Policy Statement

PS12/17

Financial Services Authority

Product projections and transfer value analysis

Feedback to Chapters 3 and 4 of CP12/10 and final rules

November 2012

FSA®
Financial Services Authority

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This Policy Statement reports on the issues arising from Chapters 3 and 4 of Consultation Paper 12/10 *(Product Projections and Transfer Value Analysis)* and publishes final rules.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

COBS	Conduct of Business sourcebook
CP	Consultation Paper
CPI	Consumer Prices Index
DB	Defined benefit
LPI	Limited Price Indexation
MiFID	Markets in Financial Instruments Directive
PS	Policy Statement
RPI	Retail Prices Index
TVA	Transfer Value Analysis
TVAS	Transfer Value Analysis System

1 Overview

1.1 In Consultation Paper (CP) 12/10 we consulted on various proposals, including:

- Chapter 3 – introduction of a separate Consumer Prices Index (CPI) assumption for transfer value analysis (TVA) when benefits under a defined benefit (DB) pension scheme are compared with the possible benefits under a personal pension scheme; and
- Chapter 4 – changes to the investment return assumptions (projection rates) in Chapter 13 Annex 2 of the Conduct of Business sourcebook (COBS).

1.2 This Policy Statement (PS) provides feedback on the responses we received to those proposals and presents the final rules we have adopted, which are contained in Appendix 1.

Background

1.3 The proposals in Chapter 3 of CP12/10 followed rules we made in April this year (see PS12/8[1]) updating the assumptions and guidance for pension TVA, following the growing use of CPI as a measure of price inflation in occupational DB pension schemes.

1.4 Chapter 4 of CP12/10 proposed changes to the projection rates in COBS 13 Annex 2 for non-MiFID packaged products, and followed a report[2] published in April, consisting of a review by PricewaterhouseCoopers (PwC) and peer reviewers' comments (the PwC report). That report supported a reduction in our current intermediate projection rate and in the adjustment for tax-disadvantaged products.

1 *Pension transfer value analysis assumptions* (April 2012): www.fsa.gov.uk/static/pubs/policy/ps12-08.pdf
2 www.fsa.gov.uk/static/pubs/other/projection-rates12.pdf

Implementation and timetable

1.5 The new CPI assumptions described in Chapter 2 of this PS will come into force on 1 January 2013. The new projection rates explained in Chapter 3 will come into force on 6 April 2014, but firms will be able to comply with them at any time from 6 April 2013, so they can change their systems and documentation at the same time as making other changes.

Equality and diversity

1.6 In CP12/10, we said we considered that our proposals would not have any impact on equality and diversity. Respondents to CP12/10 did not comment on equality and diversity specifically in their responses.

Who should read this PS?

1.7 This PS will be of interest to life insurers and other providers of personal pensions and also to firms that advise on personal pensions. Chapter 2, on the introduction of explicit CPI-linked assumptions, will also interest TVA software providers and employee benefit consultancies as well as employer sponsors of DB schemes. Chapter 3, on changes to the projection rates in COBS 13 Annex 2, affects all non-MiFID packaged products, not just pensions, so will be of interest to providers of those products and also firms that advise on them.

CONSUMERS

The rules on pension transfer value analysis are designed to make sure that anyone considering switching out of a defined benefit pension is not given a false impression of the alternative benefits being offered to them. Consumers will benefit from these new requirements and also from the amended projection rates, as both reduce the risk of consumers being given information on the potential benefits of investing in a life or pensions contract which is based on inappropriate assumptions.

2

Consumer Prices Index assumption for pension transfer value analysis

Introduction

2.1 This chapter outlines the views of the 14 respondents to the proposals made in Chapter 3 of CP12/10. Responses were received from varying types of organisations, including professional services providers, product providers and wealth management firms, as well as software providers, trade bodies and professional bodies. We have provided a full list of non-confidential respondents to this chapter in Annex 1.

2.2 We also set out our views on these responses and how we have decided to proceed.

Our proposals and summary of feedback

2.3 Our rules on pension transfer value analysis require firms to compare the benefits being given up from a DB scheme with those that could be offered by a personal pension scheme. The quantitative analysis is usually undertaken using some form of automated Transfer Value Analysis System (TVAS). The system, given a monetary transfer value, calculates the rate of return required from the personal pension scheme for it to provide the same benefits as those given up in the DB scheme.

2.4 This requires the use of certain economic and demographic assumptions, which are laid out in COBS. We regularly review these assumptions to ensure they remain valid and do not result in unrealistic analysis that could adversely affect the advice process and result in consumer detriment.

2.5 In our work on TVA earlier this year[3] we said we would introduce explicit CPI assumptions for TVA, given the growing use of CPI as a measure of inflation in occupational DB schemes. Following publication of the PwC report[4] on the economic assumptions for projections, we set out our proposals for introducing an explicit assumption for both CPI-linked revaluation in deferment and CPI-linked pension increases in Chapter 3 of CP12/10.

CPI-linked revaluation in deferment

2.6 Deferred DB scheme benefits are increased (revalued) each year until normal retirement date to protect the value from being eroded by inflation. Using information from the PwC report, we proposed a revaluation rate of 2% for benefits based on CPI, which is consistent with the government target for CPI.

2.7 We asked:

> *Q4: Do you agree with the assumption for CPI-linked revaluation in deferment? If not, please state the level at which you believe the assumption should be set and why you believe it is more suitable.*

2.8 Virtually all respondents agreed with our proposals for the CPI-linked revaluation assumption. Some respondents noted the need to keep both the Retail Prices Index (RPI) and CPI assumptions under review, particularly if there are changes to the way they are calculated. A small number of respondents were not convinced that the difference between the RPI and CPI assumptions was appropriate, in the light of the PwC report, or questioned the implicit assumption that there is no difference between the GDP deflator[5] and RPI. However, they were ultimately comfortable with the CPI assumption we proposed.

Our response

We were pleased that virtually all respondents agreed with our proposals. We note the requests for both RPI and CPI to be kept under review. The TVA assumptions generally are linked to those in COBS 13, and the economic assumptions as a whole are already reviewed regularly for their continuing validity in the long term.

3 PS12/8 *Pension transfer value analysis assumptions – feedback to CP12/04 and final rules* (April 2012).
4 *Rates of return for FSA prescribed projections* (April 2012): www.fsa.gov.uk/static/pubs/other/projection-rates12.pdf
5 The GDP deflator is a measure of inflation in the domestic economy

CPI-linked pension increases

2.9 DB schemes are now offering benefits which can increase in line with CPI (within bounds) as well as RPI-linked benefits. Previously, our rules have only specified annuity interest rates for RPI-linked benefits, but in CP12/10 we proposed an explicit CPI-linked annuity interest rate based on the RPI annuity interest rate plus 0.5%.

2.10 For benefits which have limits on their payments with maximum increases (typically referred to as caps) and/or minimum increases (typically referred to as collars) we proposed a limited price indexation (LPI) approach consistent with that used for RPI. This was based on the implicit difference between the annuity interest rate for level benefits and that for linked benefits. Our proposal was that for maximum increases of 3% or below, or minimum increases of 3% or higher, fixed rate escalation based on the maximum increase should be used. In other cases the CPI-linked annuity interest rate should be applied.

2.11 We asked:

> ***Q5:*** *Do you agree with the approach and level of the assumptions for pension increases based on CPI? If not, please explain what alternative basis you think is more appropriate.*

2.12 Most respondents agreed with our proposals for the CPI-linked pension increases. Some commented favourably on the consistent approach proposed for RPI-linked increases and revaluation in deferment. One respondent disagreed that the rate for RPI-linked benefits and CPI-linked benefits should be the same when the maximum increase is at or below 3%, preferring that the 0.5% differential was maintained.

2.13 One professional body identified that the proposals gave rise to an anomaly between RPI and CPI-linked annuity interest rates for schemes with minimum increases of 3% or more but less than 3.5%, which meant that CPI benefits could be valued as being worth more than RPI benefits. Their request for the anomaly to be removed was echoed by a product provider who worked with the professional body.

Our response

We were pleased that most respondents agreed with our proposals. We agree that the anomaly should be addressed and have made changes to the final rules accordingly. These changes should ensure that CPI-linked benefits cannot appear to be more valuable than RPI-linked benefits, as well as introducing a sliding scale for the RPI-CPI differential for minimum increases between 3% and 3.5%.

For clarity, we have also explicitly stated in the rule whether the annuity interest rate for fixed rates of increase should be used in conjunction with the maximum increase or the minimum increase. This change has also been made in the corresponding rule for LPI based on RPI increases, to ensure consistency.

Timing

2.14 In CP12/10, we did not indicate the likely timing for implementing our proposals. However, from our previous work on TVA earlier this year, we know that TVAS providers are able to implement changes relatively quickly. So we have decided that the new CPI assumptions should become effective from 1 January 2013.

Cost benefit analysis

2.15 In CP12/10, we recognised that our previous consultation on TVA had taken into account the costs associated with introducing an explicit CPI assumption for revaluation. Respondents to that consultation had said that the introduction of an explicit CPI-linked annuity interest rate could be absorbed within the costs laid out in CP12/4. The benefits of doing so were laid out in PS12/8. So, we said there were no costs or benefits to introducing CPI assumptions additional to those we discussed previously in CP12/4 and PS12/8.

2.16 We asked:

> *Q6: Do you have any comments on the cost benefit analysis for our proposals in Chapter 3?*

2.17 No respondents commented on this question.

Compatibility statement

2.18 We consider that the compatibility statement in Annex 1 of CP12/10 is still valid and does not need to be amended.

3

COBS 13 Annex 2 – changes to investment return assumptions

Introduction

3.1 This chapter outlines the views of respondents to the proposals made in Chapter 4 of CP12/10.

3.2 We received 33 responses to our consultation. These responses came from a wide range of sources, including product providers, professional services providers, and advisory firms, as well as software providers, trade bodies and professional bodies. A full list of non-confidential respondents is provided in Annex 2.

3.3 This chapter also sets out our views on these responses and how we have decided to proceed.

Out of scope issues raised by respondents

3.4 This consultation related specifically to proposed changes to:

- our intermediate projection rate;
- the adjustment for tax-disadvantaged products;
- the span of the explicit flanking rates either side of the intermediate rate; and
- the wording of a particular rule.

3.5 However, many respondents suggested wider changes to our projections rules or asked for more guidance on appropriate rates for different asset mixes. While we are grateful for all the responses we received, these issues are outside the scope of our CP and we are unable to consider them further as part of this consultation.

Summary of in-scope responses

3.6 In CP12/10, we proposed that we should change the wording of COBS 13 Annex 2R 2.4 to say that providers should always use appropriate rates, subject to the maxima represented by our standard rates. We asked:

> ***Q7:*** *Do you agree that this change of wording provides sufficient additional emphasis for providers regarding our longstanding requirement that they use appropriate projection rates?*

3.7 Most respondents agreed that the change in wording was justified or offered no specific objection.

3.8 The main concern raised by the remaining respondents related to the updated wording we proposed in CP12/10 – specifically the use of the word 'accurately'. Some respondents argued that accuracy is only possible with the benefit of hindsight and offered alternative words like 'realistically' or 'appropriately'.

3.9 Other respondents felt the change of wording was unnecessary, arguing that our 2009 'Dear CO Letter'[6] had made our expectations clear enough or that further supervisory or enforcement action would achieve this aim.

Our response

Our thematic work shows that providers have often failed to comply with our requirement that they revise our standard rates downwards where a product is unlikely to achieve returns in line with these rates.

We believe that rewording the relevant rule will provide valuable and necessary emphasis of this requirement. We are not persuaded that any of the words offered as replacements for 'accurately' achieve the necessary effect. So, we intend to proceed with our proposed rewording.

We will continue to monitor providers' compliance with this requirement and take appropriate measures where we find non-compliance.

6 www.fsa.gov.uk/pubs/other/co_letter_projections.pdf

3.10 We also proposed changes to the projection rates, and asked:

> *Q8: Do you agree that the proposed changes to these assumptions are appropriate? If not, what changes would you propose? Please explain why you would make other proposals.*

3.11 This question drew a number of detailed responses. It also attracted the most comments going beyond our proposals.

3.12 Most of the in-scope comments related to our intermediate projection rate. While most respondents agreed that this rate ought to be lower, many were unhappy with our proposal to lower it to 5%. In the main these respondents did not believe that we should lower the rate ¼% below the range quoted by PwC and argued that we should adopt a rate somewhere in the middle of that range. One respondent went on to question our spurious accuracy argument for avoiding having a ¼%, given that we also proposed narrowing the tax differential to ½%.

3.13 A number of respondents argued that we should adopt different tax differentials for each of the three projection rates (intermediate and flanking). We note these views, but will not be considering them further as part of this consultation, as our proposals related to updating our current assumption rather than any wider change to our approach.

3.14 Our proposals in relation to the flanking rates also attracted a great deal of out-of-scope commentary, mainly around other ways we could use to present information about future volatility. Otherwise no respondent argued for a span different from our proposed ±3% for flanking rates that are symmetrical and consistent across all durations.

3.15 One respondent crticised PwC's approach. They argued that stochastic modelling of joint probabilities for inflation and capital market returns would have provided a richer and more realistic basis for deterministic rates. But they did not go on to say that they disagreed with PwC's specific conclusions.

Our response

We note that a number of respondents are unhappy with our proposed intermediate rate of 5%. However, we do not believe that any of the arguments offered for a higher rate are sufficiently compelling to change our view that we should set a rate at the bottom end of the range quoted by PwC, as all of the risks they identify are on the downside.

We accept that, historically, the FSA has mandated projection rates accurate to a ½%. However, we still believe that mandating a rate accurate to a ¼% would represent spurious accuracy, which might lead consumers to regard such specific rates as being more likely to be borne out by experience.

Our proposals in relation to the tax differential and the flanking rates drew comparatively few in-scope comments, and none of these offered any strong reasons for adopting values different to those set out in CP12/10.

So we have decided to make the changes we proposed in CP12/10:

- reducing our intermediate projection rate from 7% to 5%;
- reducing the adjustment for tax-disadvantaged products from 1% to ½%; and
- increasing the span of the explicit flanking rates either side of the intermediate rate from ±2% to ±3%.

Cost benefit analysis

3.16 We asked:

Q9: Do you agree with the cost benefit analysis for our proposals in Chapter 4?

3.17 A number of respondents challenged our belief that our proposed changes should not result in significant costs to providers. Within this group there were three identifiable, but not mutually exclusive, categories:

- respondents who confined themselves to stating that the costs would be significant;
- respondents who stated that the costs would be significant but manageable if we recognised that other regulatory initiatives are making heavy demands of their systems resource and offered them a significant transitional period; and
- respondents who confined themselves to observing that the costs would be significant, but not such that we should not proceed.

3.18 Very few respondents addressed the other side of the CBA equation: the consumer benefit. Those that did argued that lower projection rates might lead to consumers believing that an investment does not represent good value. This could lead them to invest in products not covered by our projections rules that give the appearance of better performance, with the risk that these products might be unsuitable investments.

Our response

We believe that consumers should receive a realistic idea of what they may get back before they decide to invest, and do not accept that lower projection rates will significantly increase the probability of unsuitable investments being sold.

Our suitability rules will help to deal with the danger that consumers will be attracted by other products that give the appearance of better performance.

More generally, our projections regime has changed little since the mid 1990s, and there has always been a requirement that providers use appropriate rates where our standard rates overstate the investment potential of a product. Our standard projection rates have changed twice since 1988. So we consider that providers should already have the capacity to change their systems, and comply with our rules, without incurring significant additional costs.

In addition, we have added a transitional provision allowing firms to comply with the amended rates at any time from 6 April 2013 (a year before they come into force), so that they can change their systems and documentation when making other changes.

Timing

3.19 The new projection rates will come into force on 6 April 2014. As noted above, we have added a transitional rule allowing firms to comply with the amended rates early (at any time from 6 April 2013) so that they can make changes to their systems and documentation at the same time as other changes.

Compatibility statement

3.20 We consider that the compatibility statement in Annex 1 to CP12/10 is still valid and does not need to be amended.

Annex 1

List of non-confidential respondents to Chapter 3 of CP12/10

AEGON

Association of British Insurers

Aviva

Axa Wealth

Bridges UK Actuarial Services

Capita Life & Pensions Regulated Services

Fowler Drew

Friends Life

Hargreaves Lansdown

KPMG

Lighthouse Group

Society of Pension Consultants

The Institute and Faculty of Actuaries

Zurich Insurance Group

Annex 2

List of non-confidential respondents to Chapter 4 of CP12/10

AEGON

Association of British Insurers

Association of Financial Mutuals

Aviva

AXA Wealth

Barrie & Hibbert Ltd

Bridges UK Actuarial Services

Capita Life & Pensions Regulated Services

FIL Group Ltd

Financial Services Consumer Panel

Fowler Drew

Friends Life

Hargreaves Lansdown

KPMG

Lighthouse Group

Liverpool Victoria

MedDen Financial Services

Milne Craig Chartered Accountants

OAC Actuaries and Consultants

Phoenix Life

Police Mutual Assurance Society

Royal Bank of Scotland

Scottish Widows

Sheffield Mutual Friendly Society

Shepherds Friendly Society

Skandia Life Assurance Company

Society of Pension Consultants

Standard Life Assurance

Steve Dixon Associates

The Institute and Faculty of Actuaries

Zurich Insurance Group

Appendix 1

Made Handbook text

FSA 2012/63

CONDUCT OF BUSINESS SOURCEBOOK (PROJECTIONS) (AMENDMENT) INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making power); and
(b) section 156 (General supplementary powers); and

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force as follows:

(1) Part 1 of the Annex to this instrument comes into force on 6 April 2014;
(2) the remainder of this instrument comes into force on 6 April 2013.

Amendments to the Handbook

D. The Conduct of Business sourcebook (COBS) is amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (Projections) (Amendment) Instrument 2012.

By order of the Board
31 October 2012

Annex

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part 1: Comes into force on 6 April 2014

13 Annex 2 Projections

…

R			
Assumptions: rates of return			
2.3	A *standardised deterministic projection* must be calculated using rates that accurately reflect the investment potential of the product and do not exceed the following maximum rates of return:		
Nominal rates	Lower rate	Intermediate rate	Higher rate
tax-exempt business held in a *wrapper* or by a *friendly society* *personal pension schemes*, *stakeholder pension schemes* and investment-linked annuities	~~5%~~ 2%	~~7%~~ 5%	~~9%~~ 8%
all other products	~~4%~~ 1½%	~~6%~~ 4½%	~~8%~~ 7½%

R		
Exception		
2.4	A *standardised deterministic projection*:	
	(1)	~~must be calculated using lower rates of return, if the rates described in this section overstate the investment potential of the product;~~ [deleted]
	(2)	may be calculated using a lower rate of return if a retail client requests it.

…

Part 2: Comes into force on 6 April 2013

TP 2 Other Transitional Provisions

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		**Transitional provision**	**Transitional provision: dates in force**	**Handbook provisions: coming into force**
…					
2.5B	*COBS* 13 Annex 2 2.3	R	A *firm* may comply with the provision listed in column (2) as amended by the Conduct of Business Sourcebook (Projections) (Amendment) Instrument 2012 as if the amendments to the *Handbook* set out in that instrument were in force.	From 6 April 2013 to 5 April 2014	6 April 2014
2.5C	*COBS* 13 Annex 2 2.4	R	A *firm* may comply with the provision listed in column (2) as amended by the Conduct of Business Sourcebook (Projections) (Amendment) Instrument 2012 as if the amendments to the *Handbook* set out in that instrument were in force.	From 6 April 2013 to 5 April 2014	6 April 2014
…					

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CONDUCT OF BUSINESS SOURCEBOOK (PENSION TRANSFER VALUE ANALYSIS) (AMENDMENT) INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making power); and
(b) section 156 (General supplementary powers); and

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 1 January 2013.

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Conduct of Business Sourcebook (Pension Transfer Value Analysis) (Amendment) Instrument 2012.

By order of the Board
31 October 2012

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

CPI	the Consumer Prices Index.
limited price indexation	in relation to transfer value analysis, benefits which increase in line with a recognised index but subject to a minimum and/or maximum rate.
RPI	the Retail Prices Index.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

19.1 Pension transfers and opt-outs

Preparing and providing a transfer analysis

…

19.1.4 R When a *firm* compares the benefits likely to be paid under a *defined benefits pension scheme* with the benefits afforded by a *personal pension scheme* or *stakeholder pension scheme* (*COBS* 19.1.2R(1)), it must:

(1) assume that:

(a) the annuity interest rate is the intermediate rate of return appropriate for a level or fixed rate of increase annuity in ~~(~~*COBS* 13 Annex 2 3.1R(6)~~)~~) unless *COBS* 19.1.4BR applies or the rate for annuities in payment (if less);	
(b) the ~~retail prices index~~ *RPI* is	2.5%
(c) the average earnings index and the rate for section 21 orders is	4.0%
(d) for benefits linked to the *RPI*, the pre-retirement *limited price indexation* revaluation is	2.5%
(e) the annuity interest rate for post-retirement ~~limited price increases~~ *limited price indexation* based on the *RPI* with maximum pension increases less than or equal to 3.5% or with minimum pension increases more than or equal to 3.5% is the rate in (a) above allowing for increases at the maximum rate of pension increase; otherwise it is the rate in (f) below;	
(f) the index linked ~~pensions~~ annuity interest rate for pension benefits linked to the *RPI* is the intermediate rate of return in *COBS* 13 Annex 2 3.1R(6) for annuities linked to the ~~retail prices index~~ *RPI* unless *COBS* 19.1.4BR applies;	
(g) the mortality rate used to determine the annuity is based on the year of birth rate derived from each of the Institute and Faculty of Actuaries' Continuous Mortality Investigation tables PCMA00 and PCFA00 and including mortality improvements derived from each of the male and female annual mortality projections models, in equal parts;	

(h) for benefits linked to the *CPI*, the pre-retirement *limited price indexation* revaluation is	2.0%
(i) the index linked annuity interest rate for pension benefits linked to the *CPI* is the intermediate rate of return in *COBS* 13 Annex 2 3.1R(6) for annuities linked to the *RPI* plus 0.5% unless *COBS* 19.1.4BR applies in which case it is the annuity rate in *COBS* 19.1.4BR plus 0.5%;	
(j) the annuity interest rate for post-retirement *limited price indexation* based on the *CPI* with maximum pension increases less than or equal to 3.0% or with minimum pension increases more than or equal to 3.5% is the rate in (a) above allowing for increases at the maximum rate of pension increase; where minimum pension increases are more than or equal to 3% but less than 3.5% the annuity rate is the rate in (a) above allowing for increases at the minimum rate of pension increase otherwise it is the rate in (i) above;	

or use more cautious assumptions;

(2) calculate the interest rate in deferment; and

(3) have regard to benefits which commence at difference times.

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