

Adrian Hudson
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13 July 2006

Dear Mr Hudson

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 2006 for pension review loss assessments which fall outside the boundaries of the FSA pension review. The last advice was provided as at 1 October 2005. This letter sets out our recommendations for rates to apply from 1 July 2006.

There are 3 main financial assumptions underpinning the loss assessment - the expected returns on bonds, equities and expected inflation. We have based our recommendations on the calculation of reference yields as defined at the start of the FSA review. We have also considered the historical relationship between equity and gilt returns and the FSA pension review parameters. In setting the bond rate we have included an allowance for corporate bond yields. The expected rate of inflation has been set by assessing the difference between the yield on fixed interest gilts and on indexed-linked gilts, the difference being a proxy for the implied expected long term rate of inflation. As you can see, we believe financial conditions as at 1 July 2006 were so similar to those at 1 October 2005 that we do not recommend any change.

More detail on the calculation of reference yields is included in appendix 1. The graph in appendix 2 illustrates the calculated equity and gilt 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 corporate 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

Peter Tompkins
Partner
Tax

Financial Assumptions: 1 July 2006

These assumptions apply for calculations of:

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

Validity

All calculations done in the period from 1 July 2006

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 done as at 1 July 2006.

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	5.0
1	5.1
2	5.2
3	5.2
4	5.3
5	5.3
6	5.4
7	5.5
8	5.6
9	5.7
10	5.8
11	5.9
12	6.0
13	6.1
14	6.1
15-19	6.2
20-24	6.4
25-29	6.5
30 or more	6.6

The interest rate for annuities in payment is that for zero years to retirement.

Retail Prices Index ("RPI")	3.00% per annum
Limited Price Indexation ("LPI")	2.90% per annum
Section 21 orders (future)	RPI + 2.0% per annum
Statutory revaluation in deferment	3.00% per annum
Escalation of post 5 April 1988 GMP	2.90% per annum
Escalation at RPI capped at 3%	2.90% per annum

Mortality

Standard table PA(90) rated down 6 years

Appendix 1

Basis used for setting assumptions

<ul style="list-style-type: none"> ▪ Gilt returns: 	<p>Bond yields contain two elements – price inflation and the risk free real interest rate ie the return on a index-linked gilt</p> <p>Gilt rate = $(1+\text{inflation}) \times (1+\text{risk free real rate}) - 1$</p>
<ul style="list-style-type: none"> ▪ Equity returns: 	<p>The equity rate contains 3 elements – price inflation, rate of dividend increase and dividend yield. For the review, the long term real dividend yield growth has been taken as 1.5% so the formula is:</p> <p>Equity rate = $(1+\text{inflation}) \times (1+\text{dividend yield}) \times 1.015$</p>
<ul style="list-style-type: none"> ▪ Inflation rate: 	<p>The inflation rate is estimated as the difference in the yield on an irredeemable gilt and an index-linked gilt:</p> <p>Expected inflation = $((1+\text{yield on irredeemable}) / (1+\text{yield on I-L gilt})) - 1$</p>





