

Financial Ombudsman Service
South Quay Plaza
183 Marsh Wall
London
E14 9SR

6 July 2010

Dear Sirs

Assumption setting for Financial Ombudsman Service pension review cases

You have asked us to review and revise our advice on assumptions to apply from 1 July 2010 for pension review loss assessments which fall outside the boundaries of the FSA pension review. The last advice was provided as at 1 July 2009. This letter sets out our recommendations for rates to apply from 1 July 2010.

There are three main financial assumptions underpinning the loss assessment - the expected returns on bonds, on equities and expected inflation. We have based our recommendations on the calculation of reference yields as defined at the start of the FSA review. We have also considered the historical relationship between equity and gilt returns and the FSA pension review parameters. In setting the bond rate we have included an allowance for the corporate bond spread over gilts and have also considered the current annuity pricing basis of insurance companies. The expected rate of retail price inflation (RPI) has been set by assessing the difference between the yield on fixed interest gilts and on indexed-linked gilts, the difference being a proxy for the implied expected long term rate of RPI.

We have for the first time also considered the relationship between RPI and consumer price inflation (CPI) because an assumption for the expected rate of future CPI may be needed for review cases involving public service pension schemes. In the Emergency Budget on 22 June 2010, the Chancellor announced the intention to increase public service pensions in line with CPI from April 2011 rather than, as has always been the case in previous years, in line with RPI.

When considering appropriate rates to apply from 1 July 2010 we have considered the fact that the assumptions will be applied uniformly over the coming year although actual market levels may continue to fluctuate whilst also being cognisant of the practicalities of calculating using the available software.

As part of our review we have considered the cost of buying an open market annuity from an insurance company and the bond yield implied by annuity prices. We have also considered the narrowing of corporate bond spreads over gilts over the last year. Having taken this into account we consider it appropriate to set the bond assumption closer to the gilt yield than one year ago.

When the original pension review basis was considered in 1994 by the FSA with advice from a working party from the actuarial profession, we understand it was assessed on the basis of determining the kind of compensation consistent with what a court might deliver in the event of a successful mis-selling claim. On mortality, the profession considered the likely levels of mortality to be experienced by the people who had been mis-sold and these were higher than for the

population as a whole. Hence, even then, the sums computed may have been less than was likely to be charged by insurance companies for annuities for those people on a compulsory purchase basis from a pension scheme. When the FOS agreed to take over responsibility for maintaining those assumptions, we were asked to advise on the basis of a consistent approach.

We have not altered the principle of trying to assess a similar basis today but have in our thinking tried to focus on the changes which have considerably lightened the mortality assumptions both in population assessments and in insurance quotations. The most significant change is of course the higher general level of confidence that improvements in the future will continue and so the number of years by which mortality has appeared to lighten over the period since 1994 will be high.

With regard to mortality, it is necessary to be mindful of two influences.

1. Current rates of mortality improvement have generally exceeded the provision that has been made in the various standard actuarial tables currently available.
2. It is becoming increasingly common to make higher allowance for longevity to increase in the future than has hitherto been the case.

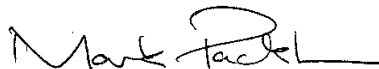
We consider that PA(90) - 10 is an appropriate mortality assumption to use in the calculations bearing in mind the cost related implications for pension review calculation software of a fundamental change in basis to an alternative table which requires a separate assumption for future improvements in mortality.

However, recognising the convention now to take future improvements in longevity into account, in addition to employing an age-rating to the existing table to reflect past improvements in longevity, we have made an interest-based adjustment to allow for improving mortality rates. It is an approximation that reasonably reflects increases in longevity that can be accommodated by existing software used to calculate loss and redress. This allowance has been built into the pre-retirement interest rate as an adjustment to the allowance made for investment returns. The adoption of this methodology better reflects the higher life expectancy of younger individuals.

More detail on the calculation of reference yields is included in appendix 1. The graph in appendix 2 illustrates the calculated equity and bond reference yields and the corresponding FSA pension review assumptions since the start of the pension review. We have included graphs illustrating how the bond rate has been set with reference to bond yields and how the historic inflation expectation has been set in appendix 3 and appendix 4.

Please do not hesitate to contact me if you have any questions.

Yours sincerely



Mark Packham
Director
Human Resource Services

**Recommendation for assumptions for the Financial Ombudsman Service
pension review loss assessments from 1 July 2010**

Financial Assumptions: 1 July 2010

These assumptions apply for calculations of:

- (a) prospective loss, and
- (b) redress

Validity:

All calculations done in the period from 1 July 2010

As at date:

All calculations of prospective loss and redress of prospective loss done in this period, and the value of all personal pensions, should be carried out as at 1 July 2010.

Discount rate

Using this basis the table of interest rates is shown below

Term to Retirement	Average Interest Rate in force over Period to Retirement
0	5.0
1	5.1
2	5.2
3	5.3
4	5.4
5	5.4
6	5.4
7	5.5
8	5.6
9	5.8
10	5.9
11	6.0
12	6.1
13	6.2
14	6.3
15-19	6.4
20-24	6.6
25-29	6.8
30 or more	6.9

The interest rate for annuities in payment is that for zero years to retirement.

Retail Prices Index ("RPI")	3.50% per annum
Limited Price Indexation ("LPI")	3.30% per annum
Section 21 orders (future)	RPI + 2.0% per annum
Statutory revaluation in deferment	3.30% per annum
Escalation of post 5 April 1988 GMP	2.90% per annum
Escalation at RPI capped at 3%	2.90% per annum
Consumer Price Index ("CPI")	3.00% per annum

Mortality

Standard table PA(90) rated down 10 years

Basis used for setting assumptions

- Gilt returns: Bond yields contain two elements – price inflation and the risk free real interest rate ie the return on a index-linked gilt

$$\text{Gilt rate} = (1+\text{inflation}) * (1+\text{risk free real rate}) - 1$$

- Equity returns: The equity rate contains 3 elements – price inflation, rate of dividend increase and dividend yield. For the review, the long term real dividend yield growth has been taken as 1.5% so the formula is:

$$\text{Equity rate} = (1+\text{inflation}) * (1+\text{dividend yield}) * 1.015$$

- Inflation rate: The inflation rate is estimated as the difference in the yield on an irredeemable gilt and an index-linked gilt:

$$\text{Expected inflation} = ((1+\text{yield on irredeemable}) / (1+\text{yield on I-L gilt})) - 1$$

