Government Actuary's Department

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By email only

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15 March 2024

Dear Nick

Subject: The Public Service Pensions (Exercise of Powers, Compensation and Information) (Amendment) Directions 2024 - Calculation and Payment of Interest

1. Thank you for your letter of 14 March 2024[1], asking for my professional opinion on the proposed amendments to the Public Service Pensions (Exercise of Powers, Compensation and Information) Directions 2022 (the 'Directions'). I understand these will be set out in the Public Service Pensions (Exercise of Powers, Compensation and Information) (Amendment) Directions 2024 (the 'Amendment Directions'). In particular, you have asked me to set out my views on the extent to which the proposed amendments meet the Government's objectives as set out in your letter.

2. You have explained that HM Treasury propose to amend the Directions to specify that the NS&I Equivalent Savings Rate will be the Direct Saver interest rates published on the NS&I website and to add a new situation in which interest should be paid, which is where a member transferred their remediable service rights to another pension scheme before remedy was implemented and the transfer was not a Club transfer to another remedy scheme.

3. You previously consulted my predecessor, Martin Clarke, on the proposed approach in December 2022 when the Directions were being developed. He concluded that the overall approach to choosing interest rates represented a reasonable approach and that, in the round, it met the Government's objectives. He also noted that there are various approaches that could have been adopted and would also have been reasonable. I agree with that conclusion.

[1] Your letter is set out in the Appendix to this letter.

4. I note that the first proposed amendment is a change in process but delivers the same policy and the second proposed amendment applies the same policy and objectives to a new situation but does not affect how the objectives are met.

5. My professional opinion is that making these amendments to the Directions will not affect that the overall approach to choosing interest rates is reasonable.

6. The remainder of this letter summarises the background including your objectives, the choice of interest rates and the previous analysis of the extent to which they meet the Government's objectives. It then sets out the proposed amendments to the Directions and my more detailed professional opinion on these including some practical observations related to them.

Background

Context to the Directions

7. The Directions set out how interest payable, to or from members, will be determined, in relation to corrective payments arising from the remedy set out in the Public Service Pensions and Judicial Offices Act 2022. This remedy is required because the transitional protection arrangements introduced in 2014/2015 were judged to be discriminatory. Transitional protection allowed older members who were within 10 years of retirement to remain in their legacy pension schemes whilst younger members moved to a new reformed pension scheme.

8. The nature of the remedy varies somewhat between schemes, but generally it enables members to receive either legacy scheme or new scheme benefits for the period 2014/2015 to 2022. For most workforces, members will get a choice at retirement between legacy and new scheme design benefits. The options exercise for Judges is currently underway and local government workers will have an automatic underpin applied at retirement.

9. Payment of interest will arise when corrections are needed to historic cashflows as a result of the remedy. Most corrections will occur at implementation. Active and deferred members of the unfunded schemes who did not originally receive transitional protection will have their remediable service returned to their legacy schemes and pensioners will make their immediate choice. This may result in member contribution corrections where these differ between the new scheme and the legacy scheme, any refunds of member voluntary contributions and any corrections to historic benefit payments.

10. Corrections can be from member to scheme or from scheme to member. Some correction payments will also occur sometime after the implementation of the remedy for those members who need a further contribution correction at the point of retirement or on leaving the scheme. Those correction payments at retirement may take place for many years to come.

Government objectives and directed interest rates

11. You have set out three objectives for the interest payments. That they:

- Reflect the position members may have otherwise been in - the determination of interest payments should consider what position the member may have been in had the payments been made on the date they originated from.

- Recognise the circumstances of the award - interest payments should reflect the context as to why the remedy is being implemented and what interest rates are being applied elsewhere as a part of the remedy.

- Do not unduly burden the taxpayer - interest payments should be proportionate and where possible not result in unnecessary costs to the taxpayer.

12. In light of the above objectives, HM Treasury has directed that the interest applicable should be:

- For payments made from the scheme to the member as a result of the implementation of the remedy, 8% simple per year up to the date 28 days after a Remediable Service Statement is first issued in relation to the member (this in line with the interest awarded to the claimants in the associated employment tribunals). Thereafter in line with the interest available on the National Savings & Investments (NS&I) easy access savings account, 'Direct Saver'. The following exceptions apply:

    - For Judges, the 8% simple per year rate will run up to the date of the remedy payment, in light of the different way their remedy operates.

    - For the Local Government Pension Scheme, the periods of interest will be set out in their scheme regulations, to take account of the different way their remedy operates.

    - Payments in relation to tax-related compensation for all schemes will accrue in line with HMRC's interest rate on tax refunds, which is set as the Bank of England base rate minus 1% with a lower limit of 0.5% p.a.

- For payments made from the scheme to the member after the implementation of the remedy, when the member retires, or otherwise leaves the scheme - in line with the NS&I Direct Saver interest rate.

- For all payments made from the member to the scheme - in line with the NS&I Direct Saver interest rate.

Previous analysis of proposed interest rates against objectives

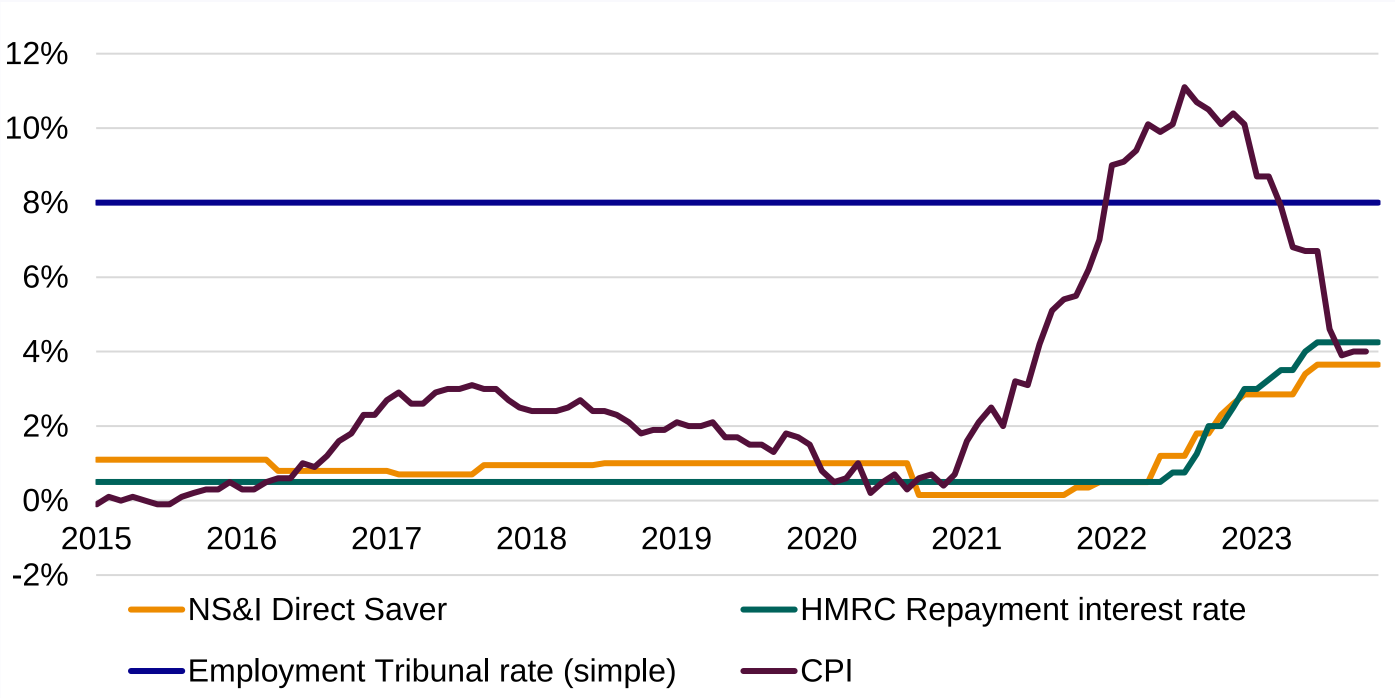
13. In December 2022, Martin Clarke concluded that the overall approach to choosing these interest rates represented a reasonable approach and that, in the round, it met the Government's objectives. He also noted that there are various approaches that could have been adopted and would also have been reasonable. I agree with that conclusion.

14. It is not possible to reflect the position each member would have been in as different members would have made different decisions with respect to their marginal income. However, the use of the NS&I Direct Saver rate is not unreasonable to meet this objective, and effectively assumes the member invested, or would have invested, any additional money in an instant access savings account. More detail about this objective is set out in paragraphs 8 to 16 of Martin's letter.

15. Since 2015, the NS&I Direct Saver rate has generally been lower than the rate of CPI inflation and lower than typical borrowing rates of interest. Any member who used the additional income to purchase goods or services or used the additional income to pay off existing debt is arguably in an advantageous position by paying interest in line with the NS&I Direct Saver rate. This is because the cost of buying something in the past, plus the interest they will be charged, is expected to be less than the cost of buying the same item today. The chart below shows the various interest rates since 2015, alongside the change in CPI inflation over the preceding year.

16. There is, of course, no guarantee that this relationship (i.e. the rate of CPI inflation exceeding the NS&I Direct Saver rate) will continue in the future, indeed these rates are now much closer than they were when the Directions were made in December 2022. I discuss review processes later in this letter.

Interest rates since 1 April 2015



17. This chart shows that the 8% employment tribunal rate has been significantly higher than the NS&I Direct Saver rate and CPI inflation for most of the relevant period, although CPI inflation was in excess of 8% over a period in 2022 and 2023.

18. The NS&I Direct Saver rate and the HMRC Repayment interest rate have largely been below CPI inflation for the relevant period apart from 2015-2016 and a brief period in 2020, while all three rates are currently at similar levels.

19. It should be noted that the employment tribunal rate of 8% is a simple rate whereas the other rates displayed are all compound rates, so they are not direct comparisons. All else being equal a compound rate will accrue more interest than a simple rate. Therefore, the chart somewhat overstates the generosity of the 8% simple rate relative to the others. The exact impact depends on the period over which interest accrues, but as an example, if

interest accrued for 7 years, a simple rate of 8% p.a. would be equivalent to a compound rate of around 6.5% p.a.

20. The objective to recognise the circumstance of the award gives a clear rationale for the use of an 8% simple interest rate up to the implementation of the remedy for cashflow corrections where the scheme owes the member because this is the basis of interest awarded by employment tribunals.

21. For correction payments where the members owe the scheme, the use of the NS&I Direct Saver rate is lower than inflation, and therefore would also appear consistent with reflecting the circumstances of the award. More detail is set out in paragraphs 17 to 22 of Martin's letter.

22. Awarding interest on tax-related compensation payments in line with HMRC interest rates reflects the nature of the award in so far as all tax-related payments will be treated the same with regards to interest irrespective of whether they are in scope of HMRC's statutory time limit or not. However, I note that members will receive substantially lower interest payments with respect to tax-related payments compared to other payments associated with the remedy.

23. The objective to not unduly burden the taxpayer aims to find an appropriate balance between the need to recognise the circumstances of the award (which lean towards being generous to the member) and responsible use of public funds. The rates selected achieve such a balance. More detail on this objective is set out in paragraphs 23 to 26 of Martin's letter.

24. The choice of interest rate is not strictly an actuarial consideration and I note that there are various approaches that could have been adopted that would also appear reasonable.

Proposed amendments

Proposed amendments to the Directions

25. Where the interest rate being used is the NS&I Direct Saver rate, the process currently set out in the Directions is that the rates to be applied before 14 December 2022 are as stated in the Schedule to the Directions and rates to be applied after that point will be published by HM Treasury. The first proposed amendment to the Directions will change the process so that the interest rates to be applied will be the Direct Saver interest rates published on the NS&I website.

26. Where a member transferred their remediable service rights to another pension scheme before remedy was implemented and the transfer was not a Club transfer to another remedy scheme, some of these members will be entitled to the remedy of an additional transfer payment. The second proposed amendment to the Directions will capture these cases. Interest will be awarded on these payments at a rate of 8% simple until 28 days after the member is informed of the amount of the additional transfer payment after which the rate will be the NS&I Direct Saver rate.

Professional opinion on amendments

27. The first proposed amendment to the Directions is solely a matter of change in process. If announced changes to the NS&I interest rates were published by HM Treasury as they

came into force, this amendment would have no effect. I am therefore content that the previous analysis and conclusions about the objectives are unaffected.

28. The second proposed amendment to the Directions ensures that a further scenario where interest is due is captured. A member transferring their remediable service rights to another pension scheme before remedy was implemented and the transfer not being a Club transfer to another remedy scheme is a new situation in which interest should be paid which was previously omitted.

29. The interest arrangements are consistent with employment tribunal interest in circumstances where the top-up is paid within 28 days of the remediable service statement being issued. However, it may be challenging to make a top-up payment to either the original receiving scheme or another scheme within 28 days. If there is a significant delay in payment, the average interest rate awarded over the whole period will fall below 8% pa simple. However, limiting the period over which 8% interest is paid goes towards achieving the objective of not unduly burdening the taxpayer.

30. It is not possible to choose a single interest rate which reflects the position each member who took a transfer to another scheme would have been in. Different members would have been given different options for their transfers depending on the rules of the receiving scheme. The outcome may depend on the member’s own salary increases while an active member of the receiving scheme or their investment choice.

31. The interest rate of 8% simple is higher than the discount rates that were typically used by pension schemes for calculating defined benefit transfer credits prior to remedy being implemented. This interest rate is therefore likely to be sufficient to compensate most members adequately for the delay since the original transfer payment, though their overall outcome will depend on their own salary growth and the transfer basis that the receiving scheme uses to determine the service credit. It is also broadly consistent with the long-term investment returns that would have typically been expected to be achieved for a diversified portfolio of investments over this period, albeit that may change in the future. It is therefore reasonable for members who had a DC investment vehicle for their transfer value in the receiving scheme, albeit that individual members will have achieved higher or lower returns in practice, depending on the time period involved and their individual investment choices. I am therefore content that the previous conclusions about the objectives also apply for this situation.

32. I note that tax treatment of interest is not determined by the Directions. HMRC Pension schemes newsletter 156 published in February 2024 sets out some circumstances when 8% simple interest may be subject to tax. In my opinion, the 8% simple interest rate achieves HMT’s objectives irrespective of the tax treatment because it is still potentially more generous than other reasonable alternatives. It therefore represents a net cost to the taxpayer compared to other alternatives. In my opinion the cost does not unduly burden the taxpayer given the purpose of this interest rate is to replicate the interest that would have been paid by employment tribunals.

Practical effects of amendments

33. Although the first proposed amendment to the Directions should “in theory” make no difference to the remedy members receive, changing the process by which the specific interest rates are set will inevitably introduce practical effects. For example, under the current approach, if there is a delay between a change to the Direct Saver rate and the

HM Treasury publication required to implement this for remedy interest purposes then some members may not receive interest exactly in line with the Direct Saver rate. Under the proposed approach, provided NS&I publish the rates on their website without delay, all members should receive interest exactly in line with the Direct Saver rate. The change in process, therefore, may improve outcomes relative to the policy intent.

34. That the rates on the NS&I website have changed many times since the Directions first came into force illustrates that the rates could change often in the future. This might suggest that relatively frequent reviews of the interest rates to apply would be appropriate. However, I note you identify the need to provide stability to schemes and members while remedy is being implemented. You therefore propose to carry out reviews in response to unexpected events and at least every five years. My view is that these proposed review processes are appropriate but I recommend that you also set up a process to regularly assess whether there have been any unexpected events.

35. In relation to the second proposed amendment, it may not always be possible to pay an additional transfer value and its associated interest to the scheme which received the original transfer value. Schemes will need to work to achieve a suitable payment destination which may be direct to the member. My view is that the interest arrangements for transfer value top-ups are appropriate even if the payment does not go to the original receiving scheme.

Compliance, limitations, and third-party disclaimer

36. 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.

37. This letter is addressed to HM Treasury. The purpose of this letter is to give my professional opinion on the proposed amendments to the Directions. The assessment contained within this letter is based on my technical analysis of the proposals and the circumstances in which they have been applied. I have not carried out a review of the draft Directions which were not included as a part of this letter exchange, nor have I considered any legal risks or risks of creating wider precedents.

38. I understand that HM Treasury may publish this letter. Other than HM Treasury, no person or third party is entitled to place any reliance on the contents of this letter. 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

Fiona Dunsire
Government Actuary

Appendix – copy of HM Treasury letter sent to the Government Actuary on 14 March 2024

HM Treasury

Nick Donlevy
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Fiona Dunsire
Government Actuary

14 March 2024

Dear Fiona,

<u>The Public Service Pensions (Exercise of Powers, Compensation and Information) (Amendment) Directions 2024 - Calculation and Payment of Interest</u>

Background

1. As you will be aware, HM Treasury have developed a set of policies to remedy the discrimination resulting from the transitional protection arrangements introduced when public service pension schemes were reformed under the Public Service Pensions Act 2013.

2. This discrimination ceased from 1 April 2022 with the closure of the legacy schemes to accrual and all active members becoming members of the new schemes. Affected members are entitled to a retrospective remedy, which will apply to a member's 'remediable service'. This is the period of eligible service from when their new scheme was first introduced up to the closure of their legacy scheme. In most cases this is 1 April 2015 to 31 March 2022.

3. The legislative framework for the remedy is set out in the Public Service Pensions and Judicial Offices Act 2022 (the Act).

4. Sections 27, 62 and 85 of the Act enable HM Treasury to make Directions regarding certain features of the remedy set out in the Act. As required under Sections 27(4), 62(4) and 85(4) of the Act, Directions that relate to the calculation and payment of interest may only be made after consultation with the Government Actuary.

In December 2022, HM Treasury made the Public Service Pensions (Exercise of Powers, Compensation and Information) (Amendment) Directions 2022 after consulting with your predecessor Martin Clarke.

5. HM Treasury has decided to amend the Directions. Two of the proposed amendments relate to the calculation and payment of interest. One amendment changes the process for implementing changes in interest rates. The other amendment adds a further situation in which interest should be paid. I am formally writing to you to ask for your professional opinion on the proposed amendments as set out in this letter. This approach will be set out in Directions in due course to enable schemes to implement the remedy for affected members.

Proposed amendments relating to interest payments

6. One of the interest rates to be used is the NS&I Equivalent Savings Rate. The intention is that this should be in line with the interest available on the NS&I easy access savings account, 'Direct Saver'. The process set out in the Directions is that the rates to be applied before 14 December 2022 are set out in the Schedule to the Directions and rates to be applied after that point will be published by HM Treasury. The proposed amendment will change the process so that the interest rates to be applied will be the Direct Saver interest rates published on the NS&I website.

7. The Directions add a new situation in which interest should be paid which was previously omitted. This is where a member transferred their remediable service rights to another pension scheme before remedy was implemented and the transfer was not a Club transfer to another remedy scheme. Some of these members will be entitled to the remedy of an additional transfer payment. Interest will be awarded on these payments at a rate of 8% simple until 28 days after the member is informed of the amount of the additional transfer payment after which the rate will be the NS&I direct saver rate.

Government objectives and rates for interest

8. The Government's objectives for the interest payments remain the same as when the 2022 Directions were made and are to:

1) Reflect the position members may have otherwise been in – The determination of interest payment should consider what position the member may have been in had the payments been made on the date they originated from.

2) Recognise the circumstances of the award – The interest payments should reflect the context as to why the remedy is being implemented and what interest rates are being applied elsewhere as a part of the remedy.

3) Not unduly burden the taxpayer – Any interest payments should be proportionate and where possible not result in unnecessary costs to the taxpayer.

9. The NS&I Direct saver interest rate is applied to the following payments made as a result of remedy:

1) Payments made from the scheme (other than Judges and Local Government) to the member when the remedy is implemented in respect of interest accruing beyond 28 days after a Remediable Service Statement is first issued in relation to the member.

   A rate of 8% simple applies up to 28 days after a Remediable Service Statement is first issued. This also applies up to the date of payment for Judges and Local Government Pension Schemes to take account of the different way their remedies operate

   Except for payments in relation to tax related compensation which will accrue in line with HMRC's interest rate on tax refunds, which is set as the Bank of England base rate minus 1% with a lower limit of 0.5% p.a.

2) Contribution refunds made from the scheme to the member when the member retires, or otherwise leaves the scheme after the implementation of the remedy.

3) All payments made from the member to the scheme.

10. HM Treasury recognises that it is important to keep the choice of interest rates set out in the Directions under review to ensure that they continue to deliver the Government's objectives. HM Treasury also recognises that while remedy is being implemented schemes and members need stability over the interest rates to be applied. The choice of interest rate will therefore be subject to a review every five years, or in response to unexpected events.

11. I would be grateful if you could offer your professional opinion on the proposed amendments to the determination of interest payments as set out in this letter. In particular, I would welcome your view on the extent to which they meet the Government's objectives.

Yours sincerely

Nick Donlevy

Director of Public Spending, HM Treasury