PCS Response to the HMT consultation on the Public Sector Pensions Discount Rate

PCS has around 270,000 public sector members most of whom are in the Principal Civil Service Scheme and some members in other schemes in the public sector such as the Police scheme.
Most of those arrangements then are generally final salary defined benefit schemes mainly the classic and premium schemes in the civil service but there are an increasing number in the ' nuvos' whole career arrangement.

PCS are opposed to any reduction in pension benefits for any public sector scheme. The NAO report published on December 8 2010 clearly gives support to the view put forward by the trade unions that the schemes are generally sustainable and do not require changes to contributions or actuarial assumptions to maintain them.

In a period of job losses, pay freezes, rising inflation and general austerity an arbitrary change to pension arrangements driven by a political agenda will only demotivate and demoralise public sector workers. A recent survey of union members undertaken on behalf of PCS and Unison, shows that almost a quarter of PCS members would consider opting out of their occupational pension due to cost. PCS are of the view that this would only pose long term problems later on the benefit system as pensioner poverty impacts.

Response to questions in consultation document

Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

PCS notes the implication in Chapter 1 of the consultation document that the review is likely to conclude that the SCAPE discount rate should in future be lower than the current rate of 3.5 per cent. We are unhappy that it has been made seemly pre-empting the review findings.

We accept any scheme would look at the discount rate, however, in the case of the PCSPS reviewing it mid valuation in a political rather than scheme specific cost context does not appear a sensible move. One of the drivers apart from the Governments cost cutting agenda seems to be the comment in the interim report of the IPSPC that states it is "... at the high end of what is appropriate". This does not preclude the possibility that, given the results of the review, the current rate will continue to be found to be the "appropriate" rate. The NAO report would support maintaining the current rate.

The PCS is concerned, at the suggestion in paragraph 1.29 "... that organisations that currently participate in the public service pension schemes have access to public service pension schemes at a lower contribution rate than would otherwise be the case."

PCS members who deliver high quality public services do so for a package of benefits, generally a lower rate of pay than private sector comparators and historically for terms and conditions such as a good defined benefit pension (at current contribution rates) and compensation arrangements. All of which are under attack from the current Government. The contribution rate has been shown to be sustainable due to a reform of benefits started with the cap and share arrangements and culminating for our scheme the introduction of the nuvos whole career scheme.

PCS along with other civil service unions have been part of the process in this reform. This has not only been through vital collective bargaining arrangements such as negotiating and balloting members on the introduction on the Premium and nuvos schemes but also by playing their part in the scheme governance and scheme Management Boards making the right decisions for the scheme.

In other schemes trustees many Member Nominated, would discuss the discount rate as part of the valuation process. It would not be a matter for shareholders to quibble about the costs of schemes it would be a scheme specific process done at the appropriate time. This review is a travesty of that process, letting politics determine the cost of individual employees pensions.

The PCS endorses TUC concerns namely that the Government is being somewhat disingenuous in paragraph 1.33, which refers to the impact of any change in the SCAPE discount rate on employees. The key section states that "... the split in respect of how much of these contributions are paid by employers and how much are paid by employees is a question of pension scheme design that is beyond the scope of this consultation." The problem is that the discount rate has a direct effect on the overall figure for the cost of future benefits and this is bound to impact on the perception of what constitutes a fair or affordable share of the cost to be met by the members.

Thus, while the TUC agrees that questions of benefit design should be outside the scope of the current consultation, since we consider that they are matters for collective bargaining, the Government must recognise that the outcome of the consultation will still constrain the scope for such bargaining.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

Paragraph 3.2 identifies five potential objectives for the SCAPE discount rate. We are endorsing the TUC comments on each of these in turn below as well as their additional and important objective that also needs to be taken into account, namely the public policy objective of encouraging "high quality pensions" for all employees.

- **To provide a fair reflection of costs:** While the consultation document suggests that there are tensions between the objectives and it is unlikely that any one approach will satisfy them all, the TUC considers that a fair reflection of the cost of prospective benefits is an absolute requirement that must underlie any decision on the SCAPE discount rate. How such fairness should be achieved is discussed in answer to subsequent questions. PCS would add that the context of shared risk in the PCSPS is a vital part of the scheme and that our members would reject any move to differentiations of relative cost between individuals.
- **To reflect future risks to Government income:** The risks faced by a Government in funding future liabilities is a factor that should be taken into account in setting the SCAPE discount rate. However, it must be recognised first, that the risk that the Government will be unable to meet its commitment is relatively low, given its ability to levy taxation, and secondly, that the minimal risk which is faced is in no way specific to future pension liabilities.
- To use the appropriate technical term, future risks are "fungible" where fungibility is the property of a good or a commodity whose individual units are capable of mutual substitution. In other words, the risk that at some point in the future the government would be unable to discharge its commitments would be shared equally by all those commitments.
- **To support plurality of provision of public services:** This is very important but what relevance to setting the discount rate does it have at this point?. The proper process is to set the discount rate first, given the appropriate objectives of fairness and practicality, and only then to decide how this impacts on plurality of provision and, hence, what if any further measures are appropriate to compensate.
- PCS believes that it would be against the interest of both the public and employees to artificially set high costs to hobble the delivery of good public services, encouraging private provision to suit a political agenda while de-valuing public service delivery. The consultation on Fair Deal launched 3rd March tends to support the view that the Government want public service delivered by by private sector providers.

  The TUC has fundamental doubts about the whole approach to the plurality of provision of public services. However, to the extent that this is an objective of public policy, the aim should be to find ways of extending the advantages in terms of costs that are possessed by the public service, particularly its ability to carry risks, to the private sector. Pensions are an obvious example of where the public service has a significant advantage in terms of its costs. To the extent that this tends to put public sector providers in a better position than those in the private sector, the discrepancy should be removed by extending the inherent advantages of public service pension provision, rather than placing artificial and inherently costly constraints on pension provision in the public sector.

- **To be transparent and simple:** PCS endorses the TUC belief that the existing system, as set out in the Green Book (HM Treasury, 2006) is both transparent and simple and we would be opposed to any changes that sought to add complexity.
- **To provide stability in employer charges:** The civil service trade unions have already entered into the process with the employer on this we accept stability of cost is not only a desirable objective for straightforward practical reasons, but also because it must be a better reflection of the underlying relationship. This review could be seen as an attack on the existing process.

In addition to the objectives listed above the PCS urges that the following objective should also be taken into account.

- **To encourage high quality pensions:** The PCS believes that there is an additional objective that the Government should take into account when setting the SCAPE discount rate, which is to encourage or facilitate a sustainable and affordable future for public service pensions that provide both adequacy and fairness.
- This objective is in line with the coalition government's stated intention, in the May 2010 Coalition Agreement, to "help reinvigorate occupational pensions" and to encourage "high-quality pensions" for all employees. We believe that a crucial part of this policy is to achieve the highest possible level of participation in public service pension schemes and there is no doubt that this will be made more difficult to achieve, the lower level at which the SCAPE discount rate is set.

In conclusion PCS are disappointed that the terms and conditions of service of civil service members including pensions are under discussion outwith the usual collective bargaining arrangements that have worked for a century or more. Is a public consultation the right way to discuss a technical issue that in any other scheme would be down to trustees? The PCSPS Governance and Scheme Management board arrangements had not broken, that forum and the collective bargaining arrangements we believe would have been the proper place to review the discount rate if it was deemed necessary on a scheme specific basis.

POLICE NEGOTIATING BOARD
STAFF SIDE

Federation House, Highbury Drive, Leatherhead, Surrey KT22 7UY Tel: 01372 352022

Our Ref: IR/sg

3 March 2011

Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
LONDON
SW1A 2HQ

Dear Sir/Madam

CONSULTATION ON THE DISCOUNT RATE USED TO SET UNFUNDED PUBLIC SERVICE PENSION CONTRIBUTIONS

Please find attached a submission to HM Treasury on behalf of the Staff Side of the Police Negotiating Board.

Staff Side consists of the police staff associations that represent all ranks in all police forces in England and Wales, Scotland and Northern Ireland. In total Staff Side represents in excess of 165,000 police officers.

We look to the Government's response on this issue.

Yours sincerely

Ian Rennie

IAN RENNIE
Staff Side Secretary

Please reply to the Staff Side Secretary

THE DISCOUNT RATE USED TO SET UNFUNDED PUBLIC SERVICE PENSION CONTRIBUTIONS

This response is submitted on behalf of the Staff Side of the Police Negotiating Board (PNB). The PNB is a statutory body, established by Act of Parliament in 1980, that exists to negotiate the pay and terms and conditions of all police officers in the UK. The PNB consists of an Official Side, a Staff Side and an Independent Chair and Secretariat. Police pensions are dealt with through the Pensions Review Working Party of the PNB, which was established in 2004.

Staff Side consists of the police staff associations which represent all ranks in all police forces in England and Wales, Scotland and Northern Ireland (See Appendix A for a list of constituent organisations). In total Staff Side represents in excess of 165,000 police officers.

Introduction

Staff Side believes there are some general principles which should guide the setting of the discount rate.

Firstly, there should be as much consistency as possible in the use of discount rates for the appraisal and evaluation of policies, programmes and projects across Government. No robust argument has been put forward as to why there should be a separate discount rate purely for unfunded public service pensions.

Secondly, the cost of public service pensions should not be artificially high. There is no virtue in over-valuing a public service scheme by reducing the discount rate if that is not fully justified. To do so could well place public sector organisations at an unfair disadvantage when competing for contracts. It could also encourage the continuation of an unnecessary race to the bottom in pension provision, because public service employers feel obliged, in the interests of staying competitive, to cut back further on schemes which have been made to look artificially expensive.

Thirdly, it must be recognised that unfunded public service schemes have a distinct advantage to the taxpayer in ensuring that no more resources than absolutely necessary are set aside for those schemes. The taxpayer should be able to benefit from the fact that the Government is in a unique position to carry risk and take a long-term view. Consequently it is not appropriate to deal with unfunded public service schemes in the same way as private sector schemes.

Lastly, the two police pension schemes require high rates of membership in order to generate the necessary cash flow to fund pensions in payment. If contributions are raised or the benefits are eroded to a point forcing members to leave, it would simply result in greater pressure on the public purse to replace the lost contributions. Staff Side would add that the New Police

Pension Scheme (NPPS) 2006 was based on an expectation that with projected membership and retention rates it would be self -funding by around the year 2030.

Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?
Staff Side considers that a lower discount rate, and any subsequent increase to contribution rates or reduction in the scale of benefits, could make the idea of belonging to, or joining, a public service pension scheme less attractive. This is particularly true in the current economic climate and in respect of Lord Hutton's review of public service pension schemes.

Our comment above reinforces our view that a cogent argument needs to be presented to change the current discount rate. Although Lord Hutton asked the Government to review the rate, in order to inform the Independent Public Service Pensions Commission's (IPSPC) final report, he did say that "Initial work by the Commission suggests that the current discount rate is at the high end of what is appropriate." It logically follows that the current rate is therefore still appropriate until proved otherwise.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?
Staff Side would caution against attempting too close an alignment with the private sector for the purpose of trying to create a level playing field since the public sector has an obligation to deliver services in accordance with Government accounting requirements, not just the market. In addition, the Government underwrites the private sector's pension provision in the form of the Pension Protection Fund and the Financial Services Compensation Scheme.

Question 3: Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

- **a rate consistent with private sector and other funded schemes;**

Unfunded schemes have a distinct advantage to the taxpayer in ensuring that no more than what is absolutely necessary is set aside for the scheme. The provision of public services which give value for money benefits the community as a whole, including the private sector.

- **a rate based on the yield on index-linked gilts;**

Staff Side considers that this approach is flawed since a pension is not based on borrowing - it is deferred pay.

- **a rate in line with expected GDP growth; and**

Our understanding is that the Social Time Preference Rate (STPR) cannot be less than the expected growth of GDP.

- **a Social Time Preference Rate (STPR) that makes allowances for the particular context of pension provision**

In Staff Side's view catastrophe risk is a relevant component of the STPR since there may be a reduction in the cost of pensions because of, for instance, an unforeseen drop in pensioners' life expectancy or because of a policy change by some future government which has the effect of reducing the value of benefits.

Further, the STPR should be retained as a robust case has not been made for a different approach.

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

For the reasons set out in answer to the points raised in Q3, Staff Side is not persuaded by the arguments for moving away from the STPR. The approach adopted in the STPR leads to a rate which best suits public service pensions and takes due account of the distinct advantages of having unfunded schemes in the public sector, which Lord Hutton recognises at paragraphs 4.67 to 4.74 of his interim report.

Private sector pension contributions may need to fluctuate quite markedly in response to fluctuations in the market value of their pension funds. This is not the case with public service defined benefit (DB) schemes. Unfunded schemes are better placed to take a long-term view and arrive at a means of valuation which can provide contribution rates which follow longer-term trends in the interest of fairness to each generation of taxpayers and to each generation of public service employees.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

Staff Side is concerned that the current rate should not be reduced without compelling reasons. One important principle is that the cost of public service pensions should not be made artificially high. The ability of the public sector to provide good pensions is a valuable asset but should not be over-valued in the belief that this is needed to create a level playing field with the private sector. The private sector has its own ways of being competitive with the public sector, for instance in having more flexible means of setting the level of pay and bonuses than the public sector.

Staff Side would comment on *two* issues in particular: the justification for applying a catastrophe risk and the relevance of pure time preference.

Firstly, Staff Side is not persuaded that catastrophe risk has no part to play. If there is a catastrophe which reduces the scale of pensions to be paid out, the Exchequer will be able to cut back on payments accordingly. A funded scheme is less flexible in that the immediate result of lower payments-out is a larger than expected fund, not less current expenditure.

Secondly, on pure time preference the key point is not that equal consideration is being given to different generations (the argument for setting it at zero), but that for each generation there is in effect a choice of either paying the workforce a larger salary up-front, out of which they can make provision for their own future in whichever way they choose, or deferring their pay in the form of future pension provision. The application of a pure time preference rate above zero is therefore justified.

Question 6: Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?
Staff Side is not well-placed to make specific recommendations, but wishes to distinguish between the need to keep the rate under regular review and the need to keep changing it. The aim should be to take a long-term view which provides stability and the ability for the public services to plan ahead with some degree of confidence.

Concluding comments

Staff Side does not believe the Government has put forward a cogent argument in support of changing the discount rate only for unfunded public service pensions. It is unlikely that the Government would change the discount rate for *all* future expenditure as this would increase its liabilities. The intention to treat public service pensions differently does not make sense and appears to purely be an attack on these pension schemes and their members.

In addition, the consultation document states that "Any change in the discount rate would have an impact on the contributions paid by public service employers, but the Government's intention is that departmental budgets set in the Spending Review will not come under additional pressure due to a change in the discount rate." The implication of this statement is that any extra costs incurred will be borne by employees or else met by reducing the value of the schemes.

Police officers already pay the highest contribution rates in the public service (11% for the 1987 scheme, 9.5% for the 2006 scheme). In the October 2010 Comprehensive Spending Review the Government announced an increase to member contributions rates in public service pension schemes. Police officers are also awaiting the outcome of an independent review of their pay and conditions of service. Staff Side would therefore have real concerns if this consultation into the discount rate is used as another means by which to artificially increase pension contributions and reduce overall remuneration.

Ian Rennie
Staff Side Secretary
3 March 2011

APPENDIX A

Staff Side Constituent Organisations

Chief Police Officers' Staff Association

Police Superintendents' Association of England and Wales

Police Federation of England and Wales

Scottish Chief Police Officers' Staff Association

Association of Scottish Police Superintendents

Scottish Police Federation

Superintendents' Association of Northern Ireland

Police Federation for Northern Ireland

PPI submission to HM Treasury's consultation on the discount rate used to set unfunded public service pension contributions

Introduction

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision makers to take informed policy decisions on pensions and retirement provision.

2. This response focuses on the impacts arising from a change in the discount rate and evidence relevant to the Government's decision making in relation to selecting a discount rate to be used when calculating contributions to the unfunded public service pension schemes.

3. The comments in this response only refer to the discount rate to be used by the Government to calculate contributions to the unfunded public sector pension schemes. In other situations, a different discount rate may be appropriate.

Impacts arising from a change in the discount rate (Question 1)

4. Unfunded public sector pensions are paid for by a combination of employer and employee pension contributions and a balancing item from the Treasury. The discount rate does not affect the cash spent each year on public sector pensions; it affects the split between the amount funded by employee and employer contributions and the Treasury balancing item.

5. If the Government were to reduce the SCAPE discount rate then the implication is that the total contributions required to pay for the unfunded public sector pension schemes would rise. If this change were to result in an increase in the pension contributions to be paid by public sector employers who offer staff public sector pensions, then this will increase the costs of employing staff for these employers relative to the costs of investing in capital. This may affect the allocation of resources by public sector employers between labour and capital. It may also make the costs of offering such public sector pensions more apparent to public sector employers.

6. The consultation document suggests that it is not the Government's intention that a change in the discount rate should put additional pressure on departmental budgets over the course of the Spending Review. This implies that the Treasury will increase departmental budgets to allow for any increased costs of providing pensions that may arise from the Government adopting a lower discount rate in calculating the employer contributions. The short-term impact of a change in the discount rate may therefore be very little in terms of the overall impact on the cost to the Treasury.

7. If the protection of departmental budgets does not extend beyond the period of the Spending Review then a change to the discount rate may have a material impact on departmental budgets. An increase in the costs to the employer of providing public sector pensions may lead to tensions with other Departmental spending plans. There may therefore be long term impacts on managing the budgets of government departments and setting priorities if pension contributions increase.

8. Some independent providers who are not funded by government but are permitted to participate in a public sector scheme may face real cost implications immediately as a result of the change in the discount rate. For example, independent schools may participate in the Teachers' Pension Scheme. Adjustments to the discount rate that increase employer contributions could have a material financial impact on such providers.

Objectives to be taken into account when setting the SCAPE discount rate (Question 2)

9. The Government has set out potential objectives to be considered when setting the SCAPE discount rate, that it should:
    - be a fair reflection of costs
    - reflect future risks to Government income
    - support plurality of provision of public services
    - be transparent and simple
    - provide stability.

10. The consultation document notes that there are tensions between some of these objectives and that some objectives may be more important than others. Given that the primary purpose of the SCAPE discount rate is to calculate the total contributions required to pay for the unfunded public sector schemes, the objectives of being a fair reflection of costs and reflecting future risks to Government income seem particularly important.

Principles in setting the SCAPE discount rate (Questions 3, 4 and 5)

11. The consultation document sets out four alternative approaches that could be taken by the Government to set the SCAPE discount rate. These options include
    - A rate consistent with the private sector and other funded schemes;
    - A rate based on the yield on index-linked gilts;
    - A rate in line with expected GDP growth; and
    - The Social Time Preference Rate

12. These options seem to cover the main alternative approaches that the Government could take so we have no further suggestions for new approaches.

13. In thinking about a reasonable approach for the Government to take in setting the SCAPE discount rate it may be helpful to first consider how contributions are set in pension schemes in the private sector.

14. Funded pension schemes in the private sector invest the employer and employee contributions in assets in order to maintain a large enough fund to cover the expected pension promises built up. Pay-as-you-go public sector pensions are unfunded; current pensioners are paid from contributions from public sector scheme members and employers (plus a transfer from the Treasury in the event of a shortfall). Public sector employer contributions for the unfunded schemes are paid for from Departmental spending budgets and therefore are ultimately funded by general taxation.

15. The principle generally used to set the discount rate when calculating the employer contributions in the private sector is to base the discount rate on the expected growth rate of the assets in the fund. A private sector pension invested in equities would be likely to use a higher discount rate to calculate employer contributions than one which was invested in gilts. This reflects the additional risk premium that is assumed to be attached to equity investment. The discount rate may also be adjusted to allow for the employers financial strength and long term commitment to the scheme (the employer covenant).

16. The unfunded public sector schemes do not have a pool of assets underlying the pension promises in this way. Current payments to public sector pensioners in the unfunded schemes are made out of current Government spending.

17. It is therefore the ability of future Governments to raise future tax revenues which serves as the ultimate source of funding for future public sector pension promises. The expected growth in future tax revenue would be analogous to the asset income generated by the assets

underpinning a pension scheme in the private sector. Therefore the private sector approach of basing the discount rate on asset growth would lead to a public sector discount rate based on the expected growth of tax revenue for calculating the appropriate level of contributions.

18. The growth in Gross Domestic Product (GDP) is a measure of the growth in the overall economy. This means it may be considered to be a reasonable proxy for the growth in future tax revenues and may therefore be an appropriate approach for the Government to use in setting the discount rate to calculate the contributions needed to pay for the unfunded public sector pension schemes. However, it should be noted that as there is uncertainty about the expected future growth of tax revenues and of GDP, it may also be appropriate for this uncertainty to be reflected in an adjustment to the discount rate.

19. For example, in private sector pension schemes an adjustment to the discount rate may be made in order to reflect the strength (or lack of) of the employer covenant. In cases where risks are higher, it is usually considered prudent to make a reduction to the discount rate in order to increase the resulting employer contributions.

Possible reviews of the SCAPE discount rate (Question 6)

20. The SCAPE discount rate should be a long term assumption reflecting the long term nature of the pension benefits accruing. However regular but fairly infrequent reviews should be made for the purpose of ensuring that the discount rate is not out of step with prevailing economic conditions. For example, if the long run rate of economic growth and therefore the expected growth in future tax revenues in the UK were expected to change, then this would also affect the expected future tax revenues from which public sector pensions are paid and may warrant an amendment in the SCAPE discount rate.

21. The Government may want to conduct a review once every few years (perhaps at the same time as other key assumptions, such as mortality, are assessed) to ensure that the current SCAPE discount rate remains appropriate in the context of the UK's economic climate. Very short term and frequent reviews should be avoided because there is a risk that frequent changes to the discount rate may cause fluctuations in employer contributions and increases in administration costs which do not really reflect any changes to anticipated cashflows.

Consultation on the discount rate used to set unfunded public service pension contributions

Response by Prospect to consultation questions.

February 2011

www.prospect.org.uk

INTRODUCTION

1. Prospect is an independent trade union representing over 122,000 professional, managerial, technical and scientific staff across the private and public sectors. In the public sector our members work in a range of jobs in a variety of different areas including in agriculture, defence, environment, heritage and scientific research. Prospect has approximately 35,000 active members in public service pension schemes.

2. The questions raised in the consultation document are very technical in nature but the issues raised are extremely important to Prospect members. We welcome the opportunity to comment and are happy to discuss any aspect of our response further.

DETAILED COMMENTS

3. The consultation document contains six questions. This response gives Prospect's views and evidence on those questions as well as some general comments on discounting unfunded pension scheme liabilities.

   - **Background**

4. Clearly the reason for reviewing the discount rate is the recommendation of the Independent Public Service Pension Commission in its interim report. While the report did not state that the current discount rate is too high it did state that it was at the high end of what is appropriate.

5. The Commission had neither the time nor the resources to conduct a fundamental review of the discount rate and this was the main reason for passing the task to Treasury. For this reason it is not appropriate to attach significant weight either to the remarks in the Commission's interim report regarding the appropriate discount rate or to the suggestion that the current discount rate may be at the high end of what is appropriate. It is important that the review team approach the issue from a neutral standpoint and base any conclusions on rigorous analysis.

6. As the Social Time Preference Rate underpins almost all financial appraisal and evaluation of projects across Government, it is inappropriate to review its operation for one purpose in isolation. The review team should widen the scope of this consultation to incorporate views on whether the Social Time Preference Rate approach remains relevant for all economical analysis undertaken by Government and whether different empirical estimates of its underlying elements are more appropriate.

7. It is important to note that the cost of public service pension schemes depends on the benefits provided and not on the choice of discount rate to set contributions. Neither does the discount rate affect the timing of the cashflows associated with these schemes. Therefore any arguments for approaches that would result in a lower discount rate in order to produce higher required contribution rates to advance greater perceived equity between generations or

between different sections of society completely miss the point of the consultation. Only changes to the benefits provided by the schemes (or, in the case of allocating costs between different generations, to the degree of pre-funding of the liabilities) will affect the cost of these schemes or the pace they are recognised at. The choice of discount rate should be assessed on its own merits and not used as a vehicle for advancing wider arguments regarding public service pension provision.

8. The consultation specifically refers to the discount rate for unfunded public service pension schemes. These schemes are, obviously, different to funded private sector arrangements and it is appropriate to allow for these differences in choosing a discount rate.

> **Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?**

9. Chapter 1, and indeed Question 1, focuses on the impacts of a lower discount rate. This, along with other aspects of the consultation document, gives the impression that Government might already be minded to adopt a lower rate. It is important that the review approaches the issue with an open mind.

10. As well as outlining the expected impacts of a lower discount rate, Chapter 1 also sets out the Government's initial thinking on how some potentially unwelcome effects might be mitigated.

    - It is stated that the Government will take advice from actuaries about whether the discount rate for purposes other than setting contribution rates will have to change. Ultimately this is a decision for Ministers but the case for using different discount rates for other purposes would appear to be very weak. Therefore it is highly likely that payments from schemes in certain cases (eg transfers out) will be higher if the discount rate is lowered.

    - It is proposed that changes to estimated liabilities in respect of past accruals as a result of changing the discount rate would not affect the contribution rate. This smacks of manipulating the SCAPE methodology to accommodate the preferred outcome of the current review of the discount rate. It is difficult to justify this approach on any theoretical basis.

    - It is stated that a reduction in the discount rate may reduce the cost advantage of public service providers when bidding against independent sector organisations to provide public services. Where this cost advantage reflects genuine efficiencies in providing pension benefits it would be completely inappropriate to reduce it. The consultation document (especially in the context of the Independent Public Service Pension Commission's terms of reference and interim report) gives the impression that reducing the cost advantage is a desirable aim in itself.

11. It would be inappropriate to adopt a discount rate for setting contributions for unfunded public service pension schemes that was inconsistent with discount rates underpinning financial analyses and decision-making across government. The review should therefore be extended to consider the approach to all analyses performed under the approach set out by the Green Book. Adopting a different basis or a Social Time Preference Rate based on different elements would therefore have immensely significant impacts on capital projects and resource allocation decisions. It is plausible that the outcome of many economic appraisals would be reversed if based on a lower discount rate.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

12. It is important that the discount rate is consistent with rates used in analyses across Government. Pension costs are simply another cost associated with the provision of public services; these should not be treated differently to other costs of a long-term nature when assessing projects. While this issue is mentioned in relation to the objective of fairly reflecting costs it is sufficiently important to warrant a separate objective. Hence an objective of consistency with approaches taken across Government, as set out in the Green Book, should be adopted for evaluating the SCAPE discount rate.

13. The objectives outlined in the consultation document vary in importance and relevance. The review should focus on the key objectives for setting the discount rate and for undertaking scheme valuations in general. The aim of the overall process is surely to impose a discipline on public sector employers to ensure that the cost of pensions being accrued are taken into account in financial decisions and to do this in a way that is not unduly volatile or inconsistent with the treatment of other liabilities. Hence 'fair reflection of costs', 'stability' and 'consistency with approaches taken across government' are the key objectives for the review.

14. The objective of supporting plurality of provision of public services is not appropriate for the purpose of choosing a discount rate to set public service pension contributions. In so much as supporting the plurality of provision of public services is an aim of public policy, this should be supported explicitly and not indirectly through adjusting factors such as the discount rate used in SCAPE valuations in order to make public provision of public services appear more expensive. Such an approach would seem to be similar to allowing for prudence in mortality assumptions through adding a margin to the discount rate; a practice that private sector schemes no longer adopt. All assumptions should be set on a best estimate basis. Simply bringing the plurality of public service provision into the issue could give the impression that the choice of discount was being set with a particular goal in mind rather than based on the evidence available and reasonable objectives.

Question 3: Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

i) A rate consistent with private sector and other funded schemes

15. Unfunded public sector pension schemes are different to funded private sector schemes; there is no theoretical requirement to adopt a consistent discount rate for setting contribution rates in both types of scheme.

16. Setting a discount rate consistent with those used in private sector schemes would require a degree of analysis and this would have to be repeated every time scheme valuations were undertaken. Obviously this is more complicated and less transparent than retaining the approach set out in the Green Book.

17. As no private sector schemes are exactly equivalent to unfunded public sector schemes there will ultimately have to be a subjective assessment of the adjustments to make to observed private sector data in setting the discount rate. Hence all that would have been achieved by switching to this approach would be the substituting of one judgement for another.

18. It would seem illogical to adjust the discount rate used to set contribution rates in unfunded schemes because the mix of assets backing completely separate funded schemes has changed.

19. Adopting a market-based approach would introduce unnecessary volatility into the system for setting contribution rates. This in turn would make financial and workforce planning much more difficult for public sector employers.

20. Adopting a similar approach across all public sector analyses would result in decisions on whether to go ahead with major projects depending crucially on the timing of the assessment.

ii) A rate based on the yield on index-linked gilts

21. There is no coherent theoretical basis for adopting this approach to setting contribution rates for public service pension schemes.

22. The yield on index-linked gilts might be considered appropriate in assessing the cost of a guaranteed level of pension to a single individual in some cases. However setting an appropriate contribution rate for public sector employers to allow for the cost of accruing benefits is different. The State is in a very different position and has a very different risk profile to individuals saving for their retirement. The State is concerned with maximising utility over time. For these reasons an index-linked gilt approach is not reasonable.

23. No gilts have been issued to back public service pension liabilities; it is not possible to say what the yield would be were such instruments placed in the market. Instead it is proposed to use the current market yield on index-linked

gilts. As these reflect current supply of, and demand for, these instruments there is no logical basis for using them to set contribution rates to unfunded schemes. Indeed any shock that dramatically reduced demand for index-linked gilts would result in lower contributions for public sector pension schemes for no apparent reason.

24. As with market-based approaches based on assets backing private sector schemes, an approach based on index-linked gilt yields would introduce unnecessary volatility with all the attendant disadvantages.

25. Adopting index-linked gilt yields for all project analysis and evaluation across government would radically alter decisions made about proceeding with major projects. The impact of adopting such an approach for all analyses must be considered before considering it as a basis for setting contribution rates for public service pension schemes.

iii) A rate in line with expected GDP growth

26. Setting a discount rate in line with expected GDP growth would at least establish a relationship between the contributions rates and the ability to pay for benefits. The higher expected GDP growth the more affordable future benefits would be and the lower contribution rates would be set at.

27. However it should be remembered that there is no link between pension contribution rates and the overall cost or timing of benefits. In times of increased economic growth, with lower resulting pension contributions, expenditure on public service pensions could actually be increasing greatly due to the demographic profile of the schemes. The purpose of setting the contribution rates is to impose a discipline on public sector employers rather than to ensure that contribution rates respond to changes in the costs of the schemes. The sustainability and affordability of these schemes are obviously extremely important but are monitored separately through projections of future cash flows and short and long term budgeting processes. For this reason there is no compelling rationale for adopting a discount rate for setting contributions that is related to the ability to pay for benefits.

28. Even if a link to expected GDP growth was deemed appropriate for setting contribution rates; this is only one element that should be considered in social discounting. Allowance should also have to be made for catastrophe risk and pure time preference.

29. In practice, adopting a discount rate in line with expected GDP growth could be consistent with the Social Time Preference Rate approach. However a change from the current approach of using growth in per capita consumption as an element of the discount rate should only be adopted if supported by academic literature or other evidence.

30. It is important to realise that the approach adopted should be suitable for use in all economic appraisals carried out by Government. Therefore a change to a Social Time Preference Rate based on expected GDP growth rather than

expected growth in per capita consumption should only be considered if it was thought to be suitable for use across Government.

iv) A Social Time Preference Rate that makes allowance for the particular context of pension provision

31. A Social Time Preference Rate is the approach outlined in the Green Book and applied in economic appraisals across the public sector. As such it should be applied to setting contribution rates for public service pension schemes unless there are good arguments for adopting another approach or the Green Book itself is revised.

32. Obviously retaining the Social Time Preference Rate approach would produce a stable result that would avoid undue fluctuations in the contribution rates paid by employers. As the Green Book methodology is clearly laid out and well understood this option is also the most transparent and simple solution.

33. It is not clear why the context of pension provision might require a specific allowance within the general approach set out in the Green Book. The consultation document does not explain why a distinction between pension liabilities and any other liabilities might be made. The Green Book approach attempts to incorporate liabilities of a long-term nature in evaluations of public projects. Whether these liabilities relate to pension payments or other costs is irrelevant to the nature of the analysis. There is no justification for making a specific allowance for the context of pension provision when setting the discount rate.

34. The Independent Public Service Pension Commission's interim report stated that, "it is debatable if the concept of catastrophe risk can be applied to public service pensions in the same way it is used to value public investment projects". Unfortunately the Commission did not present any arguments supporting the argument that the concept of catastrophe risk should not apply so it is difficult to understand what the thinking behind this statement was. There is a suspicion that perhaps the Commission thought that it was the catastrophe risk associated with the project that was relevant rather than the catastrophe risk that payments would not be made in the future. It is the latter that are relevant and the risk is the same in the case of pensions as it is for other types of long-term liabilities.

35. Reference is made in the Commission's interim report to the allowance for catastrophe risk in the Stern Review. The risk in this context was defined as the risk of extinction of the human race and hence there was a sound theoretical basis for adopting a different approach for this purpose. As the risk that future pension payments are not made is far wider than just the risk of human extinction it is not inconsistent for the Green Book approach to make a larger allowance for catastrophe risk.

36. Any change in the allowance for catastrophe risk in setting contributions for public service pensions would have to be applied across all projects assessed under the approach outlined in the Green Book.

37. The Commission's interim report also states that there is a case for setting the pure time preference at zero if equal consideration is given to different generations. Setting the pure time preference to zero would suggest that taxpayers are indifferent between consumption now and consumption later and this does not seem plausible. Setting a non-zero allowance for pure time preference simply reflects the preference for consumption now. There does not seem to be a strong rationale for setting the pure time preference to zero. The Commission did not support its contention by reference to any arguments or academic literature.

38. The context of the Commission's remarks about the pure time preference seems to be a concern about fairness between different generations of taxpayers. Of course most current taxpayers will remain taxpayers for many years. In any case the point has already been made that the contribution rate does not impact on the cost or timing of benefits from public service pension schemes. The purpose of the Social Time Preference Rate is to enable decisions to be made about the level of public services to be provided not to enable longer-term costs to be passed on to future generations. Lowering the discount rate would simply reduce the level of public services to be provided as well as affecting decisions about how they are operated; it would not result in costs that would otherwise be met in the future being paid today.

39. The Commission noted that it might be appropriate for public service pensions to have a lower discount rate due to their very long-term nature. While some liabilities currently being accrued may not be paid out for a very long time the duration of the liabilities is much shorter and will fall well within the period set for the highest discount rate in the Green Book. The Green Book rationale for declining discount rates in the long term is greater uncertainty about the future. However the Green Book is silent about which of the elements that make up the Social Time Preference Rate would be lower over the long term due to greater uncertainty. Indeed the research quoted in support of declining discount rates does not relate to social time preferences. In fact there is surely an argument that can be made that increasing uncertainty over time would require future cashflows to be discounted at a higher rate in the very long term.

40. Despite having neither the time nor the resources to carry out a full analysis of the Green Book approach to social discounting, the comments the Commission made in its interim report strongly suggest that it had come to the view that the rate currently used is too high. However the Commission only commented on elements that make up the Social Time Preference Rate where it could find reasons for arguing for a lower figure and this suggests that the Commission may have decided that a lower discount rate was a preferable outcome and that it was searching for arguments that might support such an outcome. The Commission did not refer to any academic research on the elements the Social Time Preference Rate is comprised of nor international comparisons nor any areas where there may be arguments to update elements that would result in a higher discount rate.

41. In fact international experience suggests that 3.5% is well within a reasonable range for a discount rate of this kind. A study of rates used by EU countries showed that they mostly lie in the range 3% to 5.5%[1].

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

42. Prospect supports the Social Time Preference Rate approach adopted in the Green Book and is not aware of other approaches that are significantly different from those considered in this consultation.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

43. The approach to setting the SCAPE discount rate must be consistent with the approach to other economic appraisals across government. For the reasons given above, Prospect believes that the Social Time Preference Rate, as set out in the Green Book, remains the most appropriate methodology.

44. Prospect has not seen any evidence to justify changing the Social Time Preference Rate from 3.5% over RPI. If pension increases and indexation remain at CPI over the long term then an equivalent discount rate expressed as a rate in excess of CPI may be required.

Question 6: Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often should this take place?

45. The Green Book approach to social discounting should be reviewed regularly. The SCAPE discount rate should always be consistent with the Green Book and therefore in line with the latest empirical evidence on the elements that comprise the Social Time Preference Rate.

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[1] David J. Evans, Haluk Sezer, (2005) "Social discount rates for member countries of the European Union", Journal of Economic Studies, Vol. 32 Iss: 1, pp.47 - 59

Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
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SW1A 2HQ

3 March 2011

Dear Sir/Madam

Public service pensions discount rate - consultation response

PricewaterhouseCoopers LLP is pleased to have the opportunity to respond to the discussion points raised in the document entitled "Consultation on the discount rate used to set unfunded public service pension contributions" that was released in December 2010.

We believe that the discount rate used to set unfunded public service pension contributions is vital, both for ensuring that costs of public service pensions are reflected by contributions paid now, rather than passing costs to future taxpayers, and for ensuring that there is a level playing field between public and private sector providers when bidding to provide public services.

The Appendix provides our answers to the specific questions posed in the consultation document, which are focused on achieving the outcomes above.

We would be very happy to discuss any of the points in our response. Please feel free to contact me or my colleagues listed below.

Yours faithfully

Mark Packham
Director

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Appendix - Responses to the consultation questions

1. **Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?**

   We believe this chapter sets out the main impacts. Of these, the most significant are the increase in the total contribution rate to be paid now by employers and employees, and the potential levelling of the playing field between public and private sector providers when bidding to provide public services.

2. **Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?**

   One of the objectives set out in Chapter 3 is 'fair reflection of costs'. In addition to the points made in the consultation document, it is vital that the contributions paid by public service employers and employees now cover the costs of the benefits being earned now. A discount rate which is too high will shift the cost burden towards future generations of taxpayers, as contributions paid now will not be sufficient to cover benefits paid later.

   We would again highlight the importance of the objective 'support plurality of provision of public service' which refers to the levelling of the playing field between public and private sector providers when bidding to provide public services.

3. **Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?**

   Option (a), an approach consistent with private sector and funded public service schemes such as the Local Government Pension Scheme ("LGPS"), has the advantage of promoting consistency between the public service schemes and those in the private sector. If implemented correctly, this approach would be the one which would be most likely to achieve the objective of levelling the playing field between public and private sector providers when bidding to provide public services. The choice of comparators will be key – this will need to include private sector firms with the strongest covenants as well as funded public service schemes. For private sector firms, this information is already held by the Pensions Regulator, and so is easily accessible.

   Option (b), an index-linked gilt approach, also has the advantage of being an easily accessible measure, but has many disadvantages as discussed in paragraph 4.59 of the Commission's interim report. In short, the current index-linked gilt market is distorted by undersupply and if gilts were issued to the value of unfunded public service pension liabilities then the yield on such gilts would rise significantly. As such, the current yield on index-linked gilts has little merit as an approach for setting the discount rate for contributions for public service pensions.

   Option (c), an approach based on expected GDP growth, has the advantage that payments from unfunded public service schemes will be paid out of future tax revenue (which is likely to rise broadly in line with GDP growth over the long-term). However, GDP growth estimates are likely to change from year-to-year and so it would be more practical to use a long-term trend rate of growth which could be provided by the OBR.

Option (d), a Social Time Preference Rate ("STPR"), has the advantage of stability and consistency with other decisions across Government. However, we agree with the Commission that the elements of the current STPR in respect of catastrophe risk and pure time preference are not relevant for public service pensions. Catastrophe risk has no meaning in the context of public service pensions and if equal consideration is to be given to all generations of taxpayers then pure time preference should be zero. We note that if these elements are removed then this approach is likely to give a similar result to option (c) – i.e. a discount rate based on expected GDP growth (in aggregate or per capita).

4. Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

We consider that the four options identified by the Commission are the most practical approaches and would not propose any alternatives.

5. Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

As discussed above, we consider option (b), the index-linked gilt approach, to be inappropriate for the reasons discussed in our answer to question 2.

We consider that both option (a), an approach consistent with private sector and funded public service schemes, and option (c), an approach based on expected GDP growth (which is also effectively option (d) once catastrophe risk and pure-time preference are removed) could be appropriate for setting the discount rate for unfunded public service pension contributions.

These options satisfy the key objectives of providing a level playing field between public and private sector providers when bidding to provide public services and ensuring that costs are fairly distributed between generations of taxpayers.

We note that, using the analysis provided by the Commission in its interim report, a discount rate based on option (a) could be in the region of 2.5% - 3% per annum above RPI inflation, and a discount rate based on option (c) could be in the region of 2% - 2.5% per annum above RPI inflation. Taken together, this would imply that a discount rate around 2.25% - 2.75% per annum above RPI inflation would appear reasonable.

For the purpose of future SCAPE valuations, we would recommend that a discount rate relative to CPI inflation is used as future pension indexation will be based on this measure. Based on a long-term gap between RPI and CPI inflation of 0.75%, in line with the Commission's analysis in its interim report, our analysis above would therefore imply a discount rate above CPI inflation of around 3% - 3.5% per annum.

As a final point, we would consider that having an approach to set the discount rate which relies on two measures (i.e. a comparison with private sector and funded public service schemes and a comparison with long-term expected GDP growth) will provide an in-built counter-balance in case one of these measures becomes distorted. This should ensure that the overall approach stands the test of time.

6. **Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?**

   Yes, we consider that there should be a regular review of the SCAPE discount rate. This should occur in line with the regular cycle of contribution-setting valuations of unfunded schemes (i.e. every 4 years).

   At the start of each valuation cycle, an analysis of the most recent discount rates adopted for contribution setting purposes by private sector employers with the strongest covenants and funded public service schemes should be undertaken (the private sector information should be available from the Pensions Regulator). This should be considered together with long-term GDP forecasts from the OBR and a paper should be published by the Treasury setting out the discount rate which will be used for that valuation cycle along with the rationale for this.

1st March 2011

Submission for HMT Public Service Pensions Discount Rate Consultation

Neil Record[1]

Introduction

This submission is in response to the Government's consultation on public service pensions discount rate launched in December 2010, and concluding on 3 March 2011.

I am writing as an author in this area, and the summary papers which I have authored or co-authored are listed in footnote 1 below. I also represented the views of the IoD/IEA 2010 Public Sector Pension Commission at a meeting at the Treasury on 28 January 2011.

HMT has asked six questions for which it seeks views, and the Independent Public Service Pensions Commission ("Hutton Commission") has identified four alternative approaches to setting the discount rate, the merits of each I will review.

I will deal with each of the six questions in turn, but first I will give a summary of my position on the general question, and the basis of the analysis.

Summary

The consultation document[2] has set out six criteria by which it will judge the merits or otherwise of the differing discount rate suggestions.

- fair reflection of costs;
- reflect future risks to Government income;
- support plurality of provision of public services;
- transparent and simple;
- stability; and
- any other objective you identify.

I believe that the ***purpose*** of the discount rate in public service pension calculations is to provide policy makers, expert commentators and the general public with accurate information about the ***cost*** to the taxpayer of the pension promise each year[3].

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[1] Neil Record is founder and Chairman of Record plc, a listed asset manager, and a Visiting Fellow of Nuffield College, Oxford. His publications on public service pensions include:

Sir Humphrey's Legacy, 2006, IEA – http://www.iea.org.uk/files/upld-book390pdf?.pdf

Public Sector Pensions, the UK's Second National Debt, 2009, Policy Exchange - http://www.policyexchange.org.uk/images/publications/pdfs/Public_Pensions_Final_Jun_09.pdf

The need for transparency in public sector pensions, 2009, British North American Committee - http://www.bnac.org/files/BNAC%20Public%20sector%20pensions%20BN49%20-%208%20June%2009.pdf

Reforming Public Sector Pensions, 2010, Public Sector Pensions Commission (IoD/IEA) - http://www.public-sector-pensions-commission.org.uk/wp-content/themes/pspc/images/Public-Sector-Pensions-Commission-Report.pdf

[2] Consultation on the discount rate used to set unfunded public service pension contributions, HM Treasury, Dec 2010

Normally ‘cost’ is relatively easy to define, but in the case of defined benefit (DB) pensions, there is no widely agreed methodology to calculate it. I therefore propose the following as a benchmark for judging the cost of the unfunded DB pension promise.

The ‘cost’ of the a pension each year is the price that a large private sector employer would have to pay each year in the market to buy assets with the maturity, certainty of investment returns and credit quality of the public sector, which, on the same assumptions employed in a comparable public sector scheme, would be expected to fully pay all the new pension obligations promised to employees in that year without further recourse to the employer.

This definition turns out to be the same as the Current Service Cost under SCAPE[4], but using Index Linked Gilt market rates rather than 3.5% real. Index Linked market rates are one of the four discount rate alternatives mooted in the consultation, and the only one which satisfies this definition.

Under current actuarial practice, the above definition fits into the ‘matching’ category of discount rate use. I will show later that this produces the same practical result as the ‘budgeting’ category.

I will now set out to review the relative merits this cost definition against the six criteria suggested by HMT.

The Six Criteria

<u>*Fair reflection of costs*</u>

Common sense dictates that a ‘fair reflection of costs’ in the context of an employment benefit should mean the cost that an employee would have to pay (perhaps in a pooled environment to get economies of scale and risk sharing) to get the same benefit. So if it an employee is given the use of a company car, then a fair reflection of cost would be the market price of (say, his or her employer) leasing a similar car under similar terms and conditions. Similarly, the cost of permanent health insurance cover, or life insurance cover, would likewise be the cost to an employee (or employer) of buying the same cover (again with possible allowance for bulk purchase) from an insurance company. This definition is widely used by HMRC in the calculation of benefit in kind for tax purposes, and most importantly, is widely understood by the general public to be the ‘cost’ or ‘value’ of the benefit. The definition above fits squarely into this definition of fair reflection of costs, and none of the other suggested discount rates can do this, since no comparable assets are available to buy in the market at other than market rates.

<u>*Reflect future risks to Government income*</u>

If the pension promise made by the Government in the role of employer is of the same quality and certainty as the promise made to lenders to the Government (i.e. investors in UK Government Gilts), then the future risk of non-performance (for whatever reason, including inadequate Government income) is already reflected in the market price of Gilts. If, however,

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[3] The cost to which I refer is the current service cost, a concept well established in the pension literature, including unfunded public service pension schemes, and not ‘pensions in payment’. HMT will know that the ‘Current Service Cost’ line in the Resource Accounts of the main unfunded pension schemes are currently calculated using a FRS17/IAS19 discount rate –1.8% p.a. over RPI for 2010-11, which is much lower than the 3.5% p.a. real used for contributions. Using two rates creates unnecessary is a confusion which must end.

[4] **S**uperannuation **C**ontributions **A**djusted for **P**ast **E**xperience – the Government’s preferred method for calculating the cost of public service pensions.

the promise is of a lower quality than the promise to lenders, then an additional risk premium should be demanded by pensioners. This would imply that a higher discount rate than the market price of Gilts would be appropriate, to reflect the risk of non-performance. However, it should be noted that if the Government acknowledges that its occupational pension promise is less secure than its Gilts promise, it should tell its pensioners that this is so.

Support plurality of provision of public services

This criterion seeks to allow both public and private sector employers to compete for the same roles in public service provision on the same terms with the same labour contract. A private sector employer can only compete in this way if the cost definition above is used; otherwise either (a) the pension the private sector employer offers will have to be worse or (b) the amount the private sector employer has to contribute to pay the pension cost will be higher than the public sector employer **for the same pension**. This will put the private sector provider at a disadvantage, and fail to create a level playing field in the labour market.

Transparent and simple

Transparent and simple may not be the same thing. A fixed discount rate is simple, but it may fail the transparency test ("why is the discount rate set at this level ?"). A transparent rate should be one justifiable from firmly established principles. The principle of 'same cost for public and private sector employers' is an understandable and intuitive principle. It will, however, produce a variable discount rate.

Stability

A market-based discount rate will not be stable. But nor will the price of many benefits, which will change with economic and financial conditions, sometimes radically. Selling bread at a fixed price satisfies the stability principle, but we run the danger of starving if that price falls below the economic cost, even if at some point it was above. The world is dynamic, and to satisfy the criteria above, the discount rate will have to be too.

Any other objective….

Tax

I think there is a material point on pension tax regimes. The Government sets limits on the pension benefits that can accrue to employees which remaining under beneficial pension tax arrangements – examples include maximum annual contributions and lifetime 'asset caps'. For a level playing field on tax enforcement between public and private sector, the financial assumptions need to be the same. At the moment, the artificial discount rates used in public service pensions' means that public sector workers may get differentially beneficial tax treatment versus private sector workers for the same pension. A further complication, and potential unfairness as the annual contributions allowance falls, is that members of DC pension schemes contributions are calculated on the basis of actual cash contributions paid, whereas members of DB schemes' contributions are calculated on the basis (in effect) of the current service cost calculated at artificial discount rates. This understates the future value of (largely public sector) DB schemes (expressed at market prices), and therefore discriminates on tax against DC (largely private sector) employees.

Alternatives for the Public Service Pension Discount Rate

The Hutton Commission identified four alternative approaches to setting the SCAPE discount rate:

1. A rate consistent with private sector and other funded schemes
2. A rate based on the yield on index-linked gilts

3. A rate in line with expected GDP growth
4. A Social Time Preference Rate (STPR) that makes allowances for the particular context of pension provision.

Taking each in turn.

1. A rate consistent with private sector and other funded schemes

This would conform to current FRS17/IAS19 accounting treatment, which is designed to reflect the returns available from investing in (relatively, but not perfectly) secure assets[5].

There are two telling arguments against this discount rate formulation in the public sector context.

The most obvious is that the unfunded public service pension schemes do not have any assets, and so strictly speaking using a return available to a funded scheme is not relevant. FRS17/IAS19 principles are categorised by actuaries as 'matching'[6] – i.e. that pension funds can largely match their financial liabilities by holding the specific assets (and the associated discount rate). I support the matching principle, and in the case of unfunded public service pensions, this turns out to produce the same discount rate, in my opinion, as the actuaries' 'budgeting' principle. How does this work ?

Under the current arrangements, public sector employers (NHS Trusts; Schools etc) pay both employer and employee pension contributions each year to the Treasury. With this payment employers relinquish all further pension obligations to the Treasury, who become fully responsible for fulfilling all the pension obligations.

The Treasury do not ring-fence the contributions; they go into the consolidated pot, and therefore contribute to general government revenue in the year in which they are received. However, these contributions allow the Treasury to borrow less than it otherwise would in the relevant year in which the contributions are received, and then borrow more than it otherwise would in the subsequent series of years in which pension payments are made.

So for budgeting purposes, the 'return' that the Treasury receives on the contributions is the interest saved from not borrowing in the year in which the contributions are received, with a reducing 'balance' as pensions are paid out in subsequent years, and borrowing increases, ceteris paribus. If the Treasury refrains from borrowing in maturities and in a form that best matches the duration of the future pension payments, then the best proxy for the 'return' that should apply to that years' contribution is the approximately 20-year duration Index Linked Gilt market rate. In this way, the matching principle and the budgeting principle for discount rates produce the same answer in practice for unfunded public sector schemes.

2. A rate based on the yield on index-linked gilts

This is my preferred rate, since from the evidence and argument presented here best satisfies the six criteria set out in the consultation document.

3. A rate in line with expected GDP growth

This appears to be a 'compromise' rate favoured by many commentators. Their argument runs as follows:

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[5] The assets specified are AA corporate bonds, although there are materially no bonds available in this category with full RPI or CPI index-linking.

[6] See ***Developing a framework for the use of discount rates in actuarial work***, C.A. Cowling, R. Frankland, R.T.G. Hails, M.H.D. Kemp, R.L. Loseby, J.B. Orr and A.D. Smith; Institute and Faculty of Actuaries, Sessional research paper, 4th January 2011.

Tax receipts generally run in tandem with nominal GDP growth[7]. Nominal GDP growth is comprised an inflation component (the GDP deflator), and a real component. Assuming that the GDP deflator and RPI[8], run roughly together, then this discount rate assumes a real return (over RPI) on the contributions of expected GDP growth (say 2% p.a.).

Liabilities that grow in line with expected GDP growth will, on the assumptions above, not grow in excess of future tax revenues. This has the pleasing quality of pensions' promises not expropriating an ever larger share of the Government's budget with the passage of time. However, it has one, overwhelming disadvantage – it does not represent a rate of return available to ordinary investors.

There is a school of thought that argues that investment returns follow GDP growth, but there is neither strong evidence that this is the case (China being a current counter-example; Britain from the 10th to 18th centuries being another (in the other direction)), nor is there any theory that supports this. Investment returns and national GDP growth are related loosely and sporadically, and global capital arbitrage ensures that this remains broadly the case.

The central objection to this choice of discount rate is that to allow only public sector workers, but not private sector workers, to invest for their pensions at a higher-than-market rate (when indeed it is higher than the market rate for risk-free investing) is unfair to the 80% of the workforce that works in the private sector, and is not an accurate reflection of the cost of pensions. The same objection would apply, in reverse, were the expected GDP growth rate lower than the risk-free index-linked market rate of return (which indeed is very common in history).

4. A Social Time Preference Rate (STPR) that makes allowances for the particular context of pension provision.

The origin of the current 3.5% p.a. real rate of return as the SCAPE methodology discount rate is as a Government-chosen STPR. The consultation paper sets out the current components of this rate:

- Catastrophe risk: 1.0 per cent
- Pure time preference: 0.5 per cent
- Growth in per capita consumption: 2.0 per cent

Although 3.5% p.a. is well established in Government inter-temporal decision-making, in the context of pension provision for a minority of the population, it seems entirely inappropriate. There is one overriding argument, and one subsidiary argument.

First, the overriding one.

Social Time Preference Rates are just that. They are used by Governments to choose, on citizens' behalf, the amount of society's consumption to be foregone today in return for some level of increased social consumption at future (often distant) date. Large infrastructure projects (Bridges; motorways; rail projects) are commonly analysed and cut-offs determined this way. Climate change measures are also judged this way (but at lower discount rates!).

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[7] This is sometimes expressed as GDP per capita growth. In the UK in the past ten years, the difference between the two was about 0.5% p.a., which is unusually high because of rapid population growth.

[8] In this submission I refer to RPI as the inflation measure for both Index Linked Gilts and public pensions. The latter have moved to CPI from April 2011, and I am assuming that the Government will in due course issue CPI-linked Index Linked Gilts to provide a matching asset. The 'market rate' for IL Gilts in this consultation would then be the CPI IL Gilts market rate, which is likely to be c. 0.75% p.a. higher than the RPI IL Gilts market rate.

But public sector pensions are the foregoing of consumption by one privileged section of the community now for future consumption by that same section of the community. The future consumption of that privileged section will be paid for by all taxpayers, not just that section. Whatever else it is, it is not social consumption.

The second, lesser argument, is that the value assigned to the STPR is bound to be arbitrary. Such evidence as there is has the majority of the population exhibiting personal consumption discount rates (and therefore presumably social consumption rates) much higher than any of the rates under consideration. Personal borrowing behaviour shows that a significant proportion of the population have consumption discount rates in double figures – a stark contrast with the Government's chosen 'Pure Time Preference' of 0.5% p.a. This remarkably low figure does not seem to be based on any evidence in the literature. Long-term historical studies of interest rates that prevailed during several centuries until the twentieth century show equilibrium lending/borrowing rates of around 3% p.a. for very good credits (in a nil inflation environment).

Finally, both of the other two elements of the current STPR are debatable. The catastrophe element is particularly vulnerable, since it is not clear which direction a catastrophe would run. A failure of the Government's ability or willingness to pay ? (implying a positive catastrophe component to the STPR); surprising increase in longevity (cure for cancer) ? (negative component to the STPR); widespread epidemic ? (positive component to the STPR). Although they cannot be described as catastrophic, the outturn risks have so far been skewed towards higher pension payments than expected, not lower, and therefore a negative catastrophe risk component to the STPR.

Questions

Turning now to the specific questions asked of respondents:

Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

I favour a discount rate based on IL Gilt market rates. Three major implications arise from this, and a fourth at a different level.

Firstly, there needs to be a market reference rate, namely a CPI Index Linked Gilts market running concurrently with the RPI Index Linked Gilts market. I have already arranged for a letter to be sent to the Chancellor of the Exchequer on this topic, signed by four large UK pension funds, both public and private sector, indicating their support for this proposal. They are particularly concerned that RPI Index Linked Gilts continue in their present form, with no risk of denomination to another index. This letter is available should you wish to see it.

The second implication is that the discount rate will be variable. I suggest an annual reference discount rate process is established, so that, for example, the discount rate could be set with reference to the average of the monthly closing rates for the nearest appropriate duration Index Linked Gilt issue for a specified year (November to October ?), applied to all pension accruals from the following April for 12 months.

The third implication is that either the contribution rate, or the accrual rate, would have to change each year. In my submission to the Hutton Commission, I recommend that the accrual rate be varied annually, and contribution rates kept constant, since the disruption on budgets, both public and private, would otherwise be far too high.

At a completely different level, there is one further implication, which could have a profound effect on occupational pension provision in the UK. Namely that if the Government sets discount rates for public service pensions in the way I suggest, they would be in a position to offer identical pensions to all workers, not just public service workers. There would be no budget implications of this, just a substitution of borrowing by the Government in the Gilts market with borrowing from future pensioners – both at the same interest rate. If this route were adopted, I would strongly recommend that the private sector pensions offered were fully funded by the issue of Index Linked Gilts to an appropriate agency charged with the responsibility for paying the pensions promised, and required to break even without taking material financial risk. The moral and political appeal of high quality DB occupational pensions on offer to all workers is, in my opinion, very strong.

I set this idea out more fully in my submission to the Hutton Commission.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

No. In my opinion, all the relevant considerations are discussed both in the consultation document and above.

Question 3: Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

See above.

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

No – there is no need to consider any additional approaches.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

The Index Linked Gilt market rate. For the full argument, see above. Note that if this route is accepted, then the rate itself will be variable, and possibly highly variable. There is a strong likelihood that the rate that falls out of these principles will on occasion be higher than all the rates from competing principles, rather than lower, as at the moment. This would be reflected in much higher accrual rates for pensioners, or lower contributions.

Question 6: Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?

Annually is a practical compromise between slavish adherence to the market, and stability and planning horizon.

I do think that it makes sense for a transition period for the adoption of a market rate. I would recommend a three-year transition, with the first year 75% weight to 3.5% p.a. and 25% the market rate; the second year 50% weight to 3.5% p.a. and 50% the market rate; the third year, 25% weight to 3.5% p.a. and 75% the market rate; and then fully market rate from the start of the fourth year. This will allow each employer and employee representatives time to get to grips with the new reality, and to organise pension provision appropriately. The Treasury may find that an even longer transition is more practical, and I would not be against this.

If other methods for setting the discount rate are chosen, then I strongly recommend that these are also reviewed annually. Failing this, there is a danger that, yet again, there is a further widening gap between the pensions available to public sector workers and private sector workers.

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3rd March 2011

Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team,
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Sirs,

Re Consultation on the Discount Rate Used To Set Unfunded Public Service Pension Contributions

Serco Group plc welcomes this opportunity to give evidence to HM Treasury's consultation on the discount rate used to set unfunded public service pension contributions.

Serco is a FTSE 100 international services company. We employ over 70,000 people and operate in over 30 countries around the world delivering many critical services for our customers, 90% of whom are national, regional and local governments. 60% of our £4bn pa turnover is in the UK.

Serco has operated in the UK public services market for over 40 years. We have delivered many reforms of public services on behalf of our government customers and are part of a UK industry that leads the world in delivery of high quality public services.

Treatment of pensions is a critical determinant of our ability to assist our government customers in delivering high quality value for money services to the citizen. A level playing field in pension costs in a competitive market for delivery of public services is essential and there are a number of pensions issues, including the discount rate, that adversely affect this currently.

In answer to Question 5: which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

Our view is that the discount rate should be consistent with private sector and other funded schemes as this is the position the private sector is mandated to take by regulation. We believe this is consistent and fair and help to create a level playing field in bidding for outsourcable activities. On that basis, in our view the rate should be reduced by 0.5% to 1%.

We hope this is helpful to your deliberations. If you would like to discuss this further with us please do contact me at my office.

Yours sincerely

Guy W Leach

Guy Leach, Director, Risk & Acquisitions
Serco Group plc

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4 March 2011

Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
LONDON
SW1A 2HQ

Dear Sir/Madam

HM TREASURY: CONSULTATION ON THE DISCOUNT RATE USED TO SET UNFUNDED PUBLIC SERVICE PENSION CONTRIBUTIONS

With reference to the above document, I would like to respond on behalf of the Board of Strathclyde Fire & Rescue, which employs over 3,500 personnel, all of whom are eligible to join public service pension schemes, either one of the Firefighters' schemes or the Local Government Pension Scheme.

As a member of the local government family, Strathclyde Fire & Rescue is represented within the Convention of Scottish Local Authorities (COSLA) and is aware of the submission made by them to this consultation. I am fully supportive of the issues that they have raised and would make the following points by way of emphasis from a fire and rescue service perspective.

In terms of the objectives set for determining the discount rate, while clearly it is appropriate that the factors which support sustainability of public sector pensions must be reflected, for example fair reflection of costs and risks to future Government income, I would strongly support the need for stability for employing organisations in budget setting and management, particularly in the current challenging financial climate. The timing of any changes would need to be such that the impact could be fully reflected in Spending Review decisions. Failure to make this link would have the potential to generate a budget crisis at the point of change. In the recent past all costs from the Firefighters Pension Scheme were met from local budgets and the regular fluctuation of this expenditure caused significant budgetary challenges.

Equally, dependant on the scheme rules, it is possible that fluctuations in the discount rate may affect individuals who I believe equally need financial stability. I would be concerned if any change in the discount rate at this stage led to further upward pressure on employee contribution rates and I would echo the point made by COSLA that the numerous changes currently being proposed in the pension arena must be considered collectively.

/....

It may well be appropriate to keep the discount rate under review, again my objective would be around stability. I would be hopeful that having undertaken a radical review of public service pensions at this stage it would be possible that future changes represent minor adjustments rather than major surgery.

If you wish to discuss any aspect of this response in more detail please contact Sarah O'Donnell, Head of Finance, on 01698 402261 or sarah.o'donnell@strathclydefire.org.

Yours faithfully

Brian Wallace.

COUNCILLOR BRIAN WALLACE
CONVENER
BOARD OF STRATHCLYDE FIRE & RESCUE