison is illustrated.

1.8 Our final rules, outlined in this PS, revise the mortality basis as set out in CP12/4. However, following feedback from our consultation, we have updated our approach to the LPI pension increase rate and the frequency of change of the annuity interest rate (AIR). We will still require that the comparison provided to the member is illustrated on growth rates that take into account the likely returns of the pension fund assets. However, we will not require that the comparison takes into account the transfer of risk from the DB scheme to the member.

Implementation and timing

1.9 At the time of our consultation, we were aware that most of the changes we proposed to the basis used for TVA would result in a higher critical yield. The effect of this was that, for a given transfer value, it would be less likely that a suitable recommendation to transfer could be made.

1.10 We were concerned that such a move could lead to a rush of transfer business which could potentially be detrimental for consumers. So we decided it was right to consult for a shorter period of four weeks and have also published this PS within a shorter timeframe than usual, to reduce the risk of consumer detriment arising.

1.11 Having previously discussed our proposals with a wide selection of industry stakeholders, including the software providers, we were aware that changes to the TVA basis could be

implemented within a very short timeframe. Consequently, the rules in Appendix 1 are effective from 1 May.

Equality and diversity

- 1.12 In CP12/4, we noted the equality and diversity impact of our proposals in relation to the proposal to introduce gender equal mortality assumptions when considering the value of future annuity income. Respondents to CP12/4 did not comment on equality and diversity specifically in their responses.

Who should read this PS?

- 1.13 This PS will be of interest to both regulated and non-regulated firms involved in pension transfer value analysis. In particular, financial advisory firms advising on pension transfers and software providers specialising in pension transfer software for advisory firms will need to be aware of the revised rules and guidance. We also expect the content to be of interest to employer sponsors of defined benefits schemes, employee benefit consultancies and pension providers receiving transfer business.

CONSUMERS

Consumers will benefit from these new requirements which reduce the risk of detriment associated with receiving advice on a pension transfer from a defined benefit pension scheme to a personal or stakeholder pension.

2

Changes to TVA assumptions

- 2.1 This chapter outlines the views of respondents to the proposals made in CP12/4. We received 28 responses to our consultation, although not every respondent answered all our questions. Responses came from a range of sources, including advisory firms, employee benefit consultants, product providers, TVAS software providers and professional bodies. A full list of non-confidential respondents is provided in Annex 1.
- 2.2 We also set out our views on these responses and how we have decided to proceed.

Summary of feedback to CP12/4

- 2.3 In general, respondents welcomed the review of the assumptions used for TVA and there was broad support for updating and clarifying them, although there was some disagreement about the most appropriate way to do this. In addition to the comments we received on the specific proposals, many respondents expressed further views which we have tried to incorporate where possible.
- 2.4 Respondents agreed that pension transfer advice is complex and high risk. While most respondents generally agreed that some prudence in the TVA assumptions is justified, a number commented on the need to be careful of introducing too much conservatism. In particular, some noted that raising the bar too high could mean that while those members who do transfer increase their chances of profiting from the transfer, some members may be denied the opportunity to transfer when it may be in their best interests to do so. Some respondents said the quantitative analysis should be an objective assessment of the transfer value on offer with the qualitative assessment being applied through suitability.

Mortality

- 2.5 In CP12/4, we proposed updating the mortality basis to allow for more up-to-date tables and improvement factors as well as requiring annuities to be valued on a gender equal basis. The latter proposal was precipitated by the European Court of Justice's ruling in the Test Achats case¹ which will require insurance contracts, including annuities, to be priced on a gender equal basis from 21 December 2012.
- 2.6 The basis we proposed matched the one recently published by the Board for Actuarial Standards (BAS) in Technical Memorandum 1 (TM1) for Statutory Money Purchase Illustrations (SMPIs). We indicated our intention to consult subsequently on updating the basis for Key Features Illustrations (KFIs) too.
- 2.7 We asked:
- 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?*
- 2.8 The vast majority of respondents agreed with our proposal, with many commenting favourably on us adopting a consistent approach to the mortality basis laid out by the BAS in TM1. A number said we should introduce the same basis for KFIs to prevent consumer confusion. Some also mentioned that the change would be consistent with the basis life offices generally use to price annuities. However, some respondents also indicated that the basis does not describe exactly how the male and female mortality rates should be blended.

Our response

We were pleased that most respondents agreed with our proposals. We reiterate our intention to use the same mortality basis for KFIs and expect to consult on this soon.

We have followed up on the need to introduce a more specific approach to blending male and female rates with BAS and with representatives of the Continuous Mortality Investigation (CMI) of The Institute and Faculty of Actuaries. Consequently, we will recast the rules in this area to indicate that firms should determine male and female mortality rates inclusive of improvement factors before blending the two resulting rates. We consider that specifying the approach will be helpful to firms, as well as ensuring consistency of approach.

We have recast the reference to the mortality improvement factors to include an evidential provision to provide that compliance with the rule on improvement

¹ C – 236/09

factors could be achieved by using the CMI model – the policy intent on improvement factors remains unchanged from the one in CP12/4.

Consumer Prices Indexation

- 2.9 As a result of changes to legislation in 2011, occupational schemes can now use the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) as a measure of price increases. In CP12/4, we laid out proposals for how firms should incorporate benefits linked to the CPI.

CPI-linked revaluation in deferment

- 2.10 Deferred DB scheme benefits are increased (revalued) each year up to normal retirement date to protect the value from being eroded by inflation. We proposed that an explicit limited price indexation (LPI) assumption based on CPI should be introduced to prevent the benefits in the DB scheme from being overvalued in the TVA process.
- 2.11 As we were already reviewing the economic assumptions when we published CP12/4, we delayed publishing a specific rate. Instead, we said we would consult on the rate to be used once that review was complete. We asked:

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.

- 2.12 Most respondents agreed with our proposal, although some commented on the uncertain timeframe until the proposal is actually implemented. Others felt they needed to see the proposed assumption, and in particular, the differential between CPI and RPI, before they could give unqualified agreement.
- 2.13 A small minority of responses indicated that the rates assumed for price increases in deferment should differentiate between different caps, irrespective of whether the underlying increases are based on RPI or CPI, in the same way as the Financial Ombudsman Service undertakes ‘pension review’-style loss assessments. One respondent believed that RPI should always be the default when it is unclear what approach to apply.

Our response

We were pleased that most respondents agreed with our proposal. We have subsequently published an independent review by PwC of the rates used for projections² and have indicated that we will be consulting on these. In CP12/4, we stated that we would consult on a suitable rate for CPI within the projection rates consultation, and this is still our intention.

CPI-linked pension increases

2.14 Following changes in legislation during 2011, DB schemes can now offer pension benefits linked to the CPI rather than the RPI. However, given the lack of availability of CPI-linked annuities from insurance companies or CPI-linked assets, we proposed that firms should undertake TVA using an RPI-linked annuity rate.

2.15 We asked:

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.

2.16 While respondents welcomed us addressing the issue of CPI pension increases, there were diverse views on this. Most pension providers and some smaller advisers agreed with our proposal, although some noted the need to keep the situation under review if CPI-linked annuities become available. Some also said we should avoid undue caution in the basis.

2.17 However, a significant number of respondents were opposed, in principle, to using an RPI-linked annuity rate, on the grounds that it overvalues the benefits (that would be given up). As well as commenting on the inconsistency with our approach to CPI in deferment, respondents stated that CPI pension increases are inherently worth less than RPI pension increases. There were strong views from these respondents that TVA should be an objective assessment of the value of the transfer value which has been offered and that it is not appropriate for conservative assumptions to be applied to the quantitative part of the analysis. Respondents acknowledged that CPI-linked benefits cannot be bought currently and some noted that most annuitants opt for level annuities in any case. There were also comments that flexibility in the way that retirement benefits are taken is frequently a driver for transferring. A small number of respondents commented that no account is taken of the potential to take benefits via income drawdown rather than by purchasing an annuity.

² PwC, *Rates of Return for FSA prescribed projections*, (April 2012), www.fsa.gov.uk/static/pubs/other/projection-rates12.pdf

Our response

We have considered the responses carefully and noted, in particular, the views expressed on the assumptions for TVA being more in line with nature of the benefits being valued. Such an approach would be more consistent with the assumptions used by schemes when determining transfer values. Consequently, the quantitative analysis would reflect a more neutral outcome from a mathematical perspective. The effect of this should be that the critical yield is a more realistic estimate of the rate of return required to replicate the benefits of the DB scheme. However, given the dependency of the analysis on a wide range of assumptions, advisory firms need to recognise that this more realistic rate of return has an equal chance of being too high as it does of being too low.

In principle, we agree that the use of CPI pension increase assumptions which more accurately reflect the benefits being valued are in members' best interests. We also accept that the approach we proposed was inconsistent with that proposed for CPI in deferment and, after consideration, have decided that CPI pension increases should be valued using a CPI-linked annuity rate.

Such a rate needs to be consistent with the CPI assumption determined for CPI in deferment. Consequently, we will consult on the CPI annuity rate in our forthcoming consultation on projection rates. In the meantime, we reiterate the approach set out in the CP that firms should not anticipate the introduction of such a rate.

We have noted the comments made on pension transfers enabling members to take their benefits in a more flexible way. For some members, there may be genuine reasons why the lack of flexibility in the DB scheme benefits contributes towards a decision to transfer. However, this may well not be the case for others.

Limited Price Indexation

- 2.18** We were told that firms were interpreting our rules differently when valuing pension increases with Limited Price Indexation (LPI). As the difference in the value of the benefits could be significant, we consulted on clarifying the rules to ensure consistency in approach. We proposed that LPI pension increases should be valued in the same way as RPI pension increases, irrespective of the varying 'caps and collars' which may apply to different elements of the pension.

2.19 We asked:

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

2.20 While respondents welcomed our attempt to provide clarity on LPI increases, less than half of respondents agreed with our specific proposal approach, these being mainly product providers and some advisory firms. These respondents said the suggestion was practical with an appropriate degree of caution, although some pointed out that too much caution can lead to distortions in the TVA and overstate the deferred benefits. One respondent indicated that a prudent basis for LPI increases would entail the adviser having to provide extra explanations to the member.

2.21 A significant number of respondents disagreed with the approach proposed, not only because it potentially overstates the value of the deferred benefits but because it takes no account of the differing 'caps and collars'. A small number of respondents also pointed out that, in certain circumstances, using RPI to value LPI benefits with a high collar may lead to an underestimation of the annuity benefit. A number of different approaches were suggested for how caps and collars could be accounted for in the annuity interest rate; these included applying Black-Scholes (a type of option pricing model), using simple formulas that approximate Black-Scholes or adopting simpler methods that compare the effect of the cap and collar with fixed rate escalation.

Our response:

As with CPI pension increases, we have carefully considered the arguments put forward that the pension increase assumption used should be more consistent with the benefits being valued. Again, by reducing the difference between the assumptions used to determine the transfer value and those used in the TVA, a more neutral mathematical outcome is achieved which is less likely to be biased against the interests of the member.

We have accepted that such an approach is in members' best interests and we have therefore withdrawn our proposal that LPI pension increases should be valued using an RPI-linked annuity rate.

We recognise the need for clarity regarding LPI pension increases. So we have now published rules which will distinguish LPI increases with different caps and collars.

The current annuity rate basis differs by 3.5% for annuities which are valued on level terms and those which increase by RPI, the differential representing an approximate estimate of the future long-term rate of inflation. We have used this differential for assessing the cut off for caps and collars when

assessing whether it is appropriate to use fixed-rate escalation or RPI-linked escalation.

The rules state that:

- for caps of 3.5% and below, fixed rate escalation based on the cap should be used;
- for collars of 3.5% or above, fixed rate escalation based on the cap (if there is one) should be used; and
- in all other cases, the RPI annuity rate should be used.

Essentially, this means that where pension increases are generally expected to fall at or below the approximate rate of inflation, they are being treated as fixed-rate increases at the level of the cap which will place a lower value on them compared to our original proposals. Where pension increases are expected to be at or above the approximate level of inflation and capped, these will be treated as fixed-rate increases at the level of the cap which will place a higher value on them than expected in our original proposals. Otherwise, the increases will be valued as if they were RPI-linked, in line with our original proposals.

We consider that the rules we have made are a proportionate response to the comments made during the feedback process and will provide a fairer outcome for members considering a transfer. Based on the responses, we also consider that the cost of making these changes can be absorbed within the original cost benefit analysis.

As a result of the change of approach to both LPI and CPI pension increases, we recognise that annuity rates will also be required for limited pension increases linked to CPI. This will be addressed when we consult on the rate to be used for unrestricted CPI-linked annuities.

Annual change of the annuity interest rate

2.22 In CP12/4, we acknowledged some market participants' concerns about the frequency of change of the annuity interest rate (AIR) used for valuing pension benefits. However, as the same rate is also used for the KFI document that the transferring member receives, we concluded that for consumer understanding it was better to keep the annuity interest rate the same for both, so we did not propose changing the rules.

2.23 We asked:

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.

- 2.24 There was a range of views on this question. Around a third of respondents preferred to retain the annual change of the annuity rate. It was felt to be simpler administratively and the view was expressed that, if the assumptions change frequently it appears that they are not robust enough to stand the test of time. Some respondents expressed the view that the AIR should not be based on current yields but on a long-term assumption.
- 2.25 Most respondents did want to see the AIR change more frequently to reduce the opportunity for exploiting the difference between the rate used when calculating the Cash Equivalent Transfer Value (CETV) and the AIR. However, respondents acknowledged that a more frequent change could cause administrative difficulties relative to the period the transfer value is guaranteed. A smaller number preferred to have an AIR which changed every month (or quarter) with a proviso that the rate could be held for the period of the guarantee. A larger proportion proposed the introduction of a rolling average annuity rate on the grounds that it better represents the long-term trend and ignores potentially abnormal fluctuations in the market yields (used to determine the AIR) and is less of an administrative burden for the providers of TVAS.

Our response

We have considered the responses carefully and are grateful to those who suggested alternative approaches for us to consider. We have accepted the evidence indicates that a more frequent review of the AIR is necessary.

Accordingly the rules we publish today include a provision for TVA which, in addition to the standard review of the AIR on 6 April each year, introduces a 12-month rolling average which must be applied in between the standard reviews. The provision is applied on the same timeframe as the original review and uses the same 0.2% rounding factor to determine whether the rate should be changed.

The provision will be limited to COBS 19 only. It will not apply to KFIs. We consider that the purpose of the TVA requires a different approach.

This change should benefit members as the difference between the rate used to calculate the CETV and that used in the TVA should be reduced. Further, by using a rate based on a rolling average which is smoothed over time and more stable, the administrative burdens associated with a monthly change are reduced.

Based on the feedback in the responses, we consider that the cost of this change can be absorbed within the original cost benefit analysis.

Given that both we and BAS use current market yields to determine annuity rates, we consider it would be inappropriate for us to change our approach and base rates on potential long-term yields.

Illustrating the comparison

- 2.26 Our consultation proposed additional guidance for firms when preparing comparison reports. Firstly, that the growth rates used to should take account of the likely returns of the assets in which the member would be invested if they were to transfer and, secondly, that the rates should be sufficiently conservative to take account of the loss of fixed benefits and the transfer of risk to the member. These proposals were driven by our supervisory work which indicated that few advisory firms vary the growth rates to ensure that the illustration is personalised to the member's individual circumstances.
- 2.27 We asked:
- Q6: Do you agree that there is a need for the proposed guidance?
If not, please indicate why you disagree.*
- 2.28 Most respondents agreed that the new guidance on taking account of the likely assets of the personal pension scheme was needed. There was general agreement that the standard application of the maximum deterministic growth rates (of 5%/7%/9%) for KFIs was inappropriate. It was noted that members do not necessarily understand the degree of consistency between KFIs and the TVA comparison. Indeed, some respondents stated that members are still confused about the TVA process even having been through it. However, concern was also expressed that seeking consistency between the growth rates used in TVA comparisons and those used in KFIs may discourage firms from using more cautious assumptions, as permitted by COBS 19.1.
- 2.29 There was less agreement on our proposed guidance to consider the transfer of risk in the growth rate. Many respondents agreed that there should be more emphasis on the transfer of risk and members' ability to absorb and sustain that risk. However, there was not general agreement that it should be incorporated in the growth rate or, by doing so, that members would understand what it was showing. An alternative suggestion was that the transfer of risk could be demonstrated by illustrating varying outcomes.
- 2.30 Many respondents commented in response to this question (or more generally) on risk assessment being part of suitability. A significant number of these also called for more guidance on risk and suitability, with some respondents commenting to us privately that they were disappointed that the CP only focused on the quantitative aspects of TVA or had undue focus on the critical yield. Some respondents also commented on the need to consider the risk that may be attached to remaining in the DB scheme and the strength of the employer covenant.
- 2.31 A substantial number of respondents shared our concerns that the documents given to members are too long. They felt that lengthy, complex documents prevent members from focusing on the most critical aspects. Concern was also expressed that the presentation of such documents is not clear enough to enable members to understand the decision they are expected to make.

- 2.32** We also received feedback from advisory firms that the software prevents them from changing key assumptions and is too inflexible, for example, in enabling them to change the type of the annuity to be more suited to the member's needs or to change assumptions to be more cautious.
- 2.33** Respondents also remarked on the need for the output from TVAS to indicate more clearly the assumptions used rather than automatically showing all possible assumptions. We also received similar comments in relation to the inclusion and transparency of charges associated with the proposed scheme. One respondent also expressed concern that some advisers are using assumed rather than factual commutation rates when illustrating the 'cash plus reduced pension' retirement option. The view was also expressed that, where trustees have discretion over the commutation rate, this is a risk that should be included in the TVA report to the member.
- 2.34** A number of respondents were supportive of our decision not to enforce the use of stochastic software. Others thought stochastic software could be a useful tool for demonstrating risk. One respondent raised concerns about the use of this software, including whether those using it understood it properly and questioned whether the stochastic models available in the marketplace fully recognised the range of assets available to consumers.

Our response

We are concerned to read that so many respondents believe that members are still confused about the TVA, even having been through an advice process. COBS 19.1 requires advisory firms to ensure that members have sufficient information about the comparison to make an informed decision.

Firms undertaking pension transfer advice are responsible for ensuring the software that they use is of sufficient standard to help them meet their obligations under COBS.

As our rules require a comparison of the benefits of the DB scheme and the personal pension or stakeholder scheme on reasonable assumptions, the assumptions need to be laid out clearly to demonstrate compliance. Assumptions on commutation rates would clearly not be compliant where the factual basis would be inadequate. As the benefits under the personal pension scheme partly depend upon the charges, it should also be clear that our rules require the charges to be clearly and accurately disclosed.

We were pleased that most respondents agreed with our guidance to take into account the likely expected returns of the assets and accordingly this guidance is in the final instrument.

We have not proceeded with our proposals requiring illustrative rates of return to take account of the loss of fixed benefits and the transfer of risk from the DB

scheme to the member. We agree that the presentation of these specific risks would be difficult for members to understand and introduce an unnecessary difference between the TVA comparison and the KFI.

However, it was clear from the responses that we should replace this requirement with more guidance on the loss of fixed benefits and the transfer of risk. So we have made additional guidance in the Suitability section of COBS 19.1, which specifically addresses these issues.

In particular, when discussing the transfer of risk, the guidance indicates that advisory firms need to inform members of the extent to which their benefits may fall short of replicating those in the DB scheme. Members need to understand that they may get less back if they transfer than if they had stayed in the DB scheme.

While we recognise that the benefits in the DB scheme are not guaranteed, they are fixed (in real terms) whereas those in the proposed scheme depend on unknown investment returns and future annuity pricing. The guidance also indicates that advisory firms should be informing members of the uncertainty attached to their future benefits as a result of them carrying these risks themselves rather than the risks being borne by the DB scheme. We consider that this guidance will result in members better understanding the risks they would be carrying than by proceeding with our original proposals.

Given the change of approach to CPI and LPI pension increases, we have also included guidance on the need for advisory firms to inform members that – due to the current lack of certain types of annuity – it may not be possible for the benefits of the DB scheme to be replicated if they were to transfer and subsequently purchase an annuity.

We recognise that advice on pension transfers is a combination of both quantitative and qualitative analysis and acknowledge that the CP concentrates on the numerical aspects. However, the two aspects are not exclusive but should complement each other. Furthermore, COBS 19.1 should not be read in isolation – when advising a member on a pension transfer, COBS in its entirety should be complied with, including, of course, COBS 9 on suitability and COBS 2 on client's best interest.

As a result of the feedback to this consultation, we have made a number of changes, described in this PS, to the rules and guidance we consulted upon. The effect of those changes generally will be to make the TVA comparison a more neutral measure of the sufficiency of the transfer value and, in some cases, result in a lower critical yield than had we proceeded with our original proposals.

For some members, it will be the case that even if the resulting critical yield is potentially achievable, a recommendation to transfer would still be unsuitable advice. We have added further guidance to reflect that a rate of return which may replicate the benefits should not in itself be viewed as sufficient justification for recommending a transfer.

We expect that most advisory firms will already be operating in a way which is consistent with the new guidance. For others, it should be a helpful additional guide for assessing suitability in relation to pension transfers. Overall, we consider the new guidance is consistent with the policy intent we laid out in CP12/4 and will ensure a higher degree of suitable pension transfer advice.

As most advisory firms will already be undertaking practices which are consistent with the new guidance, we do not expect there will be any material cost associated with it.

Cost benefit analysis

- 2.35** In our consultation, we outlined the expected costs and benefits associated with our proposals. We expected that the costs would largely be incurred by software providers of TVAS and estimated these as £60,000 initial costs and £15,000 per year. We recognised that our proposals could lead to a fall in transfers which could impact on both advisory firms and provider firms.
- 2.36** Most of the proposals made in CP12/4 would increase the ‘critical yield’ necessary to recommend a transfer. We estimated that transfer values may fall short of meeting the new requirements by up to £20bn although this would depend on how many transfers currently take place on critical yields that are below the new proposed level.
- 2.37** We asked:
- Q7: Do you have any comments on the cost benefit analysis?*
- 2.38** Very few respondents commented on the cost benefit analysis. Of those who did, two commented positively on the benefits to consumers in relation to industry costs and one of these agreed with our assessment of the market impact. One respondent considered that there may be additional costs to the advisory process which had not been taken into account but did not describe these. One TVAS provider made suggestions for changes to our proposals that were not dissimilar to those we have now adopted and considered that these could be accounted for within the original cost estimate.
- 2.39** A small number of respondents, either in response to this question or more generally, commented that our proposals would only benefit those who received advice and noted that members can transfer without advice or against advice. One trade body noted that some product providers would prefer not to accept transfers of this nature.

Our response

We were pleased that the costs we identified were generally considered to be appropriate. In light of the changes to the final rules and guidance, we welcomed the clarification that the direct costs of implementing these within TVAS could also be absorbed within the original cost estimate.

We are pleased that the benefits to members were recognised. As a result of the rules and guidance now being implemented we have revised our total estimate of the benefits.

Previously, we estimated that the total benefit to members would be up to £20bn. This was as a result of the proposed changes to the mortality basis and the clarification of the annuity rate to be used when valuing LPI pension increases.

Although we have modified the wording of the mortality basis, essentially it is unchanged from the proposals in CP12/4. So our estimate of the benefit to members as a result of the new mortality basis is unchanged at £5bn.

However, the benefit attributable to clarifying the annuity rate to be used for LPI pension increases has been reduced as a result of the change in our policy. We previously estimated that the benefit would be up to £15bn if we had proceeded with our proposal to value all LPI pension increases using RPI-linked annuity rates. However, the rules we are now making will value LPI pension increases in a way which is more consistent with the nature of the increase, given the cap and collar which are applied, and in some cases will place a lower value on them. While the benefit will depend on the mix of different rates of LPI, we estimate that it could be worth up to £10bn when considered in the same way as in CP12/4.

Therefore, the total benefit to members could be up to £15bn.

We also consider that the additional guidance within the Suitability section of COBS 19.1 should increase the consistency of advice provided to members, helping to prevent consumer detriment.

Annex 1

List of non-confidential respondents

ABI

Actuarial Profession

Aegon

Aon Hewitt

Argyle Consulting

Aviva

Bridges UK Actuarial Services

Chambers Townsend Consultancy Ltd

Entire Wealth Management Ltd

EValue FV

Friends Life Group

Honister Partners

Hymans

JLT

KPMG

Lane Clark & Peacock LLP

Lighthouse Group

O&M Systems

Oval Group

PSB for TIEs

Scottish Life

Skandia

SPC

Spofforths

Standard Life

Towers Watson

Appendix 1

Made rules (legal instrument)

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 149 (Evidential provisions);
 - (3) section 156 (General supplementary powers); and
 - (4) 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 1 May 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
26 April 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 take into account the likely expected returns of the assets in which the retail client's funds will be invested.

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)) <u>unless COBS 19.1.4BR applies</u> or the rate for annuities in payment (if less);	
...	
(e) the <u>annuity rate for post-retirement limited price increases at 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;</u>	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 <u>unless COBS 19.1.4BR applies;</u>	
(g) the mortality rate used to determine the annuity is based	

<u>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;</u>	
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or use more cautious assumptions;

...

19.1.4A E 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 [1.25%] and CMI(20YY-1) F [1.25%], where YY-1 is the year of the Model used, will tend to show compliance with COBS 19.1.4R(1)(g).

19.1.4B R Firms must apply the annual provisions at COBS 13 Annex 2 3.1R(6) on a monthly basis in any month where the yields on the 15th of the relevant month would give a rolling 12 month average annuity rate that varies by at least 0.2% from the previous rate.

....

Suitability

....

19.1.7A G When giving a personal recommendation about a pension transfer, a firm should clearly inform the retail client about the loss of the fixed benefits and the consequent transfer of risk from the defined benefits pension scheme to the retail client, including:

- (1) the extent to which benefits may fall short of replicating those in the defined benefits pension scheme;
- (2) the uncertainty of the level of benefit that can be obtained from the purchase of a future annuity and the prior investment risk to which the retail client is exposed until an annuity is purchased with the proceeds of the proposed personal pension scheme or stakeholder pension scheme; and
- (3) the potential lack of availability of annuity types (for instance, annuity increases linked to different indices) to replicate the benefits being given up in the defined benefits pension scheme.

19.1.7B G In considering whether to make a personal recommendation, a firm should not regard a rate of return which may replicate the benefits being given up from the defined benefits pension scheme as sufficient in itself.

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