Government Actuary's Department

Nick Donlevy,
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By email only

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9 February 2023

Dear Nick,

Review of the SCAPE discount rate methodology

Thank you for your letter of 9 February 2023 setting out the latest position on the Government's proposed response to the consultation on the SCAPE discount rate methodology used to set contribution rates for the unfunded public service pension schemes.

You have asked for my views on whether the passage of time would change any of my comments in my previous letter of 19 January 2022.

The consultation sought views on two possible SCAPE discount rate methodologies – either based on long-term future GDP growth expectations set by the independent Office for Budget Responsibility (OBR), or based on the Social Time Preference Rate (STPR) prescribed in HM Treasury guidance for project appraisal – alongside some possible modifications and changes to the rate review cycle.

Whilst there have been major changes in the economic environment over the last year, the principles that led to my conclusion expressed in my letter of 19 January 2022 – that taken together, retaining the current methodology of setting the SCAPE discount rate in line with long-term forecasts of GDP growth meet the Government's objectives for the SCAPE discount rate – still remain true.

I would note that since my previous letter, the OBR published updated long-term fiscal projections on 7 July 2022[1]. If the SCAPE discount rate is calculated using these updated OBR projections, it will result in a discount rate of CPI+1.7% a year, as opposed to the previously implied rate of CPI+1.8% a year noted in my previous letter (and the rate currently in force of CPI+2.4% a year). Such a decrease means that the expected growth in the tax base, which is the source of income from which future pension payments are ultimately funded, is slightly lower than previously. Consequently, the ability to fund these pension schemes from expected future income is further diminished, which would then be recognised through the discounting mechanism in increased charges placed on employers now. Such an outcome would seem to be wholly consistent with the "Fair reflection of costs" and "Reflect future risks to Government income" objectives, however does result in a less stable outcome (compared to the existing rate) when

[1] https://obr.uk//docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf

considering the “Stability” objective. My previous letter discussed the merits of the proposed approach, and the alternative STPR methodology, against these objectives.

In my previous letter I also noted that discount rates used to value funded defined benefit pension schemes had also reduced over the previous ten years, which had increased pension costs for private sector employers during this period. However, over the most recent year, bond yields have increased[2] which will typically feed through into increased discount rates used for funded defined benefit pension schemes and which – all else being equal – will now lead to reduced pension costs for private sector employers compared to the position a year ago. This is different to the position for the implied SCAPE discount rate used to set contribution rates for unfunded public service pension schemes, which as noted above has fallen slightly further during the last year, leading to an increased level of costs. However, as I noted previously, it is important to note that the approaches used to set discount rates for funded defined benefit pension schemes are different to those used for unfunded public service pension schemes. Accordingly, whilst both approaches are affected by the long-term economic outlook over time, these rates can sometimes move in different ways over particular time periods.

A larger reduction in the SCAPE discount rate would be a further illustration of the challenges in achieving stability in contribution rates under the chosen methodology and the inherent tension between the Government’s objectives for the SCAPE discount rate that was acknowledged in my exchange of letters with HM Treasury last year. I note that, as set out in your letter, the Government will also look to ensure that departmental budgets set in Spending Review 2021 will not come under undue pressure because of a change in the contribution rates resulting from the 2020 valuations as a consequence of changes to the SCAPE discount rate, with the Barnett formula applying in the usual way for devolved administrations. Such an approach would appear to mitigate any immediate stability implications for departments, although – as noted in my previous letter – independent providers with access to public service pension schemes may still experience financial pressures. However, and in conclusion, I can confirm that I remain of the opinion that the GDP-based approach proposed is the more appropriate methodology for setting the SCAPE discount rate in the context of the objectives that the Government has outlined.

Compliance and third-party disclaimer

This letter has been prepared in accordance with the applicable Technical Actuarial Standards: TAS 100 and TAS 300 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.

I understand that HMT intend to publish this letter. Other than HMT, no person or third party is entitled to place any reliance on the contents of this report. GAD has no liability to any person or third party for any action taken or for any failure to act, either in whole or in part, on the basis of this letter.

Yours sincerely

Martin Clarke
Government Actuary

[2] For example, the 20 year real gilt yield increased from around – 2.5% a year as at 31 December 2021 to around +0.5% a year as at 31 December 2022. Source: [Bank of England yield curve data]

Appendix – copy of letter from HM Treasury to Government Actuary

HM Treasury

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HM Treasury

Martin Clarke, Government Actuary
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09 February 2023

Dear Martin,

Review of the SCAPE discount rate methodology

1. Thank you for your letter of 19 January 2022 setting out your professional opinion on the Government's proposed response to the consultation on the SCAPE discount rate methodology used to set contribution rates for unfunded public service pension schemes.

2. I am pleased to note that you found the proposals, taken together, met the Government's objectives for the SCAPE discount rate as set out in the consultation[1].

3. The Government now plans to respond to the consultation shortly. The Government's proposed response remains to be to:

   - retain the current methodology of setting the SCAPE discount rate in line with expected long-term GDP growth, using forecasts published by the Office for Budget Responsibility (OBR), with no modifications applied at this time;

   - align future reviews of the SCAPE discount rate with the scheme valuation cycle, with the aim of conducting one review per cycle;

4. The Government will also look to ensure that departmental budgets set in Spending Review 2021 will not come under undue pressure because of a change in the contribution rates resulting from the 2020 valuations as a consequence of changes to the SCAPE discount rate. For devolved administrations, the Barnett formula will apply in the usual way. It is for the devolved administrations to decide how to allocate funding in devolved areas.

5. I would welcome your views on whether the passage of time would change any of your comments in your previous letter of 19 January 2022.

Yours sincerely

[1]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/996113/SCAPE_Discount_Rate_methodologyFD.pdf

Nick Donlevy

Director, Public Spending