



# Government Actuary's Department

**Department for Work and Pensions**

**Fixed revaluation rate for Guaranteed Minimum Pensions**

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## 1 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 2017 to 5 April 2022.
- 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.

### Past reviews and changes to fixed rate GMP revaluation

- 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	4.75% p.a.



- 1.5 The previous review of fixed rate GMP revaluation was undertaken as part of the most recent quinquennial review of contracted-out rebates (see page 40 of the GAD report "Review of rebates and reduced rates of National Insurance contributions for members of defined benefit contracted-out pension schemes", dated 21 January 2011<sup>1</sup>). The average earnings increase assumption of 4.25% pa that was derived for the purpose of the review of contracted-out rebates was constructed as follows:

CPI	2% pa
RPI (CPI + 0.75%)	2.75% pa
Earnings (RPI + 1.5%)	4.25% pa

- 1.6 It was stated in the previous review of fixed rate GMP revaluation that *"at previous reviews the then Government Actuary based his proposal for the latter fixed rate on the assumed rate of growth in average earnings underlying his recommended rebate value for defined benefit members, plus 0.5%. The addition of 0.5% to the expected future growth in average salaries is to compensate for the conversion of a variable rate of revaluation (linked to actual average earnings growth) to a fixed rate for which there has to be a 'price'"*.
- 1.7 This review proposed to continue to adopt this rationale, noting that *"a best estimate assumption is most appropriate for the current purpose"*, and concluding that *"adding 0.5% in line with previous practice ... the rate for the revaluation of GMP for members who leave pensionable service in the period 2012 to 2017 should be set at 4.75%"*.
- 1.8 DWP subsequently issued a consultation on the fixed rate GMP revaluation in August 2011<sup>2</sup>, proposing to adopt the assumption recommended by GAD of 4.75%. The response to the consultation was issued in February 2012<sup>3</sup>, confirming that the fixed rate of 4.75% was to be adopted for leavers between 6 April 2012 and 5 April 2017.

#### Factors relevant to the current review

- 1.9 Contracting-out of the state second pension on a salary-related basis ceased from 6 April 2016 and hence GAD has not been asked to review the value of the contracted-out rebates beyond that date. Therefore, there is no longer a rebate value on which to base the assumption for earnings increases for use in deriving the GMP fixed revaluation rate. In this context a methodology is required for deriving an appropriate rate of future GMP fixed rate revaluation, noting that this rate will apply for a closed group of pension scheme members and over a shorter period of time, given that GMPs ceased to accrue in April 1997.

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<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214345/gad-review-2011.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214345/gad-review-2011.pdf)

<sup>2</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220399/occ-pen-contracting-out-and-modification-regs-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220399/occ-pen-contracting-out-and-modification-regs-consultation.pdf)

<sup>3</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/184934/gov-response-occ-pen-contracting-out-and-modification-regs-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/184934/gov-response-occ-pen-contracting-out-and-modification-regs-consultation.pdf)



- 1.10 We consider it reasonable to assume that a majority of individuals leaving pensionable service during the period April 2017 to April 2022 will be less than 10 years from their GMP Age. HMRC has carried out some analysis for us 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) is around 53 years old. Furthermore, given GMPs stopped accruing nearly 20 years ago, the youngest members with a GMP are likely to be in their early 40s.
- 1.11 The approach in the past has been to take a long-term view of average earnings increases. Given the assumption relates to expected future working lifetime, we consider it reasonable to move to a more medium term outlook for earnings increases over the next 10 years.
- 1.12 We have not explicitly considered the possible impact of the outcome of the vote to leave the European Union on the economic outlook and its effect on medium term earnings growth.



## 2 Revaluation

### Earnings increases

#### Background

- 2.1 The table below sets out historic increases in Average Weekly Earnings (AWE) over the last 15 years. This indicates that earnings have increased annually by around 2.3% pa over the last 10 years; and by around 2.8% pa over the last 15 years.

Year ending	Increase in Average Weekly Earnings (April to April)
2002	3.6%
2003	2.6%
2004	5.1%
2005	4.4%
2006	4.2%
2007	4.2%
2008	4.7%
2009	1.5%
2010	0.4%
2011	2.3%
2012	2.1%
2013	4.0%
2014	-1.5%
2015	2.3%
2016	2.6%

Source: ONS - EARN01 Average Weekly Earnings - total pay, Great Britain (seasonally adjusted) ("Whole economy")<sup>4</sup>

<sup>4</sup><https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01>



### *Methodology*

- 2.2 The methodology we have established for determining an appropriate rate of future earnings growth, for use in deriving the fixed rate GMP revaluation rate, continues to be based on a best estimate assumption as for previous reviews. The assumption is constructed by:
- > Deriving an assumption based on how we might derive a “neutral” assumption for earnings increases for the purpose of advising Trustees on the assumptions to use for the formal valuation of a funded defined benefit pension scheme, relative to price inflation; then
  - > Benchmarking the assumption with any relevant forecasts or economic outlooks prepared by organisations such as the Office of Budget Responsibility (OBR) to ensure it is consistent with other forecasts being used within government.
- 2.3 GAD’s current best estimate view for earnings growth is 2% pa in excess of CPI inflation. However, we note that there is significant uncertainty in any such estimate and that neutral estimates could reasonably range from 1.25% pa to 2.75% pa.
- 2.4 To derive a nominal earnings growth assumption, this rate should be considered in conjunction with a medium-term assumption for CPI inflation. For this purpose we will use the Bank of England inflation curves to derive the relevant market-implied rate of RPI inflation, and then adjust this for the assumed long-term difference between RPI and CPI inflation.
- 2.5 The Bank of England RPI inflation curves at the end of September 2016 indicate the market expects RPI inflation to be lower in the shorter term than in the longer term and that the market-implied RPI inflation over the 10 years to September 2026 is 2.9% pa. Market-implied RPI inflation may include an inflation risk premium to compensate holders of nominal bonds for unexpected inflation. The inflation risk premium is difficult to estimate and may vary by term and through time. At the current time we do not believe that the inflation risk premium is likely to be significant and a deduction of 0.25% pa is likely to be a reasonable “neutral” estimate of this.
- 2.6 GAD’s current best estimate view for the long-term difference between RPI and CPI inflation is 1.15% pa. This is broadly consistent with other organisations’ estimates, for example, the Bank of England currently estimate 1.3% pa<sup>5</sup> and OBR’s current estimate is 1.1% pa<sup>6</sup>.
- 2.7 Based on the above, we have arrived at a medium-term view for annual average earnings increase of 3.5% pa as at the end of September 2016, which was derived as follows:

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<sup>5</sup> <http://www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14feb4.pdf>

<sup>6</sup> <http://cdn.budgetresponsibility.org.uk/March2016EFO.pdf>



Market-implied RPI (10 years)	2.9% pa
RPI (Market-implied RPI – 0.25% pa)	2.65% pa
CPI (RPI – 1.15% pa)	1.5% pa
Earnings (CPI + 2% pa)	3.5% pa

#### *Other relevant factors*

- 2.8 OBR's current short-term earnings assumptions applying from April 2017 are also around 3.5% pa<sup>7</sup>. Therefore it does not seem unreasonable to assume earnings remain closer to the OBR's short term assumptions in the short to medium term than increasing to their long term assumption of 4.5% pa<sup>8</sup>. (It should however be noted that the OBR may publish revised economic forecasts before the new fixed rate of GMP revaluation is finalised. If this is the case, it may be worth reconsidering whether the proposed fixed rate GMP revaluation assumption proposed in this report remains appropriate in that context.)

#### **Premium**

- 2.9 Given the uncertainty in future earnings increases, it may be considered appropriate to continue adding a premium for the certainty that employers gain from revaluing in line with a fixed rate. This would also be consistent with past reviews.
- 2.10 When reviewing the risks inherent in fixing an assumption for average annual earnings increases in this context, it is important to note the following:
- > With the introduction of the single-tier state pension there is no longer a GMP off-setting effect on the amount of an individual's state pension at State Pension age. As such, the fixed rate of GMP revaluation will not affect an individual's entitlement under the new State single-tier pension, it will simply impact on the cost to the pension scheme of providing the benefits promised under the scheme.
  - > Prior to the commencement of the single-tier State pension, the risk that average earnings increases were higher than expected would have fallen on the State to the extent that this would have increased the benefits payable as an Additional Pension. Following the introduction of the single-tier State pension, this risk now falls on members given their State pensions are no longer directly affected by the rate of GMP revaluation. The premium therefore provides protection to members at a cost to the scheme and their sponsors, albeit it also gives employers more certainty by fixing the rate.

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<sup>7</sup> Table 1.1 OBR's EFO March 2016 <http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>

<sup>8</sup> OBR FSR June 2015 <http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-june-2015/>





- > 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 GMP Age, the impact of the choice of fixed rate revaluation has less of an impact on the finances of the scheme.

#### **Outcome of considerations**

- 2.11 In conclusion, we would propose an assumption for increases in average earnings for members with a GMP who leave pensionable service in the period from 6 April 2017 to 5 April 2022 might be 3.5% pa based on a medium term view. The rate might be higher if a longer term view consistent with previous reviews is taken.
- 2.12 If it is considered appropriate to continue applying an additional premium of 0.5% pa, as adopted in the past, the rate of fixed rate revaluation of GMP for members who leave pensionable service in this period would be 4.0% pa. This compares to the current rate of 4.75% pa.