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CONSULTING ACTUARIES

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Government Actuary's Department,
Finlaison House
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Dear Joanne

Response to *Review of contracted-out rebates for 2012-2017*

I am writing on behalf of the Association of Consulting Actuaries in response to your consultation on the above.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest private schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

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

Main points in our response:

- Although we agree there is value in illustrating the estimated value of contracting out rebates on more than one basis, we do not agree that using the Government Actuary's estimate of a statutory funding or a best estimate basis adds any value. We give our reasons in our answer to question 2 but, in summary, both of these bases are scheme specific, so to attempt to develop proxies for these is an artificial construct. Instead, we suggest that a range of bases are illustrated, without suggesting they meet the requirements of a particular legislative or statistical approach.

- Although we recognise that the consultation is not a policy document, we believe the Government Actuary should have considered the shift in expectations that is likely to be created once contracting out on a money purchase basis has ceased (in 2012), given that many private sector contracted-out schemes are closed to new entrants.

Question 1 – Do you agree that we have correctly indentified the main relevant changes in the factors affecting the cost of providing benefits of an actuarial value equivalent to the benefits foregone by staff who are contracted-out on a defined benefit basis?

There are other relevant changes that have not been reflected in the consultation:

1. Contracting out on a defined contribution basis will end from 2012. I n the absence of amending legislation, this directly affects schemes contracted-out on a salary related basis (COSRs) by reducing the range of arrangements into which scheme members can to transfer out their benefits. We understand this is being reviewed, but in any case it raises a more fundamental question regarding contracting-out.

   Over the past ten years, many people in the pensions industry have questioned the value of contracting-out, both in the context of whether the rebates represented a 'fair' exchange and also in view of the large amount of regulation that applies to contracted-out schemes. The Government has now seen fit to wipe away all the prudential regulation that applied to schemes contracted-out on a defined contribution basis (COMPs), to the extent of removing the distinction between protected rights and non protected rights. This begs two questions:

   i) Why is it necessary to retain prudential regulation in relation to COSRs? And,
   ii) Is there still a role for contracting out on a salary related basis?

   We recognise that this consultation is not the place where those questions will be answered. However, carrying out a consultation into the rebates granted in respect of COSR membership, without raising any uncertainty as to the future of contracting-out, seems to make the process incomplete.

   Contracting out was initially proposed to encourage employers that already offered occupational pension schemes to continue to do so; the rebates calculated included incentives (based on then contemporary market expectations of the cost) to stimulate new provision. It is clear that this motivation no longer exists – no new COSRs are being established (unless there are other motivations, such as public sector comparability).

   We think it unlikely that contracting out will continue post 2017. It would seem reasonable for the likely effects of this to be considered and, if thought necessary, taken into account in the approach used to calculate the proposed rebates.

2. The consultation mentions changing membership profile as a consequence of continuing scheme closures, but doesn't consider the behavioural impacts. Most defined benefit schemes are now closed to new entrants and many have been so for several years. Although their sponsoring employers currently plan to maintain future accrual, over the next seven years the proportion of active members will fall and, in some

cases, the cost of maintaining two types of benefit provision could become disproportionate. Many employers are likely to consider closing the scheme entirely and, where possible, buying out the benefits. So a new, and material, relevant change is that the expected future existence of many schemes is now likely to be curtailed, pointing to significantly different financial considerations than those that would apply to schemes which do not plan to wind up.

3. There have been significant reforms to S2P since the previous GAD consultation on rebates, bringing forward its evolution into a flat rate regime. We also expect that the average accrual rate under S2P will have fallen, relative to the position five years ago. However, the minimum quality standard (the reference scheme test) has not been amended, so the benefit COSRs must provide in order to remain contracted out is now considerably larger than the S2P benefit foregone.

   The rebate is clearly and appropriately designed to represent the state benefit foregone, but if regulation is not amended to address the disproportionate costs imposed on employers providing COSRs, then the rebates should take some of this extra cost into account.

Question 2 – Do you agree that we are planning to advise on a sufficient number of bases?

We agree there is value in suggesting a range of approaches that could be used to determine the national insurance rebates that will be provided in relation to contracted-out employment. However, we do not understand the approaches adopted. In particular, the proposals to recommend to the Secretary of State a best estimate and a scheme funding approach seem inappropriate.

Both these terms, particularly the latter, are entirely scheme specific. Although it might be possible to infer the broad characteristics of the 'average' contracted-out defined benefit pension scheme, this is likely to be based on incomplete and out of date information. Because the range of scheme circumstances is now so wide – including schemes that are likely to continue for the foreseeable future and schemes that are likely to be wound up before the Government Actuary begins to prepare for his next quinquennial consultation (assuming this occurs) – we can see no benefit in pretending that there is a cost that 'on average' might be appropriate.

Of course, best estimate assumptions can be derived for each main asset class. However, there will be many schemes for which they do not apply, for example, because of investment decisions taken by the trustees. To present a composite of individual best estimate assumptions as a 'best estimate basis' risks being misleading and is likely to be inappropriate.

Similarly, we do not agree that it is possible to establish a composite basis that meets the requirements of the statutory funding regime. The scheme funding regime established by the *Pensions Act 2004* is scheme specific, depending on the scheme's asset and liability profile and also its sponsoring employer's covenant. An approach taken at the level required to set a single level of rebate to apply to all schemes cannot reflect this: in particular, it is impossible and inappropriate to suggest that the assumptions have been chosen with any degree of prudence, since the Government Actuary does not have access to sufficient information about individual schemes, or schemes as a whole, to determine whether this is the case.

We agree, however, that a gilts basis is a sensible starting place for determining the appropriate level of the rebate. We also agree that it would be useful to understand the level the rebates would be if they were calculated using different bases. We suggest that, in addition to an ‘unadjusted’ gilts basis, the Government Actuary also provides estimates of the rebates using discount rates different from gilt yields by (for example) 50, 100 and 200 basis points. If considered desirable, he could then illustrate where schemes might fall on this scale, on a hypothecated best estimate basis, given different asset and liability characteristics.

We also observe that, although the Government Actuary has chosen not to use the alternative of a buy out basis, this will prove to be the cost of contracting out for many employers. However, we acknowledge the impracticality of the Government Actuary attempting to illustrate on this basis, also.

Question 3 – Our proposed financial assumptions are influenced by market conditions as at end March 2010. Given that the rebates calculated will be applied in the future, do you consider it appropriate for use to update the financial assumptions when we finalise our report?

The assumptions used are unlikely to reflect the actual cost and experience of schemes over the five years 2012-17. Whilst it is reasonable to consider market information at the date the report is being prepared, the Government Actuary should consider the extent to which it is possible to anticipate how financial conditions could change over that period. For example, to the extent that the market can, reasonably reliably, provide information on forward rates, the effects of that information should also be taken into account.

Question 4 – Do you agree with the asset allocation underpinning our calculation of the best estimate discount rates?

We agree that it would be sensible to use this asset allocation to illustrate where schemes with different investment strategies might fall in the range of assumptions we have suggested should be presented in our answer to Question 2. But other investment strategies should also be considered.

Question 5 – Within the range 2.0% to 2.5% pa, what do you consider an appropriate ‘best estimate’ assumption for CPI?

We understand the difficulty in estimating future CPI inflation, in the absence of market information. The analysis set out in Appendix D of the consultation document summarises the evidence quite well. However, we believe that the evidence has to be pushed quite hard to support the assumption that, over the long term, the inflation risk premium that investors are prepared to pay to access inflation linked assets will be as high as 150 bp. Whilst we are aware of the Office for Budget Responsibility's projections and the conclusions drawn by the Bank of England's inflation report, these are likely to be influenced by the Government imposed target.

As the consultation states, on average, CPI has been only about 70bp less than RPI and the Bank of England has estimated that, in the UK, an IRP of around 30 bp would be a reasonable expectation.

Currently the difference between CPI and RPI is much larger, and it is possible that over the long term the average difference could increase; also, there are reasons why the IRP might increase above the 30bp estimated historically. However, a total difference of 225 bp, as suggested in parapgraph D.19, seems unlikely.

However, we note that the logic in Appendix D has not been fully carried through to the assumptions set out in paragraph 3.7. Our suggestion is that only the gilts basis is adopted, and this basis does not adopt the 2% CPI assumption. We believe it would be reasonable for the Government Actuary to take into account some of the analysis in Appendix D regarding IRPs in setting the inflation assumptions used for the gilts basis, but not to the extent he has for the 'best estimate' basis.

Question 6 – Do you agree with our estimates of the building blocks for deriving the financial assumptions?

As discussed, except for illustration purposes, we cannot see the benefit in trying to derive best estimate assumptions. There might be merit in using the building block approach to determine where sample schemes fall in the range of assumptions we think should be presented, and the approach adopted seems adequate for this purpose.

Although we understand that 'best estimate' inflation assumptions might differ from those implied directly by the gilts market, we are less certain of the logic for adopting different assumptions in the two bases. The comment also applies to salary assumptions, since this is derived directly from the inflation assumption.

We agree that, in assessing these assumptions for scheme funding purposes, trustees might take a more cautious approach to the assumption than a best estimate, but no evidence is provided for the differences in the RPI inflation assumptions for the different approaches. However, on balance, as suggested in out answer to Question 5, we believe there is more evidence in support of inflation assumptions at the top end of the 'best estimate' range.

Question 7 – Do you agree that taking a margin of 0.35% pa above the nominal gilt yield is appropriate to determine the typical funding post-retirement discount rate?

No. We think it is inappropriate to attempt to apply a scheme funding approach to schemes as a whole. As explained, without more information about the characteristics of the typical scheme and its sponsoring employer, it is not possible to determine an 'appropriate' basis.

Question 8 – Do you agree that taking a margin of 1.85% pa above the nominal gilt yield is appropriate to determine the typical funding pre-retirement discount rate?

See answer to Question 7.

Question 9 – Do you agree that the gilts basis post retirement discount rate should be determined with reference to the assumed fixed interest gilt return?

That seems reasonable.

Appendix D suggests that some attempt has been made to determine an appropriate 'duration' for schemes as a whole. Given that many schemes are likely to wind up within the time horizon suggested (up to 40 years), the accuracy implied by such a choice is likely to be spurious. A compromise position might be to use shorter term yields post retirement.

Question 10 – Do you agree with our term-dependent approach to setting the pre retirement discount rate?

Normally we would agree that it is appropriate to take the duration of the liabilities into account in determining the appropriate discount rates to use for estimating their cost. However, a significant proportion of the schemes included in the dataset used to derive 'typical' scheme characteristics are likely to have wound up well in advance of the 40 year horizon envisaged. Calculating the rebate based on schemes that are assumed to continue more or less indefinitely seems unlikely to present a true picture.

Question 11 – Are you content with the way the gilts basis pre retirement discount rate is determined with reference to the fixed interest gilt yield?

Yes, but see answer to previous question.

Question 12 – Do you agree that it is appropriate for the mortality assumption to be framed in terms of the suggested SAPS lives tables?

Yes.

Question 13 – do you agree that mortality improvements in line with the 2008 based UK principal population projections are suitable?

Yes.

Question 14 – For the typical funding mortality assumption, the margin of prudence is a somewhat arbitrary assumption and we welcome comments on actual practice and out proposed two year offset.

We disagree trustees are arbitrary when they make a prudent selection in relation to the base mortality table. However, as discussed previously, we do not think this is relevant concern for the purpose of calculating the contracting-out rebate. Instead, we suggest that the Government Actuary illustrates the rebates that would be generated using different mortality assumptions. For example, the Government Actuary could calculate the life expectancy at 65 associated with his central basis, and illustrate the effects using a basis that resulted in one year longer life expectancy and one year less.

Question 15 – Do you feel that the information provided to the Secretary of the State by the gilts basis could be improved if different mortality assumptions were used?

See answer to Question 14.

Question 16 – Do you consider our proportions married assumptions appropriate for all bases?

Yes

Question 17 – Do you agree with our proposal to omit any remarriage assumption?

Yes.

Question 18 – Are you content for the proposed age difference assumptions to be adopted for all these bases?

N/A

Question 19 – Do you agree that a -0.2% addition to the rebate is an appropriate allowance for administration expenses?

This seems reasonable.

Question 20 – Do you have any comments about the approach to deriving the weights or the weights themselves?

No.

Question 21 – When viewed as a whole do you feel that the best estimate basis is in line with the definition set out in section 2.10?

Because the best estimate basis will not reflect the actual investment strategy of many schemes, it does not meet the definition.

Question 22 – When viewed as a whole, do you feel that the typical funding basis is in line with the definition set out in section 2.10?

No. As explained above, with the information available, it is not possible to determine a scheme funding basis that would apply to contracted-out pension schemes as a whole.

Question 23 – When viewed as a whole, do you feel that the gilts basis is in line with the definition set out in section 2.10?

Yes.

Question 24 – Do you have any comments on our proposed approach to defined contribution schemes?

The suggested approach seems proportionate.

We hope you find the above helpful. Please contact me if you wish to follow up any points.

Yours sincerely

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