

Public Sector Pensions Briefing

Local Government Pension Scheme: FRS17 Assumptions for 31.03.07

December 06

For the 2006 FRS17 exercise we experienced a significant increase in the volume and detail of queries on the FRS17 valuations, and the assumptions, from employers and their auditors. With little prospect of reducing FRS17 deficits and the numbers now on the face of corporate accounts, we expect this increased interest to persist in 2007.

This briefing note has been prepared by Hymans Robertson LLP's Public Sector Practice specifically for employers participating in the LGPS. It is intended to assist in planning for the March 2007 FRS17 exercise and to prevent auditor queries arising at a late stage in the process.

BACKGROUND TO FRS17 ASSUMPTIONS

As for any actuarial calculation, the value of the liabilities for frs17 purposes is heavily dependent on the assumptions underpinning the calculations. If they are not already, employers should be aware that, ultimately, they are responsible for the assumptions used.

FRS17 states:

The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities. The assumptions are ultimately the responsibility of the directors (or equivalent) but should be set upon advice given by an actuary.

Any assumptions that are affected by economic conditions (financial assumptions) should reflect market expectations at the balance sheet date.

For a number of reasons, principally cost and employer timescales, we have historically recommended a standard set of assumptions for all employers within the LGPS, (subject to any specific guidelines for any group of employers, such as Government agencies who follow the Financial Reporting Manual guidance). Typically, employers unquestioningly accepted these recommendations. This has started to change: FRS17 is no longer only in the notes to the accounts and we understand that auditors' guidance now requires them to go beyond simply accepting the actuary's calculations as the work of an expert.

We welcome the greater interest in the assumptions being taken by employers and their auditors. However, in order to maintain service standards and contain costs, we believe that the current approach, where reports for all employers with the same year-end are processed using the same assumptions, remains appropriate for the majority of employers, particularly local authorities and other public sector bodies.

Corporate entities for whom FRS17 affects decision-making may take a different view, and the additional costs associated with adopting bespoke assumptions are much more likely to be worthwhile for them, bearing in mind that fees for LGPS employers are a fraction of those for sponsoring employers of stand-alone private sector schemes.

To assist employers in assessing whether they wish to accept our recommended assumptions, we have set out below the rationale for our recommendations for each of the principal assumptions.

FINAL ASSUMPTIONS

Assumption	FRS17 Requirement	Scope for Judgement	Our Recommendation
Discount Rate (a higher discount rate gives a lower liability value)	<i>Liabilities should be discounted at a rate that reflects the time value of money.... Such a rate should be the current rate of return on a high quality corporate bond¹ of equivalent currency and term to the liabilities.</i>	For LGPS liabilities, the discount rate can reflect the yield on any sterling denominated AA rated corporate bond (of appropriate term). However, we would expect that it would not be possible to pick the highest yielding bond each year to minimise the liabilities. There is therefore limited scope for judgement.	We propose to adopt the same approach as in previous years, i.e. to recommend a discount rate based on the yield on a basket of AA-rated bonds, [Iboxx Sterling Corporates AA over 15 Years Index]. Any very mature employers should consider whether a 15 year term is appropriate.
Inflation and Pension Increase Rate (a higher inflation/pension increase assumption gives a higher liability value)	<i>In jurisdictions where there is a liquid market in long-dated inflation-linked bonds, the yields on such bonds relative to those on fixed interest bonds of similar credit standing will give an indication of the expected rate of general inflation.</i>	The range of inflation assumptions disclosed in publicly available company accounts suggests that there is more scope for judgement here than meets the eye. The gilt markets give us a measure known as “break-even inflation. This is the level of future inflation that would give an investor in a conventional (non inflation-protected) gilt the same return as another who invested in an index-linked gilt. Directors of some organisations use inflation assumption below “break-even” levels. This may be justified on the grounds that the return from index-linked gilts is reduced by an inflation protection premium that investors are willing to pay. Adopting a lower pension increase assumption lowers the value placed on the FRS17 liabilities, including the service cost.	The difficulty is that extent to which index-linked gilt prices include a premium for future inflation protection is unknown - but a figure of around 0.2% appears to be in common usage in publicly quoted company accounts. In the past we have simply used breakeven inflation. The continued increase in breakeven inflation, up from 2.9% as at 31.03.06 to 3.1% today, places this assumption under the spotlight. We propose to continue to use break-even inflation without adjustment, as our default. However, we would be happy to discuss this assumption further with any employers who would like to explore reducing the inflation assumption.
Salary Growth (a higher assumption gives a higher liability value)	<i>The rate of increase in salaries and the discount rate must reflect the same rate of general inflation.</i>	The expected rate of growth in real pensionable pay (i.e. in excess of inflation) should be consistent with employers’ long-term remuneration policy or objectives. Subject to being able to justify the assumption used, there is scope for judgement here. Taking a margin out of inflation assumption could also help to reduce the allowance for earnings growth.	In previous years we have allowed for real salary increases in line with the most recent funding valuation (typically 1.5% p.a. ahead of prices). We propose to take the same approach for 2007, but would ask employers to confirm that this is appropriate for their disclosures.

¹ For this purpose, a high quality corporate bond means a bond that has been rated at the level of AA or equivalent status.

<p>Expected Return on Assets (affects only the net interest charge/ credit)</p>	<p><i>The average rate of return, including both income and changes in fair value but net of expenses expected over the remaining life of the related obligation on the actual assets held by the scheme.</i></p>	<p>The return on bonds is assumed to be in line with redemption yields so the scope for judgement here is limited. However, nearly all LGPS employers have an equity-biased investment strategy, and there is no corresponding measure for the return on equities, or other growth assets such as property. There is thus scope for judgement.</p>	<p>Our recommended expected return on assets is taken from our proprietary asset model, further details of which are available on request. The model parameters are calibrated to market conditions on a monthly basis. We are happy to discuss the assumptions further with employers.</p>
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DEMOGRAPHIC ASSUMPTIONS

Assumption	FRS17 Requirement	Scope for Judgement	Our Recommendation
<p>Pensioner Mortality (longer life expectancy increases the value of the liabilities)</p>	<p><i>The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities</i></p>	<p>Best estimate is not defined (in FRS17 or elsewhere) so there is scope for actuarial judgement.</p>	<p>Our recommended mortality assumptions have, to date, been based on those adopted for the most recent funding valuation. These have been set after extensive analysis of actual LGPS pensioner experience, and consultation with the individual funds.</p> <p>In all cases, we have adjusted the 92-series of mortality tables of the Continuous Mortality Investigation Bureau (CMIB) of experience of life insurance company pensioners, to tailor them to LGPS mortality patterns.</p> <p>These assumptions represent our best estimates based on that past experience.</p> <p>Successive CMIB analyses have revealed that mortality rates have reduced for life company pensioners. More recent evidence – which supports the evidence we have seen in the LGPS – suggests that occupational pension scheme mortality rate are higher than those of life company pensioners.</p> <p>There is no guarantee that the past mortality reductions will continue or, if they do, at what rate. The so-called short, medium and long cohort adjustments to the 92-series (which are commonly used in the private sector) are just one possible way of making an allowance for improvement.</p> <p>Different approaches are taken by our client funds:</p> <ul style="list-style-type: none"> • For many funds in England and Wales and Northern Ireland, the 2004 funding valuations made no allowance for possible future improvements in life expectancy when setting employer contributions. (There was also no anticipation of the abolition of the Rule of 85, which has a similar but opposite financial

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			<p>effect.)</p> <ul style="list-style-type: none"> In Scotland in 2005, most funds decided to include an allowance for longevity improvement in their contribution rates. <p>We do expect to make some allowance for future improvements in the 2007 valuations. It could be argued this is likely to be as a margin against possible future adverse experience so this is not in itself a reason for amending the FRS17 assumptions. However, we are aware that the norm in the private sector would be to make allowance for life expectancy improvements and are considering our approach for the 2006/7 FRS17 exercise.</p>
Commutation (a higher allowance for commutation will reduce the value of the liabilities)	<i>The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities</i>	Best estimate is not defined (in FRS17 or elsewhere) so there is scope for actuarial judgement.	We will be seeking data on commutation over the period since this option became available to LGPS members. Although this data will inevitably be limited ² , we believe that it is essential for any assumptions to have an evidential base. We propose to recommend the same commutation assumption for all LGPS funds unless there is specific justification for not doing so. We will adopt different assumptions for funds in England and Wales and Scotland if the data supports this approach. For funds where no allowance was made for life expectancy improvements in the last valuation, we will consider whether it is appropriate to offset the possible effect of commutation against life expectancy improvements. Further details of our recommended assumptions will be available in due course.
Other demographic assumptions, e.g. withdrawal assumption, ill-health early retirements etc			Our recommendations will be as for previous years, i.e. the same assumptions as adopted for the most recent formal funding valuation. Collectively, these are intended to be best estimate and are derived from specific past experience of LGPS funds.

² Commutation has only been an option since April 2006 (England, Wales and Northern Ireland) or October 2006 (Scotland)

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TAKE IT IN THE ROUND

FRS17 does not require that every individual assumption is a *best estimate*. The Directors of the organisation should be satisfied that the combined effect of the assumptions as a whole is reasonable in the round.

Besides the margin that is arguably implicit in the inflation assumption, there are some member behaviours that could reduce the liabilities which we have not anticipated in our assumptions in the past. For example:

- we have not taken credit for savings arising from members retiring after their earliest (Rule of 85) retirement age; and
- we have not anticipated any savings from members electing to use the new facility to commute pension for a bigger lump sum. We plan to gather data on commutation experience for the 31.03.07 FRS17 reports and will be considering the extent to which it is appropriate to allow for commutation.

If our assumptions were altered to include an allowance for future life expectancy improvements, at the same time as making these other adjustments, the net effect may be little change.

As soon as our investigation into commutation experience is complete, we will provide an update on our recommended assumptions. In the meantime, we would be pleased to receive any input from employers and their auditors on the extent to which they believe allowance for possible future improvements in life expectancy should be incorporated into the FRS17 results for 2007/08.

EFFECT OF 2007 FUNDING VALUATIONS

It should be noted that we will be revisiting the demographic assumptions as part of the 2007 formal funding valuation exercise for funds in England, Wales and Northern Ireland. These assumptions would not usually feed through into the FRS17 exercise until the following year, i.e. 2008.

We would note that it is perfectly justifiable to use different life expectancy assumptions for funding and accounting, as has been confirmed very recently by the actuarial profession, in their e-alert to pensions actuaries (particularly where the

funding assumptions include a margin for prudence).

We would also point out that, in our view, comparisons made by auditors between funding and accounting and with the private sector pension schemes are not necessarily helpful in light of the different requirements and the regulatory regime.

Nevertheless, we will be re-considering both the commutation assumption and the allowance for life expectancy for the 2007 FRS17 exercise and will provide a firm recommendation in due course. In the meantime, as indicated in the table above, we are keen to hear employers' views on the extent to which they wish to incorporate an allowance for longer life expectancy in the FRS17 disclosures.

NEXT STEPS

ASSUMPTIONS

Unless otherwise advised, any FRS17 reports commissioned by employers through the Administering Authority will be based on our default recommended assumptions. Other than possibly commutation and life expectancy, the demographic assumptions will be as in previous years, i.e. taken from the most recent formal funding valuation.

Our recommended assumptions are intended to fully comply with FRS17.

We would be delighted to tailor any of the assumptions to the needs of individual employers. We would ask that any employers who may be considering this consult with their auditors at an early stage and advise the Administering Authority in advance that they may wish to commission a bespoke report. Any additional work producing bespoke reports will fall outside of our standard fee scale and timetable.

NEW DISCLOSURES

Employers who may be considering early adoption of the new FRS17 disclosures (which is the subject of a separate briefing note) should also let the Administering Authority know in advance of commissioning an FRS17 report.