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The Financial Ombudsman Service
Exchange Tower
London
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6 July 2016

Dear Sirs

Assumption setting for Financial Ombudsman Service pension review cases

You have asked us to review and revise our advice on assumptions to apply from 1 July 2016 for pension review loss assessments which fall outside the boundaries of the FSA pension review. The last advice was provided as at 1 July 2015. This letter sets out our recommendations for rates to apply from 1 July 2016.

A loss assessment involves calculating a single amount representing the future pension and lump payments an individual (and any dependants) might be expected to receive from their occupational pension scheme. Many pension scheme payments increase with inflation (or in line with rules that reference a measure of inflation in some way), so an assumption about future rates of inflation is necessary. As the payments occur in the future, it is necessary to discount them in the expectation that money invested to provide for those payments will benefit from income and capital appreciation. An appropriate discount rate will depend on the returns expected in the long-term on appropriate classes of investment, typically bonds and return seeking assets like equities.

Three main financial assumptions underpin a loss assessment: the expected returns on bonds and equities and expected price inflation. Our recommendations for these three assumptions are based on the calculation of reference yields as defined at the start of the FSA review (see Appendix 1).

In recommending assumptions for expected returns on bonds and equities, we have also considered the historical relationship between equity and gilt returns and the FSA pension review parameters. In setting the bond rate we continue to include an allowance for the corporate bond spread over gilts.

In recommending an assumption for expected price inflation, we recognise that two measures of price inflation - Consumer Price Inflation (CPI) and Retail Price Inflation (RPI) - are now commonly used as reference points for revaluation of deferred pensions and indexation of pensions-in-payment in occupational pension schemes. The appropriate measure to use in loss/redress calculations will depend on the rules and documentation of the specific pension scheme in question and on statutory requirements.

To inform our recommendation for the expected rate of RPI from 1 July 2016, we have had regard to the spot inflation curve published by the Bank of England, being the difference between spot yields on fixed interest gilts and on indexed-linked gilts. For illustration, historical Bank of England spot RPI figures at duration 25 years are shown in the chart in Appendix 4.

As in previous years, the expected rate of CPI is assumed to be on average 1.0% p.a. less than RPI, reflecting differences in how the two indices are calculated.



When considering appropriate rates to apply from 1 July 2016 we have considered the fact that the assumptions will be applied uniformly over the 12 months to the next planned review on 1 July 2017. However, our recommendations are inevitably influenced by the latest investment market information available to us at time of writing in late June 2016, a time of particularly high volatility in the immediate aftermath of the result of the EU referendum on 23 June. We will keep our recommendations under review and an interim change may be necessary if market levels move significantly up or down in the coming weeks and months.

The mortality assumption is unchanged from our advice as at 1 July 2015. For reference, the assumption is the "SAPS" mortality table for normal retirements with the CMI 2012 model of future improvements.

Our recommendations continue to recognise that there are practicalities in carrying out loss calculations using the available software.

When the original pension review basis was considered in 1994 by the FSA with advice from a working party from the actuarial profession, we understand it was assessed on the basis of determining the kind of compensation consistent with what a court might deliver in the event of a successful mis-selling claim. When the FOS agreed to take over responsibility for maintaining those assumptions in 2005, we were asked to advise on the basis of a consistent approach. This remains the basis on which we are instructed and it remains our view that, no doubt, a more fundamental review will be required in due course.

As such, given this historical situation and in order to achieve the consistency that is implicit in our instructions, we do not expect the assumptions we recommend will generally correspond with those that might be adopted by insurance companies for pricing annuities. At the present time, we expect the cost of purchasing an annuity from an insurer will exceed the capitalised value of the annuity payments determined in accordance with our advice for the purpose of loss assessment.

More detail on the calculation of reference yields is included in Appendix 1. The graph in Appendix 2 illustrates the equity and bond reference yields and the corresponding FSA pension review assumptions since the start of the pension review. We have included graphs illustrating how the bond rate has been set with reference to bond yields, and how the historic inflation expectation has been set in Appendix 3 and Appendix 4.

Please do not hesitate to contact me if you have any questions.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Packham', enclosed within a thin black rectangular border.

Mark Packham
Director
Human Resource Services

cc Financial Conduct Authority



**Recommendation for assumptions for the Financial Ombudsman
Service pension review loss assessments from 1 July 2016**



Financial Assumptions: 1 July 2016

These assumptions apply for calculations of:

- (a) prospective loss, and
- (b) redress

Validity:

All calculations made in the period from 1 July 2016 to 30 June 2017

As at date:

All calculations of prospective loss and redress of prospective loss done in this period, and the value of all personal pensions, should be carried out as at 1 July 2016.

Discount rate

Using this basis the table of interest rates is shown below

Term to Retirement	Average Interest Rate in force over period to retirement
0	2.25
1	2.5
2	2.7
3	2.8
4	3.0
5	3.1
6	3.3
7	3.4
8	3.5
9	3.7
10	3.8
11	3.9
12	4.0
13	4.1
14	4.2
15-16	4.3
17-19	4.4
20-22	4.5
23-27	4.6
28-29	4.7
30 or more	4.7

The interest rate for annuities when they come into payment is that for zero years to retirement.



Consumer Price Index (“CPI”)	2.25% per annum
Limited Price Indexation (“LPI”) (CPI capped at 5%)	2.25% per annum
Statutory revaluation in deferment (lower of CPI or 5% p.a.)	2.25% per annum
Escalation of post 5 April 1988 GMP	2.05% per annum
Retail Prices Index (“RPI”)	3.25% per annum
RPI capped at 5% (on aggregate basis, similarly to statutory revaluation)	3.25% per annum
RPI capped at 5% (each year, similarly to LPI)	3.20% per annum
RPI capped at 3% (each year, similarly to LPI)	2.60% per annum
Section 21 orders (future)	RPI + 2.0% per annum

Mortality

	<i>Base table</i>	<i>Improvements</i>
<i>Males</i>	100% x S1NMA	CMI_2012 1.25% p.a. long-term improvement rate
<i>Females</i>	100% x S1NFA	CMI_2012 1.0% p.a. long-term improvement rate

Methodology in place from July 2015

- Gilt returns: Bank of England 25-year spot rate (annualised)

- Equity returns: The equity rate contains 3 elements – price inflation, rate of dividend increase and dividend yield. The formula is:

$$\text{Equity rate} = (1 + \text{retail price inflation}) * (1 + \text{dividend yield}) * (1 + \text{rate of dividend increase}) - 1$$

We have taken the prospective long term real dividend growth to be 0.5% p.a.

- Retail price inflation rate: Bank of England implied inflation 25-year spot rate (annualised)

Historical basis used for setting assumptions

- Gilt returns: Bond yields contain two elements – price inflation and the risk free real interest rate ie the return on an index-linked gilt

$$\text{Gilt rate} = (1 + \text{retail price inflation}) * (1 + \text{risk free real rate}) - 1$$

- Equity returns: The equity rate contains 3 elements – price inflation, rate of dividend increase and dividend yield. The formula is:

$$\text{Equity rate} = (1 + \text{retail price inflation}) * (1 + \text{dividend yield}) * (1 + \text{rate of dividend increase}) - 1$$

We have taken the prospective long term real dividend growth to be 0.5% p.a.

- Retail price inflation rate: The retail price inflation rate is estimated as the difference in the yield on an irredeemable gilt and an index-linked gilt:

$$\text{Expected inflation} = ((1 + \text{yield on fixed gilt}) / (1 + \text{yield on I-L gilt})) - 1$$

For this purpose, gilt and index-linked gilt yields are taken to be the spot yields at term 25 years on the gilt and index-linked gilt curves published by the Bank of England.

In setting interest rates to be used in the period to retirement, a balance is struck between equity and bond returns. For periods to retirement in excess of 10 years, we have assumed that the proportion of notional investment relating to equities is 50%, with the balance bond related, and with the 50% reducing to nil on a linear basis over the 10 years before retirement.





