HM TREASURY

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

guidance issued by HM Treasury

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1 Summary

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. 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].

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 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.

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

[1] This will also apply correspondingly in the event of the dissolution of a civil partnership.

2 Legislative framework

2.1 The public service schemes are subject to Chapter 4 of the Pension Schemes Act 1993. This Act and regulations under it 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.

2.2 Under the Occupational Pension Schemes (Transfer Values) Regulations 1996, SI 1996/1847, as amended, 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 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.

3 Discount rate assumptions

3.1 Under the transfer value regulations[1], 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.

3.2 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 will generally 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.

3.3 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 assumption for determining CETVs for public service pension schemes is therefore the real (net of prices) discount rate.

[1] The Occupational Pension Schemes (Transfer Values) Regulations 1996 SI 1996/1847 as amended

4 Background and previous guidance

4.1 HM Treasury's guidance dated 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 (RPI).

4.2 Previous HM Treasury guidance also included some limited linkage to the gilt market, recognising that CETVs taken from public service pension schemes will in general be invested in market assets. The previous guidance stated that this would be reconsidered at the next review of these assumptions.

4.3 On 22 June 2010, in the Budget, the Chancellor announced the Government's intention to use the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) for the up-rating of the majority of state benefits and tax credits from April 2011. This change also applies to public service pensions through the statutory link to the indexation of the State Second Pension.

4.4 In August 2010 HM Treasury amended the guidance referred to above to reflect an immediate and interim review to enable the determination of CETVs following the change in up-rating. This amended guidance provided that the real CETV discount rates should be increased by an addition of 0.75 percentage points to reflect the long-term expectation of the difference between CPI and RPI.

4.5 The Budget of 23 March 2011 announced that, following a full public consultation as recommended in the interim report of the Independent Public Service Pensions Commission chaired by John Hutton, the Government had 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 Gross Domestic Product 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.

4.6 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.

4.7 Accordingly, and in light of the change to the SCAPE discount rate and to indexation by CPI, HM Treasury has undertaken a review of the discount rate used for calculating CETVs. In doing so, HM Treasury has considered the advice of GAD.

4.8 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' issued in updated form in March 2011.

5 The discount rate for the purpose of calculating CETVs

5.1 The Treasury considers the following objectives to be the most relevant in setting an appropriate discount rate for the purpose of calculating Cash Equivalent Transfer Values:

- Consistency with the relevant legislation.
- Stability of the discount rate.
- Transparency/simplicity of the approach.
- Administrative convenience.

5.2 Under the relevant legislation governing the assumptions to be used in calculating CETVs, the transfer value regulations, trustees and managers must determine the assumptions used with the aim that, taken as a whole, they should lead to the 'best estimate of the initial cash equivalent.'

5.3 When reviewing the discount rate used for calculating unfunded public service pension contribution rates under Superannuation Contributions Adjusted for Past Experience (SCAPE), 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 believes that the primary objectives of the SCAPE discount rate are consistent with the objectives and governing legislation of the CETV discount rate.

5.4 Based on the above objectives, and in light of the relevant legislation, the other relevant factors 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 3.0 percent above CPI inflation. It also considers that the limited linkage to the gilt market should no longer continue.

5.5 The public service pension schemes to which this guidance applies will therefore adopt with immediate effect the following discount rate for the determination of cash equivalent transfer values:

- A rate of 3.0 per cent per annum net of changes in the Consumer Prices Index.

5.6 For benefits which are not indexed by pension increases under the Pensions (Increase) Act 1971, the following discount rate assumptions will apply:

- For non-increasing benefits the discount rate will be 5.0 per cent per annum.
- For GMP benefits accrued after 1988 which carry scheme increases up to 3 per cent per annum, the net rate, in excess of pension increases, will be 3.25 per cent per annum.

HM Treasury contacts

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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