HM TREASURY

Basis for setting the discount rate for calculating cash equivalent transfer values payable by public service pension schemes

updated guidance issued by HM Treasury

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Contents

Revision to guidance following change in discount rate used for setting unfunded public service pension contribution rates

Following a full public consultation, the Government has decided that the appropriate discount rate for calculating unfunded public service pension contribution rates (the SCAPE discount rate) should be based on the long term expectations of GDP growth. A discount rate of three per cent above CPI inflation will therefore be adopted for calculating unfunded public service pension contributions in actuarial valuations.

The Treasury is reviewing the discount rate used to calculate Cash Equivalent Transfer Values in light of changes to the SCAPE discount rate. Individuals seeking the calculation of a Cash Equivalent Transfer Value should be aware that the discount rate used in those calculations is being reviewed and may change, subject to actuarial advice.

1 Summary

1.1 This guidance sets out the assumptions for discount rates for calculating cash equivalent transfer values payable from the public service pension schemes. The guidance note has been issued by HM Treasury after taking actuarial advice from the Government Actuary's Department (GAD).

1.2 The guidance applies to all unfunded public service pension schemes and to the Local Government Pension Schemes for England and Wales, Scotland and Northern Ireland and to the Parliamentary Contributory Pension Fund, which have statutory guarantees in addition to investment funds.

1.3 The Emergency Budget of 22 June 2010 announced that the uprating of the majority of state benefits and the State Second Pension would be changed from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) with effect from April 2011. This change is expected to apply to both accrued and future service public service pensions through the statutory link to the indexation of the State Second Pension.

1.4 The following guidance replaces the previous guidance, 'Basis for setting the discount rate for calculating cash equivalent transfer values payable by public service pension schemes' of 11 September 2008. The guidance reflects an immediate and interim review to enable the determination of cash equivalent transfer values following the change in uprating, and ahead of the report of the Independent Public Service Pensions Commission (IPSPC) chaired by John Hutton. The discount rate set out here could be reconsidered in light of the findings of the IPSPC.

1.5 In this guidance, references to the law applicable in Great Britain should be taken to include corresponding legislation in Northern Ireland

2 Background

2.1 Pension legislation obliges occupational pension schemes to provide deferred pension benefits to the majority of members who leave the scheme before normal pension age. The option of a cash equivalent transfer value (CETV) must also be provided. This is the amount which can be taken to another pension arrangement in lieu of deferred pension benefits which the member holds within the pension scheme. CETVs are also the basic measure of value for assessing the pension component of assets of a marriage during divorce proceedings, and for any consequent repackaging of pension rights between a scheme member and a spouse to implement a divorce settlement.[1]

2.2 Under the transfer value regulations[2], the CETV is to be the amount required within the pension scheme to provide the deferred benefits which would otherwise be provided.

[1] This will also apply correspondingly in the event of the dissolution of a civil partnership.
[2] The Occupational Pension Schemes (Transfer Values) Regulations 1996 SI 1996/1847 as amended

3 Legislative framework

3.1 The public service schemes are subject to Chapter 4 of the Pension Schemes Act 1993. This Act and its regulations require the schemes to make available cash equivalent transfer payments in the same circumstances as a private sector scheme and follow the same detailed processes on payment and on guaranteeing the terms offered for a prescribed period.

3.2 Under the Occupational Pension Schemes (Transfer Values) Amendment Regulations 2008, SI 2008/1050, responsibility for setting the economic, financial and demographic assumptions for CETVs moved to scheme trustees/managers with effect from 1 October 2008. This document provides guidance on the discount rate under Regulation 7B(6) for unfunded public service pension schemes, the Parliamentary Contributory Pension Fund and the Local Government Pension Schemes for England and Wales, Scotland and Northern Ireland. It covers the discount rate for benefits with the most common types of indexation in these schemes. Responsibility for all other calculation assumptions will rest with the managers of the individual schemes. Discount rates for benefits with any type of indexation not specifically covered in this note should be consistent with the discount rates set out in this note.

4 Discount rate assumptions

4.1 The public service pension schemes provide deferred benefits to early leavers that are calculated by reference to completed service and to pensionable earnings. On 22 June 2010, in the Budget, the Chancellor announced that the Government will use the Consumer Prices Index (CPI) for the price indexation of benefits and tax credits from April 2011. This change will also apply to public service pensions through the statutory link to the indexation of the State Second Pension. Upratings previously awarded based on the Retail Prices Index will continue to apply. However, for future upratings under the Pensions (Increase) Acts, increases in benefits will be in line with changes in CPI, published by the Office for National Statistics. This will apply during deferment and in payment, both to the member and any dependants. That part of the benefit which is guaranteed minimum pension (GMP) will generally be uprated at a lower rate, if at all, once benefits are brought into payment (GMPs are uprated in line with earnings during deferment). GMPs are generally small parts of the overall benefit provisions for most scheme members.

4.2 Assumptions have to be made for valuing all material components of the benefits to be exchanged for a CETV. The stream of payments which the CETV will replace may extend for many decades once prospective payments to the member and his or her eligible dependants are considered. It follows from the benefits provided that the main assumption in the calculation is the rate of discounting to be applied to future benefit payments, which are themselves rising in line with prices, and the length of time the benefits will be paid. The key discount rate assumption for determining CETVs for public service pension schemes is therefore the real (net of prices) discount rate.

4.3 HM Treasury's guidance dated 11 September 2008, regarding the basis for setting the discount rate for calculating CETVs payable by public service pension schemes, prescribed a long-term discount rate of 3.5 per cent per annum net of changes in the Retail Prices Index.

4.4 The Treasury recognises, however, that CETVs taken from public service pension schemes will in general be invested in market assets. To reflect this there will be some limited continuing linkage to the gilt market, which will be reconsidered at the next review of these assumptions.

4.5 Having considered the relevant factors, the public service pension schemes to which this guidance applies will adopt with immediate effect the following discount rates for the determination of cash equivalent transfer values:

- An assumed long-term discount rate of 3.5 per cent per annum net of changes in the Retail Prices Index.
- An initial discount rate applying in the market, measured as the yield on index linked government bonds with duration of 15 years or more averaged between the 0 per cent and 5 per cent assumed inflation values.
- The above real rates are with reference to RPI, rather than CPI. These real rates must therefore be increased by an addition of 0.75 percentage points to reflect the long-term expectation of the difference between CPI and RPI; and

- The discount rates are assumed to move from the initial discount rate to the long-term discount rate over a period of 15 years.

4.6 For benefits which are not indexed by pension increases under the Pensions Increase Act, the following adjustments to the discount rate assumptions will apply:

- For non-increasing benefits the long-term discount rate will be 6.0 per cent per annum.

- For GMP benefits accrued after 1988 which carry increases up to 3.0 per cent per annum, the net rate, in excess of pension increases, will be a long-term discount rate of 4.75 per cent per annum.

4.7 For calculation purposes scheme administrators will allow for the current yield on index-linked bonds using published market rates updated at the start of each month. Calculation factors reflecting the impact of the initial yield will be prepared by the scheme actuary and incorporated in scheme administration systems. These factors will allow for the effects of both pension and retirement cash lump sum benefits.

5 Review

5.1 This guidance will be reviewed at regular intervals or at such time as the Treasury, having taken advice from GAD, considers appropriate.