FINANCIAL ASSISTANCE SCHEME

REVISION TO THE ANNUITY FACTORS EMPLOYED BY THE FINANCIAL ASSISTANCE SCHEME

THE GOVERNMENT RESPONSE TO THE CONSULTATION

June 2008

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INTRODUCTION

1. The Financial Assistance Scheme (FAS) was set up in September 2005 to provide help to certain pension scheme members who had lost out on their final salary pension in circumstances of company failure prior to the introduction of the Pension Protection Fund (PPF).

2. On 17 December 2007 the Government announced reforms to the FAS. Amongst other changes the Government announced that all FAS qualifying members will be guaranteed 90 per cent of their accrued pension (rather than the current 80 per cent), paid from the later of the scheme normal retirement age (NRA) and age 60 (rather than at age 65), subject to a cap.

3. Typically, FAS payments are calculated as top-up payments to the pensions paid to beneficiaries by their pension schemes. In certain circumstances, where 'full' rates of scheme pension are unavailable (for example where lump sums have been taken by members) annuity factors are used to approximate the annual rate of pension that could alternatively have been secured for the member by way of bulk annuity purchase.

4. Implementing changes to re-calculate FAS payments at 90 per cent and from NRA provided a suitable opportunity to review the annuity factors used for this purpose. On 6 March 2008 the Government launched a consultation seeking views on the proposed revision of those factors[1].

5. The use of the annuity factors in the determination of FAS payments is provided for in legislation (specifically in Schedule 2 to the Financial Assistance Scheme Regulations S.I. 2005/1986). However the detail of the operation of the factors and the factors themselves are not set out in legislation and consultation on the factors is not required by statute.

6. The consultation period lasted six weeks and ended on 18 April 2008. A consultation period of six weeks is in line with the Department's practice in relation to limited technical consultations.

7. The reforms to the FAS announced in December 2007 will mean that actuarial factors are likely to be required in an additional range of circumstances (for example, in relation to providing lump sums to members by giving up part of their FAS payment). We will be consulting further on the factors that might be used in such circumstances as part of the process to put in place further parts of the package of improvements to the FAS. However, as part of the consultation we welcomed initial views on whether the proposed basis of the revised factors might also be appropriate for these additional functions.

[1] A copy of the consultation document can be found on the FAS website.

8. This document sets out the main points made in relation to the consultation and provides the Government response.

9. Five respondents provided their views or those of the organisation they represent. A list of the respondents is contained in an **Annex A** to this document. The Government is grateful for the contribution of all respondents.

10. Whilst the Government does not plan at this stage to make any changes to the factors as a consequence of the consultation responses it will continue to consider the issues raised by respondents in the context of delivering the full package of reforms announced in December 2007, subject to further consultation and draft regulations later in the year.

11. This document is available on the DWP website: http://www.dwp.gov.uk

12. A paper copy of this document can be obtained from:
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RESPONSE TO CONSULTATION

Discussion

13. Respondents raised a number of queries on the proposed revisions to the annuity factors. Some common concerns were raised:
    - on the assumptions underlying the factors in relation to indexation;
    - that annuity factors should not be employed where the scheme pension given up for the cash sum is known; and
    - that use of the annuity factors means members will not actually receive a guaranteed 90 per cent of their accrued pension.

    A number of technical queries were raised and some comments made on the use of the revised annuity factors in other contexts to help facilitate the delivery of the full package of FAS reforms announced in December 2007.

General queries and comments

Indexation

14. The annuity factors do not make any allowance for indexation. Three respondents stated that the annuity factors should allow for indexation at least in respect of pension accrued since 1997.

Response

15. We propose to use the revised annuity factors to help deliver enhanced payments under current FAS rules and processes. Under current rules, final FAS entitlements ("annual payments") are calculated as top-up payments to annuities that are secured at the end of wind-up with the share of scheme assets allocated to a member by the scheme trustees. Where information cannot be provided on the rate of annuity that was secured or that could have been secured with the member's share of scheme assets we must approximate the rate of bulk annuity that could have been secured. Deferred annuities purchased as part of the scheme wind-up process for underfunded schemes eligible for FAS do not typically include indexation. Thus it is appropriate that the proposed factors used to approximate deferred annuity rates do not assume any indexation.

16. The announcement made in December 2007 stated that Government would absorb the residual assets in FAS schemes and make associated payments as they fall due. The statement also said that FAS assistance derived from post-1997 service will be indexed and that, where their share of scheme funds allows, members whose assets will be taken into FAS will be able to commute some portion of their FAS payment for a lump sum. We are considering how these commitments will be implemented, including whether it might be

appropriate for lump sum commutation factors to include any allowance for indexation. We will be consulting further on the actuarial factors that might be used in such circumstances as part of the process to put in place the further reforms to FAS.

Use of annuity factors where amount of scheme pension given up is known

17. Under current FAS processes the annuity factors are used whenever information on the rate of annuity that could have been secured with the full amount of scheme assets allocated to the member has not been provided by trustees or other information providers. Three respondents suggested that annuity factors should not be employed where the scheme pension given up for the cash sum is known; instead the amount of pension sacrificed should be taken into account.

Response

18. Under current rules, final FAS entitlements ("annual payments") are calculated as top-up payments to annuities secured at the end of wind-up with the share of scheme assets allocated by the scheme trustees to a member.

19. If a member takes a lump sum during scheme wind-up then their share of assets is reduced and we need to take account of the full amount of assets allocated to the member when calculating their annual payment. In such circumstances, scheme trustees are unlikely to be able to provide us with the annuity rate that could have been secured at the end of wind-up had that lump sum not been taken. In the absence of this information and in order to take account of the lump sum we use the annuity factors to approximate a rate of bulk annuity that could alternatively have been secured with the lump sum.

20. It is recognised that information on the amount of scheme pension commuted may be available in relation to lump sums taken during wind-up. However, given the changes in scheme circumstances and financial conditions over the period between the time such lump sums might be taken and the time when annuities might be secured, the amount of scheme pension sacrificed may be very different from the amount of annuity that could ultimately have been secured with the lump sum.

21. Depending on individual circumstances and the specific commutation factors employed by their scheme the amount of scheme pension sacrificed by a particular member may be higher or lower than the ‘notional rate of annuity’ derived from the cash sum received by application of FAS annuity factors. Use of the annuity factors helps to ensure consistency between FAS members.

22. It should also be noted that FAS 'initial payments' paid to members during wind-up are made on account of their final FAS entitlement. In

order to calculate initial payments for members who have taken lump sums during wind-up we follow the same 'conversion' process as we do in relation to annual payments. This helps to ensure consistency between the way that initial payments and annual payments are calculated in order to help ensure potential overpayments are avoided.

Relation to 90 per cent assistance rate.

23. Under recent changes to the FAS members will receive payments that top-up any scheme pension paid to 90 per cent of their accrued pension, subject to a cap. Three respondents queried whether use of the annuity factors might mean that members receive less than 90 per cent of their accrued pension.

Response

24. In certain circumstances, where a member has taken some or their entire share of scheme assets as a cash sum (whether as a transfer value or a lump sum) rather than an annuity, we use the annuity factors to approximate the rate of bulk annuity which could have been secured for the member with that cash sum. FAS then pays a top up to that 'notional rate of annuity' so that the member receives benefits to the value of 90 per cent of their accrued pension (subject to a cap). In such circumstances members will not be receiving their full 90 per cent in the form of a pension or FAS assistance because they have already received some of their benefits in the form of a cash sum or will receive benefits derived from their transfer value.

Technical queries and comments

Difficulty of estimating annuity prices

25. Three respondents commented on the difficulty of accurately estimating annuity prices particularly due to recent shifts in the market caused by new providers and practices. One respondent commented that the true cost of buy-out might be understated by the proposed factors whilst another respondent suggested the factors might overstate buy-out costs. Because of the difficulty of accurately estimating buy-out costs it was suggested that that factors should be subject to regular review.

Response

26. The Government acknowledges the difficulty of estimating buy-out costs in the current market which was highlighted by the contrasting views on whether the proposed factors understated or overstated those costs.

27. The Government will consider appropriate processes for reviewing the annuity factors depending on their final use within the full package of FAS reforms.

Factors for normal retirement ages (NRAs) other than 65.

28. One respondent wanted clarification that different factors would apply for NRAs other than 65.

Response

29. Different factors have been calculated for use where members' NRAs are other than 65. Some of those factors are used in the examples provided in the consultation document.

Market Value Adjustment (MVA) tables

30. One respondent asked why a formula could not be adopted to calculate the correct MVAs without the need for tables or interpolation.

Response

31. The current FAS annuity factors are accompanied by tables of MVAs which are applied by FAS Operational Unit staff in calculating the level of assistance to which members are entitled. Theoretically it would be possible to evaluate these MVAs using the underlying formula which could then be applied during the calculation rather than the explicit interpolation between factors using the tables provided. The specification of the formula is set out in **Annex B** to this document.

32. The end result of these two approaches would be, by definition, the same given that the formula would be written explicitly to replicate the effect of the existing MVAs. Given that staff working on FAS are currently accustomed to finding the correct MVAs by using and interpolating within the tables provided it is felt there is little gain to be achieved, whether actuarially or administratively, in changing to a different calculation method at this point. Such a change would impose increased costs in requiring additional training to staff and changes to IT implementation processes.

MVA dates

33. One respondent suggested that MVAs should be used at the date of calculation not at the date of payment.

Response

34. Under current FAS processes MVAs are used as at the date that the cash sum was taken by the member. In doing so the annuity factors seek to approximate the rate of bulk annuity that could have been

secured as at the date the cash sum was taken. The Government has no plans to change this approach.

Annualisation of yields

35. The yields required to calculate are often quoted semi-annualised. We were asked how the factors allow for the annualisation of yields.

Response

36. When determining the appropriate MVA to apply in calculating a member's entitlement to FAS assistance it is necessary to consider the yield on conventional and/or index-linked gilts. These gilt yields are commonly quoted, for example in the Financial Times, in semi-annual terms. For the purposes of applying these yields in the calculations annualised yields must be used. This means that a transformation must be applied to convert the recorded semi-annual gilt yields into annualised rates. For example, a quoted yield of 8 per cent implies an annualised yield of 1.04 x 1.04, i.e. 8.16 per cent.

37. This conversion is allowed for in the calculation of the MVAs and the yields are converted to annualised figures before they are used to look up the appropriate MVAs from the tables provided.

Year of use basis for application of mortality rates

38. One respondent stated that they would rather see a year of birth approach than the year of use approach adopted in determining the appropriate mortality rates to use in calculating the factors.

Response

39. The factors were calculated using mortality rates appropriate to the year of use approach where the year of use is set equal to 2007. This means factors for a given age x are calculated using mortality rates appropriate to someone who is age x in 2007 and then allowing for future improvements. For example an age 50 factor would use the mortality rates for a 50 year old in 2007; a 51 year old in 2008; a 52 year old in 2009 and so on. This is equivalent to using a year of birth approach.

Assumptions on death benefits

40. One respondent wanted clarification of the interaction of the assumptions made in relation to 5 year guarantees and spouses' pensions.

Response

41. The annuity factors seek to approximate a typical deferred annuity secured with a five year guarantee and with 50 per cent of benefits payable to surviving spouses. The factors are calculated such that if a member dies within five years of their retirement the 50 per cent dependants' pension payable to their spouse is paid in addition to the balance of pension payments payable in respect of the guarantee . The factor includes the five year guarantee by making allowance for payments to continue for five years whether the member is alive or not.

Mortality tables

42. One respondent noted that it is proposed to retain the UK actuarial profession's Continuous Mortality Investigation (CMI) '92 series' amounts tables for the underlying base mortality rates rather than, for example, later '00 series' tables.

Response

43. As set out in paragraph 15 of the consultation document the proposed factors are based on work by PricewaterhouseCoopers (PwC) when they peer-reviewed the updated model of the financing of the FAS. Page 13 of PwC's December 2007 validation report (http://www.dwp.gov.uk/lifeevent/penret/penreform/fas/pwc-validation-report.pdf) sets out the assumptions made in this work, including use of the '92 series' amounts tables of mortality rates as issued by the CMI and appropriate adjustment to reflect mortality improvements since 1992, the year which the '92 series' base tables relate to. These mortality assumptions reflected what PwC believed to be a typical insurer's buy-out basis.

44. There are a range of base tables that might be adopted for these purposes, including two other series published by the CMI - the '00 series' or the preliminary results of investigations into the mortality rates of self-administered pension schemes (SAPS). It is important to consider the mortality basis used as a whole including the allowance made for future improvements. It was felt that the overall mortality basis suggested by PwC was appropriate for use and as such the '92 series' tables remain to be used as the base table. As noted in paragraph 27 above, the Government will consider appropriate processes for reviewing the annuity factors depending on their final use within the full package of FAS reforms.

Future use of annuity factors

45. A number of responses were provided on the potential use of the proposed annuity factors in a range of additional circumstances in order to facilitate delivery of the full package of FAS reforms announced in December 2007.

Response

46. The Government is grateful for the views that were provided on the further uses of the annuity factors. The responses will be carefully considered as policy is developed to deliver the commitments made in December 2007. Further consultation is planned before the end of this year.

Thanks

47. The Government is most grateful to all those who took the time to comment on the proposed revisions to the annuity factors.

Annex A

LIST OF RESPONDENTS [2]

Name	Organisation
Dominic Grimley	Hewitt, Bacon and Woodrow
Terry Monk	Pensions Action Group
Robin Bradford	Bradstock Action Group
David Unsworth	The Pensions Regulator
Kenneth Donaldson	N/A

[2] DWP officials also held meetings with Unite, Community and GMB unions and with the Pensions Action Group at which the proposed annuity factors were discussed.

Annex B

SPECIFICATION OF MARKET VALUE ADJUSTMENTS (MVAs)

1. Further detail on the use of MVAs is contained in Annex D to the consultation document. This annex sets out the specification of how these MVAs are calculated.

Conventional gilt MVAs

2. An MVA based on the level of conventional gilt yields must be applied to the annuity factors for both pensioner and deferred members or survivors. The conventional gilt MVA applies in respect of the post-retirement period.

3. The proposed annuity factors are calculated on a central conventional gilt yield, for the period after retirement, of 4.5%. This means that when conventional gilt yields are equal to 4.5% an MVA of 1 will be applied. A margin of 0.5% is subtracted from this central yield in calculating the central annuity factors. To the extent that, on the date of calculation, conventional gilt yields differ from this central yield, the MVA applied will scale the value of the annuity up or down.

4. The conventional gilt MVA is calculated by taking the ratio of two immediate annuities at age 65. This ratio compares the value of an annuity on the conventional gilt yield applicable as at the date of calculation with the value of the same annuity calculated using the central conventional gilt yield:

$$\text{Conventional gilt MVA} = \frac{\text{annuity valued on the conventional gilt yield at date of calculation}}{\text{annuity valued on the central conventional gilt yield}}$$

5. All other things being equal, the lower the yield used to calculate an annuity the higher its value. Therefore for gilt yields lower than the central yield the annuity valued at the conventional gilt yield as at the date of calculation will take a larger value than the annuity valued using the central yield. In these cases the resulting MVA will be larger than one. The opposite applies when the conventional gilt yield is higher than the central conventional gilt yield. The MVA will be equal to one when the conventional gilt yield at the date of calculation is equal to the central yield of 4.5%.

6. Gilt yields are published in 0.01% intervals in the Financial Times and other sources. Those yields which give the same figure for the MVA when the MVA is rounded to two decimal places (0.01) are grouped together. The resulting table is shown in table 1 of Annex D to the consultation document.

7. In valuing this ratio unisex factors are applied based on joint life immediate annuities with the following structure:

First life's sex	Female
Second life's sex	Male
Proportion married	80%
Age disparity	Husbands 3 years older than wives
Proportion inherited by spouse/survivor	50%
Guarantee	No guaranteed death benefit

8. Including a guarantee in these annuities would make very little difference to the MVAs. As we are taking a ratio of annuities the additional value added to the annuities by inclusion of a guarantee would largely cancel out when we calculate the MVAs.

9. The MVAs would also be very similar if the first life was chosen to be male with a female spouse and the assumed proportion married was increased to 90%.

Index-linked gilt MVA

10. An MVA based on the level of index-linked gilt yields must be applied to the annuity factors for deferred members. The index-linked gilt MVA applies in respect of the pre-retirement period.

11. The proposed deferred annuity factors are calculated on a central index-linked gilt yield, for the period before retirement, of 2.0%. This means that when index-linked gilt yields are equal to 2.0% an MVA of 1 will be applied. A margin of 0.5% is subtracted from this central yield in calculating the central annuity factors. To the extent that, on the date of calculation, index-linked gilt yields differ from this central yield, the MVA applied will scale the value of the annuity up or down.

12. As for the calculation of the conventional gilt MVA the index-linked gilt MVA is calculated by taking the ratio of two annuities, although now deferred annuities are used rather than immediate annuities. This ratio compares the value of an annuity on the index-linked gilt yield applicable as at the date of calculation with the value of the same annuity calculated using the central index-linked gilt yield:

$$\text{Index-linked gilt MVA} = \frac{\text{annuity valued on the index-linked gilt yield at date of calculation}}{\text{annuity valued on the central index-linked gilt yield}}$$

13. The deferred annuities are valued using a post-retirement discount rate of the central conventional gilt yield of 4.5% reduced by a margin of 0.5%, assuming a retirement age of 65. The other details of these annuities are as outlined in paragraph 7 above for the conventional gilt MVAs.

14. Given that these are deferred annuities the MVA will differ depending on how many years the member has left to their Normal Retirement Age (NRA). MVAs are calculated for index-linked gilt yields at intervals of 0.5%. For a given term to retirement interpolation is required to find the MVA valued at the index-linked yield as at the date of calculation. Details of this interpolation process are set out in Annex D to the consultation document. The required two-way table of MVAs is shown in table 2 of Annex D to the consultation document.

15. For gilt yields lower than the central yield the annuity valued at the index-linked yield as at the date of calculation will take a larger value than the annuity valued on the central yield and the resulting MVA will be larger than one. The opposite applies when the index-linked gilt yield is higher than the central index-linked gilt yield. The MVA will be equal to one at the central yield of 2.0%.