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

Introduction

1.1 Pension legislation obliges occupational pension schemes to provide deferred pension benefits to the majority of members who leave the scheme before normal pension age where sufficient periods of qualifying service have been awarded. The option of a cash equivalent transfer value (CETV) must also be provided in certain circumstances. This is the amount which can be taken to another pension arrangement in lieu of deferred pension benefits that 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 or in the dissolution of a civil partnership, and for any consequent repackaging of pension rights between a scheme member and a spouse/civil partner to implement a divorce settlement/dissolution.

1.2 This guidance sets out the assumptions for discount rates for calculating CETVs 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).

1.3 The guidance applies to the following schemes:

- all unfunded public service pension schemes in England, Wales, Scotland and Northern Ireland
- the Local Government Pension Schemes for England and Wales, Scotland and Northern Ireland and
- the Parliamentary Contributory Pension Fund

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

Legislative framework

1.5 Public service pension schemes are subject to Part 4ZA of the Pension Schemes Act 1993. This Act and regulations made under it require these schemes to make available cash equivalent transfer payments in certain circumstances.

1.6 Under the Occupational Pension Schemes (Transfer Values) Regulations 1996,[1] referred to in this document as the transfer value regulations, the trustees or managers are responsible for setting the economic, financial and demographic assumptions for CETVs. This document provides guidance on the discount rates under regulation 7B(6) to:

- all unfunded public service pension schemes in England, Wales, Scotland and Northern Ireland
- the Local Government Pension Schemes for England and Wales, Scotland and Northern Ireland

[1] SI 1996/1847.

- the Parliamentary Contributory Pension Fund

1.7 It covers the discount rates 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 in accordance with the provisions of those 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.

Discount rate assumptions

1.8 Under the transfer value regulations, a CETV should be the amount required within the pension scheme to make provision for the accrued benefits, options and discretionary benefits which would otherwise be provided.

1.9 The public service pension schemes provide deferred benefits to early leavers that are calculated by reference to completed service and to pensionable earnings. Under the Pensions (Increase) Act 1971, benefits are up-rated in line with inflation during deferment and in payment both to the member and any dependants. That part of the benefit which is guaranteed minimum pension (GMP) or national insurance modification may be up-rated by the schemes at a lower rate, if at all, once benefits are brought into payment. GMPs are up-rated in line with earnings during deferment.

1.10 Assumptions have to be made for valuing the 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 assumptions for determining CETVs for public service pension schemes are therefore the real (net of benefit increases) discount rates.

Background and previous guidance

1.11 At Budget 2011 the government announced that, following a full public consultation, the appropriate discount rate for calculating unfunded public service pension contribution rates (the SCAPE discount rate) would be based on the long term expectations of Gross Domestic Product growth. A discount rate of 3% above CPI inflation was therefore adopted for calculating unfunded public service pension contributions in actuarial valuations.

1.12 The SCAPE discount rate consultation document made clear that other discount rates used in public service pensions calculations were outside the scope of the review but that, should the SCAPE discount rate change, the government would take advice from actuaries about whether it remained appropriate to use the same discount rate for these purposes.

1.13 Accordingly, HM Treasury undertook a review of the discount rate used for calculating CETVs and, having considered the advice of GAD, in October 2011 published a previous version of this guidance. That (previous) guidance prescribed a long-term discount rate of 3% per annum net of changes in the Consumer Prices Index (CPI).

1.14 When the SCAPE discount rate was set in 2011 the government committed to review the rate every five years and the methodology every ten years with the possibility of out-of-cycle reviews. The Budget of 16 March 2016 announced the outcome of the first five yearly review and that the government had decided that the SCAPE discount rate should be revised to 2.8% above CPI inflation (in line with the Office for Budget Responsibility's long-term expectations of Gross Domestic Product growth at that time).

1.15 The Budget on 29 October 2018, confirms that the SCAPE discount rate is 2.4% above CPI inflation (in line with the Office for Budget Responsibility's latest long term expectation of Gross Domestic Product growth).

1.16 This guidance replaces the previous guidance, 'Basis for setting the discount rate for calculating cash equivalent transfer values payable by public service pension schemes' issued in March 2016.

The discount rates for the purposes of calculating cash equivalent transfer values

1.17 The Treasury considers the following objectives to be the most relevant in setting appropriate discount rates for the purpose of calculating CETVs:

- compliance with the pensions legislation
- stability of the discount rates
- transparency and simplicity of the approach
- administrative convenience

1.18 Under the transfer value regulations trustees and managers must determine the assumptions used in calculating CETVs with the aim that, taken as a whole, they should lead to the 'best estimate of the initial cash equivalent'.[2]

1.19 When the discount rate used for calculating unfunded public service pension contribution rates under Superannuation Contributions Adjusted for Past Experience (SCAPE) was reviewed in 2011 and 2016, the primary objectives were to ensure that the future costs of today's pension promises are fairly reflected in current contributions, and to ensure that government has as much confidence as possible that promises made today are being made on a sustainable basis. The Treasury continues to believe that the primary objectives of the SCAPE discount rate are consistent with the objectives for the CETV discount rates and the transfer value regulations.

1.20 Based on the above objectives, and in light of pensions legislation and the advice of GAD, the Treasury considers that the discount rate for calculating CETVs should be in line with the new SCAPE discount rate of 2.4% above CPI inflation.

1.21 The public service pension schemes to which this guidance applies should therefore adopt with immediate effect the following discount rates for the determination of CETVs:

- in respect of a benefit which will be increased under the Pensions (Increase) Act 1971, a discount rate of 2.4% per annum net of benefit increases
- in respect of a guaranteed minimum pension which will be in payment and of which part is attributable to earnings factors in any of the tax years 1988-1989 and following, a discount rate of 2.6% per annum net of benefit increases
- in respect of a non-increasing benefit, a discount rate of 4.448% per annum

[2] Regulation 7B(5).