Government
Actuary's
Department

Fixed Rate of Revaluation of Guaranteed Minimum Pensions

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Introduction

Background

1.1 The Government Actuary's Department (GAD) has been asked by the Department for Work and Pensions (DWP) for advice on the fixed rate of revaluation of Guaranteed Minimum Pension (GMP) for contracted-out members who leave pensionable service in the period 6 April 2022 to 5 April 2027.

1.2 Schemes have been able to choose between two approaches for the revaluation of GMPs in this situation:

> In line with increases in average earnings (as specified in annual orders), or

> In line with a fixed rate (as specified in orders which apply usually for leavers in specified five-year periods).

1.3 This paper deals with the rate to be determined under the second bullet point above.

1.4 In the past, fixed rate GMP revaluation has generally been reviewed every 5 years:

Date of leaving	Annual percentage increase
Leavers after 5 April 1978 but before 6 April 1988	8.5% p.a.
Leavers after 5 April 1988 but before 6 April 1993	7.5% p.a.
Leavers after 5 April 1993 but before 6 April 1997	7.0% p.a.
Leavers after 5 April 1997 but before 6 April 2002	6.25% p.a.
Leavers after 5 April 2002 but before 6 April 2007	4.5% p.a.
Leavers after 5 April 2007 but before 6 April 2012	4.0% p.a.
Leavers after 5 April 2012 but before 6 April 2017	4.75% p.a.
Leavers after 5 April 2017 but before 6 April 2022	3.5% p.a.

1.5 In GAD's last review[1] we proposed a rate of either 3.5% p.a. allowing only for the growth in average earnings, or 4% p.a. including a 0.5% p.a. premium to allow for the conversion of a variable rate of revaluation (linked to actual average earnings growth) to a fixed rate.

1.6 Around the time of our last review in 2016, HMRC carried out some analysis indicating the average age of individuals with an open contracted-out Defined Benefit entry with a start date before 6 April 1997 (the date at which GMP accrual ceased) was around 53 years old. Furthermore, given GMPs ceased to accrue in 1997, the youngest members with GMPs are likely to be in their mid-40s. We have therefore concluded it was reasonable to move from a long-term view of inflation to a medium-term view, which at that time we considered to be around 10 years.

1.7 We arrived at the earnings assumption of 3.5% p.a. by determining an estimate of CPI inflation and allowing for our expectations of earnings relative to CPI. We initially looked at market implied break-even RPI and adjusted this for an inflation risk premium of 0.25% p.a. We then used the RPI assumption to set our CPI estimate allowing for our best estimate of the long-term difference between RPI and CPI of 1.15% p.a. as detailed in the table below. We then assumed earnings to increase on average at 2% p.a. above CPI inflation. The derived assumption was consistent with the OBR short to medium term earnings assumption of 3.5% p.a. in place from April 2017.

Market-implied RPI (10 years)	2.9% p.a.
RPI (Market-implied RPI - 0.25% p.a.)	2.65% p.a.
CPI (RPI - 1.15% p.a.)	1.5% p.a.
Earnings (CPI + 2% p.a.)	3.5% p.a.

1.8 When setting the fixed rate GMP revaluation in the past an additional 0.5% pa premium was added to the assumed level of earnings increases. This premium represented the price to exchange a variable rate of revaluation for a fixed rate. Following responses to the consultation issued in October 2016, DWP decided that circumstances had changed sufficiently so as not to include the 0.5% p.a. premium referred to above and opted for a fixed rate GMP revaluation of 3.5% p.a. based only on the earnings increase assumption[2].

Other relevant factors relating to this review

1.9 In November 2020 the UK Statistics Authority and HM Treasury published their joint response to the consultation[3] on the potential reform of RPI. This confirmed that the methodology for calculating RPI will be aligned with that for CPIH in February 2030.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/564535/gad-report-fixed-revaluation-rate-for-guaranteed-minimum-pensions.pdf

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/599457/government-response-to-occupational-pension-schemes-regulations-2017-and-related-issues-consultation.pdf

[3] https://consultations.ons.gov.uk/rpi/2020/

1.10 The announcement of changes to the future of the RPI index has made it more difficult to derive a best estimate RPI assumption from market implied inflation, suggesting this is perhaps a less reliable indicator for future RPI inflation. In view of this we now consider it to be more appropriate to set the proposed inflation assumption relative to the Bank of England target and OBR forecasts, rather than relying primarily on market implied inflation.

1.11 As defined benefit pension schemes mature and the proportion of members with GMPs reduces, and given that active members with GMPs are now much closer to the age at which they will receive their GMP than at the last review five years ago, the impact of the choice of fixed rate revaluation has even less of an impact on the finances of the scheme. To reflect the maturing GMPs, we now intend to look at market implied inflation over a period of 7.5 years compared to the 10 years used at the previous review.

Revaluation

1.12 To determine the average earnings increase we first derive a CPI inflation assumption and then add on a fixed margin to reflect how we expect earnings to increase in real terms relative to CPI inflation over the relevant period. The methodology we used to derive these assumptions is discussed below.

CPI Inflation

1.13 The Bank of England long term target[4] for CPI is 2% p.a. This is also consistent with the OBR's medium-term forecast for CPI. However, the Monetary Policy Summary and minutes of the Monetary Policy Committee meeting[5] published by the Bank of England in June 2021 stated that "*CPI inflation is expected to pick up further above the target, owing primarily to developments in energy and other commodity prices, and is likely to exceed 3% for a temporary period*." The statement goes on to say "*More generally, the Committee's central expectation is that the economy will experience a temporary period of strong GDP growth and above-target CPI inflation, after which growth and inflation will fall back.*" Given that we are looking at a term of 7.5 years it seems reasonable to make some allowance for CPI being higher than the 2% p.a. target over the short term.

1.14 Current Bank of England inflation curves suggest the market expects RPI to be around 3.5% p.a. on average over the next 7.5 years. Assuming an RPI-CPI gap before 2030 of 1% p.a. would imply an inflation risk premium of around 0.5% p.a. assuming CPI of 2% p.a. In the last review we allowed for an inflation risk premium of 0.25%. Therefore, an inflation risk premium of 0.25% to 0.5% pa would seem reasonable given the uncertainty of the impact of the announcement of the changes to RPI and the uncertainty over future price inflation as we emerge from the COVID-19 pandemic.

1.15 Based on the above, a CPI assumption in the range of 2%-2.25% p.a. over the next 7.5 years seems reasonable.

Gap between inflation and earnings

1.16 Previously we considered the gap between inflation and earnings over the medium term. However, given that the period we are looking at is now likely to be less than 10 years we now place more relevance on the short-term outlook when setting this assumption.

1.17 OBR's medium-term earnings assumption applying from 2025 is 3.5% p.a.[6], which is 1.5% p.a. above its CPI assumption of 2% p.a. In years 2022 to 2025, the earnings assumptions are around 1% lower, reflecting both a lower assumed CPI and a smaller gap between CPI inflation and forecast earnings. Allowing for lower assumed gap between earnings and CPI over the next few years (an average of 0.7% p.a.), an average gap of earnings over CPI inflation of 1% to 1.25% p.a. might be considered more appropriate (i.e. around 3% to 3.5% in total).

[4] https://www.bankofengland.co.uk/monetary-policy/inflation

[5] https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/june-2021

[6] https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/ Table 1.1

1.18 OBR also produce a long-term earnings assumption, the latest long term assumption is 3.8% p.a. [7]. However, as noted, we are only considering medium time period of around 7.5 years. Together with analysis of ONS's average weekly earnings data[8] over the last 10 years, which shows that the average annual earnings growth was around 2% p.a. it seems more appropriate to adopt an assumption that more closely relates to OBR's short to medium-term assumptions. .

1.19 Independent short-term forecasts[9] on earnings increases, published by HMT in May 2021, ranged from 2%-5% p.a. over the period from 2022-2025, with an average of 3.2% p.a.

1.20 There is still much uncertainty in respect of the impact of the COVID pandemic and the impact of furlough on average earnings increases. This is demonstrated by the independent forecasts ranging from 0.6% to 6.3% when forecasting increases for 2022. Private sector regular pay in the three months to April was 5.6% higher than a year earlier. The Bank of England note that '*measured pay growth continues to be boosted by compositional effects, given that job losses have been skewed towards lower-paid employees during the pandemic. In addition, the base effect of the drop in pay in spring and summer 2020 will continue to distort the annual comparison, such that, even if the level of private sector regular pay were to remain unchanged in May and June, twelve-month pay growth would still rise to close to 8% in the second quarter. Underlying pay growth appears to be around pre-Covid rates'*.

1.21 Given that this year's increases in earnings have been distorted by the impact of the COVID pandemic and the furlough scheme, and the underlying pay growth appears to be around the pre-COVID rate, we think it reasonable to use the averages over the medium term as described above, without any explicit allowance for the higher pay increases reported over the last year. Taking the above into account we suggest an earnings increase assumption as follows:

CPI	2% to 2.25% p.a.
Earnings (CPI + 1% to 1.25% p.a.)	3% to 3.5% p.a.

Outcome of considerations

1.22 In conclusion, we would propose an assumption for increases in average earnings for members with a GMP who leave pensionable service in the period 2022 to 2027 of between 3% p.a. and 3.5% p.a. based on a short to medium term view for inflation and real earnings growth. DWP may wish to consider consulting on the range and arriving at a specific rate once responses have been received. However, if DWP prefer to consult on a specific rate then in our view 3.25% p.a. is reasonable and the mid-point of the range above.

1.23 We have assumed DWP will continue to exclude the additional premium of 0.5% p.a. (as referred to above) which applied to the fixed revaluation rate prior to 2017. Our view is that excluding the premium remains appropriate based on the reasons set out in the March 2017 response, and that nothing has changed that would require a reintroduction of the premium compared to previously.

[7] https://obr.uk/fsr/fiscal-sustainability-report-july-2020 Table 4.2

[8] ONS EARN01 – Average weekly earnings total pay

[9] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/987466/Forecomp_May_2021.pdf