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Peppi Knott
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Dear Peppi,

Good practice when choosing assumptions for defined benefit pension schemes with a special focus on mortality

This is the response of the Association of Consulting Actuaries to the Pensions Regulator's consultation paper *Good practice when choosing assumptions for defined benefit pension schemes with a special focus on mortality.*

Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the vast majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

Responses to the ten specific questions raised are set out below. The key points we would like to make are:

- We welcome the aims of educating trustees and of ensuring that the mortality assumptions are properly discussed and debated. We are however concerned that the proposed introduction of a single assumption trigger based on one specified table will have the undesirable effect of encouraging adoption of this assumption without proper consideration.
- The massive uncertainty surrounding future mortality improvements needs more emphasis. The favoured concept of 'a margin for prudence over best estimate' cannot be reliably applied for this assumption.
- In our view, the document should be more balanced, rather than having a clear bias towards the arguments for stronger assumptions. It needs to be borne in

mind that there are non-trivial downsides to overestimating longevity as well as to underestimating it.

- The proposed new trigger appears to be based on a greater allowance for mortality improvements than that being made by insurance companies, who might normally be expected to adopt more cautious assumptions than trustees. (This view is based on the PPF's recently-revised basis for undertaking s179 valuations.)
- There are a couple of aspects of assumption-setting (the meaning of prudence and its application to individual or combined assumptions) where we perceive that the Regulator is moving its position, slightly but discernibly, from the Code of Practice. If it the intention to amend or 'clarify' the CoP, we think this should be done via an explicit process.
- We believe that any newly-introduced triggers should not, in general, be applied to valuations with historical effective dates.

Question 1: Do you agree that we should issue guidance on this subject?

Yes, it is right for the Regulator to try to educate trustees and so help them to adopt an appropriate process. There is however slight confusion regarding the title and scope of the document – it is clearly intended to relate to assumption choice generally but this fact is likely to be missed by many readers who will easily assume that it is only about mortality. We suggest that the Regulator either explicitly restricts this document to mortality, or further develops the application of the general principles to the other assumptions.

Question 2: Have we identified the appropriate principles to apply when choosing prudent funding assumptions?

The Regulator's interpretation that 'prudence' necessarily means "taking a margin on the cautious side of a best estimate" can be questioned, bearing in mind a dictionary definition of 'prudent' as "acting with or showing care and thought for the future". That is not to say that we would disagree with the suggestion that most trustees are likely to want to interpret it in the way the Regulator wishes, but only to say that we think that the interpretation should not be expressed as a 'given' without discussion. (We note that paragraph 85 of the Code of Practice appears to be consistent with our view on this, with its reference to "the appropriate margin (if any) to take over best estimate values".) Whilst it might appear to be nice from the trustees' perspective to take a cautious view and build in as many margins as possible, it will not always be appropriate to tie up extra capital by funding under such assumptions. This point is acknowledged in the BAS's recent paper on mortality assumptions, with paragraph 2.19 stressing that both over- and under-estimation of future mortality improvements can "have adverse effects".

We agree with the view that "an appropriate overall level of prudence in the technical provisions should be the paramount objective". We note that the Code of Practice (paragraph 84) also focuses on the overall assumptions and not on individual assumptions, and would suggest that comments we have heard the Regulator make (to the effect that the mortality assumptions taken on their own should be prudent) indicate something of a move away from this position, as does some of the rest of this consultation document, including in particular the explicit statement which appears in paragraph 1.3 that the base mortality to be assumed should be determined by "taking a margin below best estimate rates". If the Regulator is subtly moving away from the position that was initially widely inferred from the CoP, then that movement is something

of which we do not approve and if a change is desired it needs to be made through a formal revision to the CoP following the appropriate consultation procedure.

We agree with the general principle that assumptions should be evidence-based. However, it needs to be made clear that although past experience is frequently the most important piece of evidence, this is not invariably the case.

Question 3: Have we identified the appropriate matters for trustees to consider with their actuary?

From its position in the document, we assume that this question relates solely to the mortality assumptions.

In broad terms, our response here is similar to that for Question 2. However, future changes in mortality (the key focus of the whole paper) are a particularly tricky assumption and, as paragraph 1.24 acknowledges, an "area of great uncertainty". We think that the guidance should make this uncertainty much clearer. In particular, reliable 'evidence' is difficult to come by (and some might even say non-existent) and inevitably what is decided upon will have a high level of subjectivity (even if the assumption is, 'simply', that past rates of change over some agreed period continue). It is also important for trustees and others to appreciate that it is dangerous to ascribe the phrase 'best estimate' to any assumption of future mortality changes, and the idea of choosing a 'prudent' assumption by taking a margin over 'best estimate' does not really work in this case.

The fifth bullet point in paragraph 1.2 indicates that there will not normally be evidence to make a scheme specific allowance for future improvements. We think that this statement blurs the distinction between a lack of scheme-specific evidence on future longevity changes and the provision under the funding legislation for a scheme-specific approach which would take account of other factors, such as the other assumptions and the employer covenant, when determining what allowance to make for mortality changes.

Further, while it may not be possible to make scheme specific assumptions about improvements, it may be possible to develop other group specific assumptions. For example, we can foresee the possibility of assumptions for different industry or social groupings (for example, reflect the different stages at which groups are giving up smoking). Indeed, existing projections already differentiate between men and women.

Our impression is that the slant of the guidance is clearly towards encouraging trustees not to underestimate longevity, rather than to ensure that they take all relevant factors into consideration. For example, paragraph 1.22 specifically mentions to trustees that they should take care not to understate longevity by double-counting the effects of low pensions and industry, without also pointing out that a similar double-counting (resulting in an overstatement of longevity) could just as easily take place in a 'high average pension' scheme.

Question 4: Have you any other suggestions for the effective illustration of the impact of mortality choices?

Of the four types of illustration mentioned in 1.25, we think that 'expectations of life' has value in terms of trustee comprehensibility, but the effect on the technical provisions (and contribution rates to meet the statutory funding objective) is the most relevant. We think that the idea of expressing the effect in terms of a reduction in discount rates (as

suggested by the BAS in 3.19 of its recent paper) could be another useful tool to help illustrate the effect.

Question 5: Are we right to discourage allowance for the effect of a factor by way of adjustment to another assumption?

No, we don't think this should be *discouraged*, although we would agree that if the method is used it needs to be properly *explained*. On some occasions, this approach can be a neat and simple way of making an appropriate allowance for improvements into the distant future, expressing the allowance made in terms consistent with what is usually the other key long-term assumption (the discount rate).

Question 6: Are we right to encourage adoption of the CMI's recommended notation for describing mortality assumptions?

In formal documents where it is important that the assumptions made can be determined precisely, we agree that the standard notation should be used. However, it needs to be made clear that relying on this notation will not always be appropriate – most trustees and members will find it meaningless unless it is properly explained.

Question 7: Is this background material helpful? Have you anything further you would like to see included?

To an extent, any attempt to give some coherent and reasonably concise background material on this subject is useful. However, the guidance document needs to make it clear that the summary is not a substitute for trustees ensuring that they get their advisers to put the material into the appropriate context for their own schemes. In addition, in our view the current summary is not entirely objective, having a clear tendency to present the material in a way which favours one side of the argument.

Here are a few comments on some of the specific points made:

- The CMI's 'cohort' effect (1.34 ff) relates to insurance company data and it is not known whether or not a similar effect has occurred for self-administered schemes (even though it might be suspected that one has).
- The chart in 1.36 is for one cohort only –the picture is less dramatic for other cohorts.
- The implications of some of the data from tPR's recovery plan analysis (1.45) are unclear. For example, the fact that 33% of schemes did not explicitly allow for the cohort effect should not be taking as meaning that these schemes did not make any 'equivalent' allowance.
- It is incorrect to say (1.47) that "no view of the future need be taken" where past data and trends are being used – in doing this, a view is being taken that the future will follow the past in the way provided for by the model used.
- There is a key comment (feeding in to the 'triggers' proposed later) in the middle of the analysis (1.50), giving the Regulator's own views on prudence. Notwithstanding all the data appearing to either side of it in the 'annex', there appears to us to be little substance to the comment at the point where it is made.
- The figures presented in 1.51 count the last 22 years in all three rows. A slightly different and more balanced impression would be given if the rows covered the last 22 years, the previous 20 years and the (further) previous 30 years, with figures in the male column then being around 2.0%, 1.0% and 0.8%.

- In 1.52, it would seem fair to mention also the (less conservative) PPF's s179 and s143 bases. The s179 basis is mentioned in paragraph 2.4, but here we think that the implication that this basis is 'optimistic' is unreasonable given that the basis is still in essence an estimate of the 'buyout' price and insurance companies would generally seek to use assumptions that were 'more prudent' than under the pensions regime. In this respect, it is interesting that the PPF's analysis prior to its recent review of the assumptions guidance apparently revealed that it was still normal for insurance companies to be using medium rather than long cohort as the starting point.
- Given that most occupational schemes provide pension increases and dependants' pensions, it would seem better to quote annuity values in 1.54 that reflect this, otherwise the figures given could give the trustees a misleading impression of the effect on technical provisions. It would also be helpful, to trustees who might be considering the likely effect of a change in the improvement assumptions, to quote the corresponding figures for a younger member (say a 45-year-old reaching pension age in 20 years' time).

Question 8: Do you agree that a focus on mortality improvement assumptions is appropriate?

We agree that it is reasonable to have a special focus on this aspect at the current time, to ensure that trustees and others address the issues appropriately. However, it must be appreciated that the 'sharpness' of any such focus must be 'blurred' by the amount of uncertainty in this area, and also that if the focus is disproportionate it may detract attention from other important areas.

Question 9: Do you agree that our proposal offers the best way for the Regulator to identify mortality improvement assumption risks?
Question 10: If your answer to question 9 is no, what other approach would you prefer and why?

It is convenient to respond to questions 9 and 10 together.

We have concerns as to whether it is appropriate to have a trigger at all relating to one specific assumption, given the principle discussed under question 2 that it is the overall prudence of the technical provisions that is paramount. Given this, and a desire to have as few triggers as possible, we hope that it would be possible to accommodate the Regulator's concerns regarding adequate mortality assumptions within the current 'PPF' trigger – the Regulator could set this trigger at a slightly higher level (say 105% or 110%) if it thought that it would otherwise be too weak. And, bearing in mind the great uncertainty of this assumption, it could be highly misleading to create a debate around whether 'long cohort' is adequate and 'medium cohort' inadequate, given that the range of uncertainty far outstrips the difference between these two tables.

The objective of the guidance should be to ensure that trustees and others go through a proper process and consider all the relevant evidence and other facts. However, regardless of whether or not the Regulator wishes – and even exhorts – otherwise, there is a great danger that the trigger gets taken by many schemes as defining the 'right' assumption to adopt. It would be interesting to know what will happen to schemes that fail any new 'mortality improvement' trigger; will they be able to convince the Regulator that they have gone through a reasonable process (and just happened to arrive at an answer different from what the Regulator might have used itself), or will there be an assumption (even if potentially dependent on the other circumstances of the scheme) below which the Regulator will not allow the trustees to stay even if the process (other

than its conclusion) appears perfectly satisfactory? We have a concern that, given the Regulator's apparent stance (e.g. in paragraph 1.2) that scheme-specific differences in mortality improvement are difficult to justify, trustees and others will expect that the Regulator's approach on failing this new trigger will not be the same as with the other triggers (where the ability to demonstrate that the relevant factors have been properly considered in the context of the scheme should normally be sufficient), and the 'trigger' here will be taken as (very close to) a 'minimum acceptable assumption'.

If there is, despite the reservations above, going to be a 'mortality improvement' trigger, we believe that it would be a mistake to frame it in terms of a specific table which could then easily become a 'target' instead of a 'trigger'. We would particularly query the use of the long cohort table, given its uncertain application to self-administered schemes and the arbitrary nature of the assumptions underpinning it. In our opinion, if there is to be a trigger it would be preferable to express it in terms of the effect that the assumed mortality changes have on the overall technical provisions (and to make it clear that the Regulator does not consider that a sufficiently well thought-out way of allowing for improvements is simply to add this percentage to the liabilities without having first gone through the process of identifying the levels of longevity improvement that the trustees want to allow for).

Finally, we have concerns about the intention to apply any new trigger to all valuations with effective dates in March 2007 or later. This will encompass many valuations where the trustees, in accordance with the Regulator's advice, have planned ahead and carried out their discussions on assumptions at as early a stage as possible. A move to re-open negotiations on assumptions that were agreed some time ago will not be appreciated by the parties involved, especially where the valuation is close to sign-off. If a trigger is introduced and applied to these valuations, it will be especially important for the Regulator to focus on the process adopted in determining the assumptions and satisfy itself that it was robust in relation to the guidance and opinions around at the time the discussions took place, and not to measure it against 'conventional wisdom' as it may stand several months later.

If the Regulator is concerned that schemes which are currently completing valuations might (if the new proposed trigger is not applied to them) leave it for several years before re-visiting their mortality assumptions, we would support guidance indicating that this aspect should be discussed at the annual report stage (so that even if no change is made to the assumptions at that time, the ground is at least well-prepared for the next full valuation).

Yours faithfully

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Chairman
Pension Scheme Committee
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