



HM TREASURY

## Revision to guidance following change in basis for setting the discount rate for calculating cash equivalent transfer values payable by public service pension schemes to CPI indexation

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In his budget of 22 June 2010, the Chancellor announced that the uprating of the majority of state benefits and the State Second Pension will be changed from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) with effect from April 2011. This change is expected to apply to both accrued and future service public service pensions through statutory link to the indexation of the State Second Pension.

The impact of CPI uprating in respect of public sector transfers is under active consideration. Effective from Tuesday 6 July 2010, the current basis for setting the discount rate for calculating cash equivalent transfer values **should not be used** until the CPI issues have been worked through and a new basis is agreed. We are working to revise this guidance and will re-issue it as quickly as possible.

Please note that Club transfers are unaffected.

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

**Guidance by HM Treasury**

11 September 2008

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# INTRODUCTION

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## SUMMARY

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**1.1** This guidance sets out the assumptions for discount rates for calculating cash equivalent transfer payments paid 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).

**1.2** 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.

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



# 2

## BACKGROUND

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**2.1** 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.<sup>1</sup>

**2.2** Under the transfer value regulations<sup>2</sup>, the CETV is to be the amount required within the pension scheme to provide the deferred benefits which would otherwise be provided.

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<sup>1</sup> This will also apply correspondingly in the event of the dissolution of a civil partnership.

<sup>2</sup> The Occupational pension Schemes (Transfer Values) Regulations 1996 SI 1996/1847



# 3

## LEGISLATIVE FRAMEWORK

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**3.1** The public service schemes are subject to Chapter 4 of the Pension Schemes Act 1993. This Act and its regulations 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.

**3.2** Under the Occupational Pension Schemes (Transfer Values) Amendment Regulations 2008, SI 2008/1050, responsibility for setting assumptions for CETVs will move to scheme trustees with effect from 1 October 2008. This document sets the discount rate 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. Responsibility for all other calculation assumptions will rest with the managers of the individual schemes.



# 4

## DISCOUNT RATE ASSUMPTIONS

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**4.1** 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 Acts, benefits are updated in line with changes in the Retail Prices Index, published by the Office for National Statistics, 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 uprated at a lower rate, if at all, once benefits are brought into payment. GMPs are uprated in line with earnings during deferment. GMPs and National Insurance modification are generally small parts of the overall benefit provisions for most scheme members.

**4.2** Assumptions have to be made for valuing all material 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.

**4.3** Unlike most private sector schemes, the underlying scheme benefits for unfunded public service pension schemes are not supported by investment of assets. Benefit payments form part of government expenditure when they fall due and are financed through the income government raises at that time, which in turn depends upon activity in the UK economy. For instance, the long term cost to government of providing a set of benefits from the public service schemes is not that implied by the marginal cost of borrowing through gilts at any time: their price and the yield they offer investors will be subject to the balance between their availability on the market and demand from those seeking to purchase.

**4.4** Prospective benefit payments from such public service pension schemes, such as deferred pensions, are one form of long-term government obligation. The Treasury publishes *The Green Book, Appraisal and Evaluation in Central Government*, The Stationery Office, London, 2003, which sets out the basis for valuing government programmes that involve medium and long-term cashflows. The social time preference rate (STPR) set out in the Green Book is the appropriate discount rate for measuring the cost to government of providing these prospective pension benefits. CETVs are also a cost to the scheme and government and the STPR for cashflows of an appropriate duration for CETVs is 3.5 per cent per annum net of prices.

**4.5** The Treasury recognises, however, that CETVs taken from public service pension schemes will in general be invested in market assets. To reflect this there will be some limited continuing linkage to the gilt market, which will be reconsidered at the next review of these assumptions.

**4.6** Having considered the relevant factors, the public service pension schemes to which this guidance applies will adopt from the effective date of the relevant transfer regulations (*The Occupational Pension Scheme (Transfer Value)(Amendment)(No 2) Regulations 2008*) the following discount rates for the determination of cash equivalent transfer values:

- An assumed long-term discount rate of 3.5 per cent per annum net of changes in retail prices;
- An initial discount rate applying in the market, measured on the FTSE index of index linked government bonds with duration of 15 years or more averaged between the 0 per cent and 5 per cent assumed inflation values; and
- The discount rates are assumed to move linearly from the initial discount rate to the long-term discount rate over a period of 15 years.

**4.7** For benefits which do not carry full price inflation increases the following adjustments to the discount rate assumptions will apply:

- For non-increasing benefits the long-term discount rate will be 6.0 per cent per annum; and
- For GMP benefits accrued after 1988 which carry increases up to 3.0 per cent per annum, the net rate, in excess of pension increases, will be a long-term discount rate of 4.0 per cent per annum.

**4.8** For calculation purposes scheme administrators will allow for the current yield on index-linked bonds using published market rates updated at the start of each month. Calculation factors reflecting the impact of the initial yield will be prepared by the scheme's actuary and incorporated in scheme administration systems. These factors will allow for the effects of both pension and retirement cash lump sum benefits.

# 5

## REVIEW

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**5.1** This guidance will be reviewed at regular intervals or at such time as the Treasury, having taken advice from GAD, considers appropriate.