

Financial Ombudsman Service
South Quay Place
183 Marsh Wall
London
E14 9SR

29 June 2007

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 2007 for pension review loss assessments which fall outside the boundaries of the FSA pension review. The last advice was provided as at 1 July 2006. This letter sets out our recommendations for rates to apply from 1 July 2007.

There are 3 main financial assumptions underpinning the loss assessment - the expected returns on bonds, on 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. We believe that financial conditions as at 1 July 2007 have changed relative to 1 July 2006 such that we recommend a 0.5% increase in the bond yield whilst keeping equity and inflation rates at their 1 July 2006 rates.

When the original pension review basis was considered in 1994, 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 misselling claim. On mortality, the profession considered the likely levels of mortality to be experienced by the people who had been missold and these were higher than for the population as a whole. Hence, even then, the sums computed may have been less than was likely to be charged by insurance companies for annuities for those people on a compulsory purchase basis from a pension scheme.

We have not altered the principle of trying to assess a similar basis today but have in our thinking tried to focus on the changes which have considerably lightened the mortality assumptions both in population assessments and in insurance quotations. The most significant change is of course the greater optimism generally that improvements in the future will continue and so the number of years by which mortality has appeared to lighten over the period since 1994 will be high.

With regard to mortality, it is necessary to be mindful of two influences.

1. Current expectations for future rates of mortality improvement generally exceed the provision that has been made in the various standard actuarial tables in use in recent years.
2. It is becoming increasingly common to make higher allowance for longevity to increase in the future than has hitherto been the case.

Taking these trends into account, we suggest a change in the mortality table offset from -6 years to -9 years. Typically, we would expect this to increase the value of the liabilities for a non-pensioner by around 9%.

We consider that PA(90) - 9 is an appropriate mortality assumption to use in the calculations bearing in mind the implications for pension review calculation software of a fundamental change in basis to an alternative table which requires a separate assumption for future improvements in mortality.

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

**Recommendation for assumptions for the Financial Ombudsman Service
pension review loss assessments from 1 July 2007**

Financial Assumptions: 1 July 2007

These assumptions apply for calculations of:

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

Validity:

All calculations done in the period from 1 July 2007

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 2007.

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	5.5
1	5.6
2	5.6
3	5.7
4	5.7
5	5.8
6	5.8
7	5.9
8	6.0
9	6.1
10	6.2
11	6.3
12	6.3
13	6.4
14	6.4
15-19	6.5
20-24	6.6
25-29	6.7
30 or more	6.8

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 9 years

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 a index-linked gilt

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

- Equity returns: The equity rate contains 3 elements – price inflation, rate of dividend increase and dividend yield. For the review, the long term real dividend yield growth has been taken as 1.5% so the formula is:

$$\text{Equity rate} = (1+\text{inflation})*(1+\text{dividend yield})*1.015$$

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

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





