Financial Ombudsman Service
South Quay Plaza
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12 July 2012

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 2012 for pension review loss assessments which fall outside the boundaries of the FSA pension review. The last advice was provided as at 1 July 2011. This letter sets out our recommendations for rates to apply from 1 July 2012.

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.

In summary, 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 have included 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.

The expected rate of RPI 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 RPI. The expected rate of CPI is assumed to be on average be 0.75% p.a. less than RPI, reflecting in part differences in how the two indices are calculated.

When considering appropriate rates to apply from 1 July 2012 we have considered the fact that the assumptions will be applied uniformly over the coming year although actual market levels may continue to fluctuate whilst also being cognisant of the practicalities of calculating using the available software.

Guidelines adopted by the European Commission, following a ruling by the European Court of Justice (ECJ) on 1 March 2011, confirm that insurance terms for contracts completed from 21 December 2012 may not be gender-dependant. This is likely to affect how insurers price annuities but the extent of the impact remains unclear, with different insurers potentially reacting in different ways. In view of this, as instructed, we have not recommended any change to the methodology or assumptions for loss assessment at this time. However, this will be kept under review, particularly if experience starts to show significant changes to annuity terms (for example, annuity rates for men moving some or all of the way towards those for women).

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, we were asked to advise on the basis of a consistent approach. As such, 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 would expect the cost of purchasing an annuity from an insurer to exceed the capitalised value of the annuity payments determined in accordance with our advice for the purpose of loss assessment.

On mortality, the profession considered the likely levels of mortality to be experienced by the people who had been mis-sold 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 focused on the changes which have considerably lightened the mortality assumptions both in population assessments and in insurance quotations.

The most significant change is the higher general level of confidence that improvements will continue in the future. Given this, and the time now elapsed, 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 rates of mortality improvement have generally exceeded the provision that has been made in the various standard actuarial tables currently available.

2. It is becoming increasingly common to make higher allowance for longevity to increase in the future than has hitherto been the case.

Bearing in mind the cost related implications for pension review calculation software of a fundamental change in the mortality basis, and the lead-in time needed for this, we consider that PA(90) - 11 is an appropriate mortality assumption for loss assessments from 1 July 2012. As in previous years, we have made an interest-based adjustment (built into the pre-retirement interest rate) to make approximate allowance for increases in longevity that are not recognised by PA(90). The adoption of this methodology better reflects the higher life expectancy of younger individuals.

However, we intend to change the mortality assumptions for loss calculations from 1 July 2013. We envisage (a) a newer base mortality table (such as being based on the "SAPS" table relating to the mortality experience members of self-administered pension schemes) and (b) a separate

assumption for future improvements in mortality, such as the "CMI" projections published each year by the Continuous Mortality Investigation Bureau.

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

Mark Packham
Director
Human Resource Services

Recommendation for assumptions for the Financial Ombudsman Service pension review loss assessments from 1 July 2012

Financial Assumptions: 1 July 2012

These assumptions apply for calculations of:

(a)   prospective loss, and
(b)   redress

Validity:

All calculations done in the period from 1 July 2012

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 2012.

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	3.5
1	3.7
2	3.8
3	3.9
4	3.9
5	4.0
6	4.1
7	4.2
8	4.4
9	4.5
10	4.7
11	4.8
12	5.0
13	5.1
14	5.1
15-19	5.4
20-24	5.6
25-29	5.7
30 or more	5.8

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

Consumer Price Index ("CPI")	2.75% per annum
Limited Price Indexation ("LPI") (CPI capped at 5%)	2.60% per annum
Statutory revaluation in deferment	2.75% per annum
Escalation of post 5 April 1988 GMP	2.20% per annum
Retail Prices Index ("RPI")	3.50% per annum
RPI capped at 5% (on aggregate basis, similarly to statutory revaluation)	3.50% per annum
RPI capped at 5% (each year, similarly to LPI)	3.30% per annum
RPI capped at 3% (each year, similarly to LPI)	2.90% per annum
Section 21 orders (future)	RPI + 2.0% per annum

Mortality

Standard table PA(90) rated down 11 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

  Gilt rate = (1+retail price inflation)*(1+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:

  Equity rate = (1+retail price inflation)*(1+dividend yield)*(1+rate of dividend increase)-1

  For previous reviews, that long term real dividend yield growth has been taken as 1.50% p.a. In this review, we have taken the prospective long term real dividend growth to be 0.75% 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:

  Expected inflation = ((1+yield on irredeemable)/(1+yield on I-L gilt))-1