LCP's response to the PPF Board's consultation on assumptions to be used for valuations under section 143 and section 179 of the Pensions Act 2004

20 February 2023

This document sets out LCP's response to the PPF's consultation on assumptions to be used for valuations under section 143 and section 179 of the Pensions Act 2004 published on 9 January 2023 (the "Consultation").

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, and business analytics. We have over 900 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 90% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 10% relates to insurance consulting, business and health analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

LCP is a leading advisor on buy-ins and buy-outs in the bulk annuity market. We advise on broadly 30% of all transactions completed each year and advised on more transactions than any other adviser in 2022. We are also a member of the PPF's specialist actuarial panel for helping schemes secure benefits with insurers.

Our high-level comments on the Consultation

Overleaf we provide answers to the questions in the Consultation. Overall, we are supportive of the proposed section 143 assumptions. In particular, we are strongly supportive of a move to a curve-based approach. However, we have some comments on some of the individual assumptions.

We are happy for LCP to be named as a respondent to the Consultation and happy for our response to be in the public domain. We are happy for you to reference our comments in any response as long as you attribute them to LCP.

We look forward to seeing the final version of the section 143 and section 179 assumptions in due course and trust that our comments are helpful.

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About Lane Clark & Peacock LLP

LCP's response to the questions in the Consultation

1. Do you agree that we should introduce both section 143 and section 179 assumptions from 1 April 2023? If not, what date would be more appropriate?

- If the consultation results are published in March, the new assumptions will need to be adopted almost immediately. However, as schemes have 12 months to complete section 143 valuations, we do not expect this to cause any issues, especially as we understand that going forwards these valuations will only be carried out by the panellist firms.
- The proposed changes to the section 179 assumptions are relatively modest and we do not foresee any issues with the proposed implementation date, as the new assumptions would be in effect for the 2024/2025 levy year onwards.

2. Do you agree that it is appropriate to move to a yield curve approach for valuations under sections 143, 152 and 158 but that a single discount rate should be maintained for all other valuations, including section 179 and section 156 valuations? If not, please specify your reasons and the approach you would favour for each valuation type?

- We are strongly supportive of moving to a yield curve approach for section 143 valuations and agree that the assumptions for sections 152 and 158 valuations should be consistent.
- We can understand why you would not want to introduce the additional complexity of a yield curve approach for section 179 valuations, given these valuations are only used for levy distribution purposes.
- We think the assumptions for section 156 valuations should ideally be set consistently with the assumptions for section 143 assumptions and would therefore favour a yield curve approach for these valuations. In particular, any schemes who entered the assessment period after 1 April 2023 (the proposed introduction date for the new assumptions) will have necessarily already carried out a section 143 valuation using a curves approach and would already have the required models in place.
- However, it would seem reasonable on the basis of proportionality and the number of schemes likely to carry out these valuations, and considering any schemes who entered the assessment period prior to this date, to adopt the proposed approach of setting assumptions consistently with section 179 assumptions.

3. Do you foresee any problems in using these curves as a basis for determining the appropriate discount rate and inflation assumption when a curve-based approach is used? Are there any other curves that you believe would be more appropriate?

- We view adopting a curve-based approach for the section 143 valuations as a significant improvement over using single yields, particularly in light of the increased volatility seen in the financial markets recently.
- We have three comments on the proposed curves:

  1. LCP prefers not to be reliant on Bank of England ("BoE") data and instead we use our own gilt curves based on a model fitted to market gilt yields. This can be different to the BoE curves. We understand that other consultancies have adopted similar practices. Our reasons for not wishing to be reliant on BoE data include that the BoE methodology is not as transparent as it might be and there are sometimes discrepancies between the BoE data and observed market gilt yields, with the reason for this not always being clear.

     In the interest of consistency, we agree that all panellists carrying out section 143 valuations should adopt the same curves. The PPF may want to discuss this aspect with panellist firms and explore whether it is worth the PPF providing a prescribed curve on a periodic basis.

  2. The BoE data for nominal and inflation rates are gilt-based. Our view is that that swap-based curves provide a better metric for matching insurer pricing, noting that insurers' regulatory regime, Solvency II, uses swap yields as a basis for setting insurer capital requirements.
  3. Most of the BoE yield data is only available at month-end dates (typically the last working day of the month. Daily yield data is only available for a limited set of terms. This means that even if BoE data is used as a starting point PPF panel firms will need to carry out some form of curve fitting process for alternative dates and terms. It is important that any such methodology is consistent between firms.

4. **Do you foresee any potential issues incorporating the proposed approach into existing processes for section 143, 152 and 158 valuations? If so, are there any structural changes you would propose that would materially reduce the implementation burden?**

- We understand that curve-based approaches are common practice for carrying out funding valuations and would expect the panellist firms to have appropriate models in place.

5. **Do you believe that the proposed assumptions are appropriate? If not, which assumptions do you believe should be changed, and why?**

This question has been posed by reference to both the section 143 and 179 proposed assumptions. In our response below we are commenting solely in respect of the proposed section 143 assumptions, unless otherwise made clear.

It is important to consider the strength of the basis and impact of changing key drivers as a whole, and not consider single assumptions in isolation. Differences in individual assumptions may arise from construction and in particular, different insurers and consultancies will allow for prudence within insurer pricing bases within different elements.

We have compared the value of liabilities for a range of LCP advised pension schemes calculated using the proposed section 143 assumptions against LCP's insurer pricing. On average, the liabilities (excluding wind-up expenses) on the proposed section 143 assumptions are c5-10% lower than the equivalent liabilities using LCP's insurer pricing basis, albeit with some variation between schemes. Noting the stated intention for the section 143 basis to understate insurer pricing and the variability of insurer pricing over time (and between schemes) we believe this differential is reasonable.

We set out some comments on the key section 143 assumptions below (while noting the point above that it is the overall strength of the basis that is most important, rather than individual assumptions):

- **Discount rate:**
  - The proposed discount rate structure and premiums of gilts+0.4% for pensioners and gilts+0% for non-pensioners is broadly consistent with the levels of pricing we have seen available within the market in recent months. However, markets are currently volatile and pension scheme demand has materially increased over recent months which could impact insurer appetite and therefore pricing.
  - We feel that a term-dependant structure would be more appropriate. However, the proposed pensioner/non-pensioner structure is a reasonable alternative on the grounds of simplicity.
  - We typically review insurer pricing on a quarterly basis. While appreciating that it is unlikely to be feasible for the PPF to change its assumptions this frequently, we suggest that some level of ongoing monitoring would be appropriate as insurer pricing can and does change materially over short time periods.
- **CPI inflation:**
  - The CPI inflation assumption proposed is derived from the BoE RPI inflation curve less a term-dependant adjustment, where this adjustment includes an allowance for the difference between gilt and swap implied inflation and the difference between RPI inflation and CPI inflation. It is not clear how the adjustment breaks down into these two elements – in particular:
    - How is the adjustment for the difference between gilt and swap inflation derived?
    - How regularly will this component be reviewed or marked to the market?
  - Adopting a term-dependant wedge with a pre-/post-2030 structure is consistent with market practice. However, the pre-2030 wedge of 0.2% pa is lower than we would typically use. We would expect the difference to be in the region of 0.5%-1.0% pa and typically use 0.8% pa, based on combination of our in-house view and evidence of insurer views including pricing evidence from actual transactions and a survey involving 7 of the main insurance market participants.

- **Pension indexation model:**
  - On the grounds of simplicity and consistency between firms, it is reasonable to adopt the pension increase model proposed
  - It is worth noting that the insurers and consultancies use a variety of different models such as the SABR model and the Jarrow-Yildirim model, along with a combination of marking to market and marking to model to parameterise them. The outputs can be different - we have seen 0.1% pa - 0.2% pa differences in the assumptions for a LPI(0,2.5) increase generated by different approaches in some cases (albeit usually the differences are smaller). Typically the Black inflation model will tend to understate liabilities compared to most alternative approaches.
- **Mortality**
  - Our main comment relates to adopting a single set of assumptions for all schemes when setting a mortality base table. Typical industry practice is to carry out scheme-specific analysis such as post-code modelling to obtain assumptions that more closely reflect the characteristics of the scheme. Grouping members into pension bands and applying a different table for each band has been proposed as a proxy for this. We feel that post-code based scheme specific analysis would provide a better match.
  - We have set out some further comments below.
    - The S3 tables contain a known error. Whilst this is reasonably small the PPF may wish to consider adjusting the base tables proposed for this. Further details on this issue are set out on the IFoA website here.
    - There is a relatively large jump between the resulting life expectancies calculated using the prescribed base tables for males, ie S3PMA_L, S3PMA_M, S3PMA_H and S3DMA. The PPF could consider using a larger number of narrower bands incorporating base table scaling factors if necessary in order to reduce the step change in liability.
    - The same Dependant tables are used for all dependant members and second lives, irrespective of the first life's pension bands. The PPF could potentially incorporate the S3DFA_L table and S3DFA_VL for female contingent second lives and a scalar for male contingent second lives (note that given the small amount of data an equivalent S3DMA_L table does not exist)
    - We note that the process of mapping deferred members revalued pension to a pension band (as determined from pensions in payment) is likely to understate the total pension benefits of the deferred member. The PPF could consider using separate bands for pensioner and non-pensioner members to allow for this.
    - The A parameter within the CMI projections could be linked to the base table applied, i.e. the highest pension bands could be mapped to a higher A than 0.25%.
    - A higher long-term rate of improvements is proposed for males than for females. We would suggest the same long-term rate for both sexes.
    - We are broadly supportive of the application of a "w" factor for 2020 and 2021 data when setting future improvement assumptions (our internal basis uses w=0 for 2020 and w=10% for 2021). Insurers and reinsurers are increasingly placing some weight on the knock-on impacts of Covid-19 on future health outcomes. However, the position remains uncertain and we recommend this is kept under review. We note that the CMI core projections do not place any weight on 2020 and 2021 data, though the CMI consultation on CMI 2022 is proposing a 25% weighting on CMI 2022.
- **Wind-up expenses**
  - The proposed wind-up expenses assumptions are expected to produce results that are lower than our internal buy-out basis does on wind-up expenses. We have not reviewed the proposed assumptions for wind-up expenses further as we are aware that schemes carrying out section 143 valuations will typically be in different circumstances and have different characteristics compared to many of the schemes we advise. For example, most schemes in PPF assessment will complete significant data cleansing work in advance of the section 143 valuation.
  - Adopting the same assumptions for section 179 valuations could understate liabilities for most schemes that have not carried out any buy-in preparation work such as data cleansing. However, given the purpose of the section 179 valuation, adopting the same assumptions is a proportionate approach.

6. Do you have comments on any other matter in this consultation document which is not included in responses to the questions above?

As per our response to question 1, the proposed date of 1 April 2023 for implementing the proposals does not pose any issues from our perspective. However, in general, a longer period between announcing the results of the consultation and any changes coming into force would be helpful, particularly where more substantial changes are proposed.

We have no other comments.