ASSOCIATION OF
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CONSULTING ACTUARIES

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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 Sirs

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

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to your consultation on the discount rate used to set unfunded public service pension contributions

Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Institute and Faculty of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes, including Local Authority Pension Funds.

The ACA is the representative body for consulting actuaries in the UK, whilst the Institute and Faculty of Actuaries is the professional body.

Members of the ACA provide advice to thousands of pension schemes, including most of the funded public service schemes – most notably the 100 funds that make up the Local Government Pension Scheme or LGPS. Members however are also involved in advising some of the unfunded public service schemes such as the NHS Scheme, Police and Fire Schemes and the Civil Service Schemes.

Below we set out our thoughts on the questions you have raised. However before tackling the questions that have been raised we believe it is appropriate to make some more general comments about discount rates and their derivation.

Cessation	**4.5% per annum**

Typically a 1% difference in discount rate changes typical pension scheme liabilities by 20%.

Our view is therefore that in assessing the discount rate to be used for unfunded pension schemes, it should be recognised that different discount rates may be appropriate in different circumstances depending on the question being asked, but that similar principles should be adopted as would apply for funded pension schemes.

The consultation document lists the various purposes where discount rates rate are required including:

- Setting the level of employer contributions to recognise the value of the pension promise being provided
- Sharing of pension costs between employee and employer / cap and share mechanisms
- Assessing individual transfer values and other similar calculations

Whilst these situations are all quite different and indeed may be essentially asking quite different questions, the practice to date has been to use the same SCAPE rate which has been set as the Social Time Preference Rate of 3.5% in excess of RPI.

In the early days of FRS17 this was also the rate adopted by public sector bodies for valuations of both funded and unfunded pension liabilities. However these days, discount rates are usually corporate bond yields as per private sector pension schemes. We do not go into the relevance of corporate bond yields as a discount rate for accounting purposes of public sector employers.

Thus we already have more than one discount rate being used for valuing unfunded pension liabilities.

The consultation document does not ask us to consider what discount rate should be used to assess the discounted value of future unfunded pension liabilities, a topic that receives much press coverage.

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?

Our view is that there should be different discount rates depending on purpose which may or may not result in discount rates that are higher or lower than the current SCAPE 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?

The objectives set out in chapter 3 of the consultation document are sensible. However again we would approach this by first of all agreeing what the question is which should then make the choice of discount rate more straightforward.

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?

Again the question assumes the use of one discount rate for all purposes.

Thus whilst there is no external investment in assets there has effectively been internal investment. There is therefore a case we believe that the discount rate that is used to value unfunded public sector pension liabilities for at least some purposes should reflect the expected return on these internal assets. This does lend itself to adopting a discount rate linked to our expected increase in national wealth.

Some will argue that this is too subjective but in reality such an approach is not that different to the assumptions about future equity returns adopted for funding purposes in funded schemes.

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

There is clearly some logic in adopting such a rate for making decisions about how to spend money now for different future benefits. However even with some adjustments to try to make it fit the pensioncontext, it still represents a very different approach to determining discount rates for valuing pension liabilities. The component parts also look rather subjective and do not appear to be evidentially based. - The allowance for time preference of 0.5% seems low based on current yield curves, which indicate spot yields increasing from about 1% to over 4% at longer durations.

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?

Whilst it would be possible to concoct alternative approaches, we believe the 4 approaches put forward in the consultation document represent the 4 most obvious approaches. However, although we have no direct experience, we expect other countries have experienced similar issues and the solutions adopted could be worth investigating.

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?

As already discussed we believe that the discount rate that is to be adopted will depend on the purpose for which it is put or equivalently what question is being asked in the first place. There is no single "correct" approach.

The question being asked in the consultation document is to do with the level of employer contribution that is to be calculated. However the follow up question is for what purpose is the employer contribution being calculated.

These seems to be 3 key reasons

- Deciding the value of the pensions package and then allocating the cost between employee and employer

- The amount that public sector employers should be charged to represent a "fair reflection" of the cost of the benefits being provided (arguably for internal charging purposes)

- As above but for bidding against private sector organisations for public sector contracts.

Whilst we may suggest different approaches for valuing pension liabilities for other purposes, there is a degree of commonality between at least the first 2 purposes and possibly the third.

Of the 4 proposals put forward we would favour the expected growth in GDP approach as the liabilities will be met from future national income. We would still anticipate that this produces a

Yours sincerely

Graeme D Muir FFA
ACA Main Committee

ACPOS
ASSOCIATION OF CHIEF POLICE OFFICERS IN SCOTLAND

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Your Ref:
Our Ref: DC/TC/0001494
Date: 4 March 2011

Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
By e-mail

Dear Sir

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

I refer to your e-mail message of 9 December 2010 inviting views from organisations with an interest in unfunded public service pension schemes on the appropriate discount rate to use in the calculation of the contribution rates for unfunded public service pension schemes. I understand the final date for submission was yesterday however Mr Cant of my staff has spoken with Miss Brothers of your Team and been advised that a response today would be included. I submit this on behalf of the Association of Chief Police Officers in Scotland (ACPOS).

ACPOS is an independent, professionally led strategic body acting as the principal voice of police leadership in Scotland. The organisation consists of the Chief Constables, Deputy Chief Constables, Assistant Chief Constables and Senior Police Staff from the eight police forces in Scotland.

ACPOS recently provided additional information to the Independent Public Service Pensions Commission review of public sector pensions and some of the comments are repeated in this response. In my capacity as Chairman of ACPOS Finance Management Business Area I am sighted on the response to this consultation from the Convention of Scottish Local Authorities (COSLA). I fully support the points contained within the COSLA response, however I would wish to add some further comments, in respect of Police Officers and Police Staff specifically.

You will be aware that pension arrangements for Police Officers were reviewed and modernised as recently as 2006 when the New Police Pension Scheme was introduced. The new scheme extended the qualifying pensionable service necessary to achieve full benefits from 30 to 35 years and also diluted the benefits payable thereby reducing the overall cost of police pensions. It is anticipated these reform measures will be reflected in any proposals which come forward.

In addition to the two separate pension schemes for Police Officers there is a third pension scheme in operation. Police Staff have access to the Local Government Pension Scheme. While it is acknowledged that the terms and conditions, including pension entitlements, are different it is important that any proposed changes treat all staff in an equitable manner. The Local Government Pension Scheme in Scotland was recently reviewed and the revised scheme effective from 1 April 2009 introduced a five-tier employee contribution rate dependent on salary. Again it is anticipated this progressive move in tackling pension costs will be reflected in any proposals which come forward.

Police officers and Police Staff tend to be very loyal to their organisations and turnover of staff is relatively low. While salary rates within the Police service may be less attractive compared to the private sector this position may in part be attributed to the overall salary and benefits package including pension entitlements. It is accepted that the changing financial environment requires the affordability and sustainability of current schemes to be examined. Pensions are however a fundamental and valued part of the terms and conditions of those that work within the Police service. It is important that any changes made do not dilute the entitlements staff have worked for and contributed to and therefore these should not impact on the arrangements for those currently employed in the service.

It is also important that future arrangements are sufficient to attract the quality of Police Officers and Police Staff necessary to deliver an effective policing service. Any proposed changes will require to be fully explained and understood by key stakeholders and the benefits of any change fully articulated and evidence based.

Pensions are a long term issue and a degree of stability is needed to assist with financial planning particularly in the current financial climate. ACPOS recognise there is public concern over the affordability and cost of pensions however this is only part of the overall remuneration package which requires to be sufficient to attract the quality of staff and protect the benefits of those who have already contributed into the pension schemes in good faith.

ACPOS would wish to continue to cooperate with this review and offers to participate in any debate on proposals to be contained in the final report.

I trust you find this in order. Should you require any further information, please do not hesitate to contact either myself on 01382 596200 or Mr Allan Macleod on 0141 532 2731.

Yours sincerely

Doug Cross
Chairman ACPOS FMBA

The Actuarial Profession
making financial sense of the future

Consultation response
HM Treasury

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

March 2011

About the Actuarial Profession

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

The Actuarial Profession
making financial sense of the future

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

3 March 2011

Dear Sirs

I am writing on behalf of the Actuarial Profession in response to HM Treasury's consultation on the discount rate used to set unfunded public service pension contributions.

The Actuarial Profession represents the members of the Institute and Faculty of Actuaries, the chartered professional body for actuaries in the UK. Approximately 2,000 of our 6,000 Fellows advise the sponsors or trustees of pension schemes either in the public or private sector.

With this in mind, it is important to recognise that there could be a wide range of views across the profession on the question of discount rates, all of them perfectly defensible depending on the different objectives that are being targeted. It is likely, therefore, that there isn't a single, definitive answer to some of the questions posed. Instead, we have sought to focus on the areas of the consultation where we hope our observations and commentary will be helpful to the development of HM Treasury's thinking.

There are two general points that have framed our responses to the consultation:

- The starting point for any process to choose what discount rate might be appropriate is an understanding of what the results of the analysis will be used for. The consultation document sets out the parameters for the views being sought.
- In responding to the different questions raised in this consultation we have kept in mind the particular purpose that the discount rate is to be used to set contributions in the unfunded public service pension schemes.

For the reasons outlined above we have chosen to respond only to the questions in the consultation where we believe our commentary can provide distinctive value. Our responses are set down below.

Q1 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?

Paragraphs 1.24 – 1.35 cover a number of consequences of lowering the SCAPE discount rate but one area not addressed is any consequences for the cap and share policy introduced into certain public service pension schemes (paragraph 1.18 mentions this point). Despite the valuations of these arrangements having been suspended, any increase in overall total contribution rate resulting from using a reduced

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discount rate will inevitably alter the perspective on any cost sharing arrangements between employees and employers.

The statement is made that a change in the contribution rate is not to affect the overall financial position of public sector employers. However, as mentioned, there will be a consequential effect for any other employers whose staff have retained continuing membership of a public services pension scheme. Whilst the statement in paragraph 1.35 of the consultation document is true (that the discount rate chosen to determine the contribution rates does not have a material impact on the annual cost to the taxpayer of unfunded public service pension schemes), this only holds good at the current time. It is to be expected/hoped that over time a different annual cost will emerge as the consequences of adopting a different SCAPE discount rate unfolds, e.g. by management making different hiring/investment decisions.

Q2 Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

The observation is made in the consultation document that no single approach towards setting the discount rate will produce a result that satisfies all five of the objectives set out in chapter 3. We would agree absolutely that any single approach is incapable of satisfying all five objectives. Where objectives are in conflict, a decision is needed on which of the different objectives are the most desirable – for example, **stability** is desirable for long-term planning and the consistent allocation of the national resources, but this could conflict with any **fair reflection of costs** between public and private sector employers. Therefore some pragmatism will be needed in arriving at the best result. The judgement of the relative balance between these objectives is essentially a political decision.

One further objective that could guide the approach to be adopted would be whether the discount rate chosen should influence the extent of public sector pension provision - a sensitive issue but it is related to the relative size of the public sector. An objective of reducing the relative size of the public sector would be consistent with the adoption of a lower discount rate and the correspondingly higher contribution cost. Alternatively, adopting a higher discount rate/lower cost model could encourage the relative growth of the public sector. The removal of any disincentive to the development of a wider variety of providers of public services with an accompanying wider variety of pension provision could be seen as attractive. However, such a development needs to be tested for **transparency and simplicity**.

Q3 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?

Looking at each option in turn we would make the following comments:

- *a rate consistent with the private sector and other funded schemes* – this option suffers from the wide variation in the approach and resulting contribution rates that are used in such private sector schemes (the covenant strength of the sponsor is but one aspect of the different approaches taken by trustees that manage these pension schemes). A significant practical limitation is that there are now a much lower number of private sector schemes that could be seen as suitable comparators for the range of existing public sector pension schemes.

However, the public sector could borrow the private sector discipline of having to reflect not only the ongoing cost of the scheme in the rate it pays, but the cost of any deviations from experience. In unfunded schemes, these will largely emerge due to increases in longevity, which might be managed via the cap and share policy. However, other demographic changes could also be significant and there could be other experience gains or losses depending on the discount rate adopted (for example, if the GDP approach is adopted).

This option could satisfy the objective of a fair reflection of costs (if an appropriate solution to the discount rate can be found) but it would not be so transparent and simple.

- *a rate based on the yield on index-linked gilts* – This yield represents the marginal cost at which government can borrow against a series of cash flows with similarities with a series of pension payments. Whilst this might appear initially as an attractive approach, there are many influences that interact to produce this marginal rate that are not relevant to the question being addressed. As an example, pension cash flows are not transferrable in the way that index-linked cash flows are. In addition, the present perceived market imbalance between supply and demand is seen as one of the causes for the present levels of yield.

  Whilst linking the approach to the SCAPE discount rate to such a market could be seen as transparent and simple and would be close to the 'minimum risk' cost assessment used by some private sector entities, it would not assist the objective of stability nor the fair reflection of costs.

- *a rate in line with expected GDP growth* – There are parallels between the long-term nature of pension provision and many government projects. One needs to be clear whether one is looking at GDP growth in aggregate or on a per capita basis. The comments in Chapter 3 indicate an aggregate view but this is inconsistent with the approach underlying the STPR rate described in paragraph 2.10. This approach could arrive at a rate that could reflect the risks to Government income but again there is a question on the fair reflection on costs objective.

  It could also be argued (at least by reference to previous prudent private sector practice) that a modest reduction should be made to reflect potential adverse risks (e.g. that GDP may run below trend for a number of years).

- *a Social Time Preference Rate (STPR) that makes allowances for the particular context of pension provision* – The different elements used in the construction of the STPR are described in Chapter 2. This rate is used as a hurdle rate to assist the comparison of the costs/benefits of competing projects where available resources are limited. Such costs could include employment and the related pensions costs. In any such comparison it is important that the STPR is applied consistently. However, the analysis in paragraph 2.10 is more easily and readily understandable when applied to the consideration of capital projects.

If the elements that make up the STPR are examined separately, refinements should be made to allow appropriately for the context of pension provision. The adjustment for catastrophe risk leads to an increase in the discount rate to allow for the possibility that emerging benefits will be lower than anticipated. In the context of pensions, such catastrophe risk can be seen as being two-sided – it could be higher due to unexpected improvements in longevity resulting from medical advances for example, or lower due to the consequences of increasing prevalence of obesity within the retired population. Thus a nil effect for "catastrophe" could be more appropriate. A figure for pure time preference of 0.5% - a measure of the extent to which immediate consumption is preferred to delayed consumption – appears low in the context of pensions. Currently, both corporate bond and gilt yield curves are positive over terms of 1 to 10-20 years, with gilt spot yields increasing from about 1% to over 4% at longer durations; in previous years the yield curve has been flatter or even downward sloping, perhaps because of the market imperfections mentioned previously. Finally, how the allowance for future growth in consumption within the economy should translate into changes in the overall cost of public sector pension provision is a combination of a multitude of effects. Nevertheless, the conclusion from this analysis could be the same total rate as is used for STPR.

This approach could satisfy more of the potential objectives but there could be issues with the fair reflection of costs and whether this reflects the future risks to Government income.

Q5 Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider to be appropriate?

Depending upon the relative importance of the stated objectives, an argument could be mounted for any of the four approaches covered in the consultative document. No single approach is actually correct and a pragmatic solution will evolve. Whatever conclusion might arise from the more theoretical analysis of the issues behind the selection of the SCAPE discount rate, any substantial change could result in some dislocation for both the public and private sector employers whose employees participate in public sector pension schemes. Having decided on the direction of travel, it may be desirable to reach the destination in stages.

The UK is not alone in having unfunded pension obligations for its public sector employees, and therefore having to grapple with the issue of the cost of such accruing pension benefits. An analysis of how other economies have addressed the issue of measuring the growing costs might be instructive.

Q6 Do you consider that there should be a regular review of SCAPE discount rate? If so, how often should this take place?

The simple answer is yes there should be a regular review of the SCAPE discount rate but that such reviews need not necessarily lead to any change. The adoption of the STPR may have been an appropriate approach, but conditions (and the objectives that the SCAPE discount rate is aiming to achieve) will evolve and therefore the rate itself will need to change. As far as the frequency of such reviews, a three (or possibly five) yearly review should produce the benefit of having to make only a small adjustment, should one be required.

We hope you find these comments helpful. We would be happy to answer any questions you may have on our observations and, of course, provide any further assistance on this matter that you think would be useful.

Yours faithfully,

Ronnie Bowie
President
Institute and Faculty of Actuaries

ASCL Association of School and College Leaders

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

Response of the Association of School and College Leaders

1 The Association of School and College Leaders (ASCL) represents over 15,000 members of the leadership teams of maintained and independent schools and colleges throughout the UK. This places the association in a good position to comment on the possibility of change in the Teachers' Pension Scheme.

2 ASCL is a signatory to the Joint Response by the Teachers' Side of the Teachers' Superannuation Working Party.

Introduction

Before responding to the specific questions posed in the consultation document ASCL would wish to make some general observations.

3 In his interim report Lord Hutton observed that the discount rate is "...at the high end of what is appropriate". He did not say that it is inappropriate and whilst calling for a review did not recommend change.

4 It is noted, with disappointment, that the status quo is not offered as an alternative. Current arrangements should be considered along with alternatives.

5 The apparent desire to align public sector pensions with, or at least to compare them to, funded defined benefit schemes such as those found in the private sector is ill considered. Public sector pensions are not dependent upon the markets, have the security of guarantee from the state unavailable in the private sector, and can be planned for over long periods.

6 The current discount rate has been set for good reason and no decision to change it should be taken lightly. The same methodology is used in other areas of public expenditure and there may be considerable ramifications from any change.

7 It was anticipated that the scheme would be subject to valuation before changes were made in contributions. It is noted that the valuation has been postponed until after decisions on the discount rate are made.

8 It is necessary for there to be an understanding of the significance to public sector workers of their pensions, as part of their remuneration and as part of their identity as public servants. Pensions have a significant part to play in the recruitment and retention of staff.

9 There is grave concern that assumptions, if not decisions, have already been made in this matter and that of employee contributions.

Responses to questions in the consultative 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?

10 This question assumes that a change in the discount rate is inevitable. ASCL maintains that a change is unnecessary.

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?

11 These objectives appear to cover the main issues.

Comment is offered on the objectives:

- To provide a fair reflection of costs:

12 This is a reasonable aim but the costs should be established by a scheme valuation.

- To be transparent and simple:

13 ASCL would support this aim. It is hoped that transparent and clear would refer to the understanding by members of the scheme and not just professionals and experts.

- To reflect future risks to Government income:

14 This is an appropriate matter for consideration but the clear distinction between public sector pensions and private sector funded schemes must be taken into account.

- To provide stability in employer charges:

15 The cost sharing agreement of 2006 already provides for this in the Teachers Pension Scheme.

- To support the plurality of provision of public services:

16 ASCL rejects the concept that this motive should drive a change in the discount rate.

- To encourage high quality pension provision:

17 This is a key element and if such an aim is to be realized it must be taken into account in setting the discount rate.

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

18 ASCL rejects the options linking the discount rate to private funded schemes or market returns due to the different nature of public sector pensions. Option 4 is supported as it is consistent with current practice, not just in pensions but across government spending.

Question4. Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

19 ASCL is unaware of other 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?

20 ASCL would prefer the social time preference rate, on the current discount rate of 3.5% and using the RPI not CPI.

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?

21 There is no apparent need for such reviews to take place regularly.

22 ASCL is willing to be further consulted and to assist in any way that it can.

David Binnie

ASCL Pensions Specialist

25 February 2011

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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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2 March 2011

Dear Sir

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

I am writing on behalf of the Board for Actuarial Standards (BAS) setting out our comments on your consultation on the discount rate used to set unfunded public service pension contributions. We welcome the consultation and are pleased to provide a formal response.

The BAS is an operating body of the Financial Reporting Council, the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The BAS sets technical actuarial standards in the UK.

Our standards are intended to support our Reliability Objective, that the users for whom a piece of actuarial information was created should be able to place a high degree of reliance on the information's relevance, transparency of assumptions, completeness and comprehensibility, including the communication of any uncertainty inherent in the information. It seems to us that this objective is relevant and appropriate for this consultation.

Our standards include principles for the selection of discount rates and communication of actuarial information to decision makers, which we consider are applicable to the selection of the discount rate used to set unfunded public service pension contributions.

We have frequently noted that the discount rate used to establish a single value for a stream of cash flows is an assumption that leads to confusion on the part of users of actuarial work, because of the sensitivity of the answer to small changes in the discount rate. We would urge you not to allow this debate to overwhelm a good understanding of the potential cash flows, and the assumptions to which they are sensitive (inflation and longevity in particular).

One of the most important of our principles is that assumptions should be appropriate for the purpose for which they are used. When choosing an approach for setting an assumption, such as a discount rate, the objectives of the exercise should be agreed and the purpose of the assumption should be clearly defined and should support the agreed objectives.

We note that the purpose of the discount rate being consulted on is clear, but our experience tells us that answers to your question will be used for purposes other than the one you intend. Selecting an assumption on the basis of a particular user need holds risks, if that assumption is then also used in other circumstances without recognising possibly important differences in the user's needs. The high profile of this consultation is such that whatever option is selected might well have an unintended influence on decisions in other areas, in both the public and private sectors. Any communication of decisions about discount rate assumptions resulting from this consultation should make it clear that different assumptions might be more appropriate for other uses. The need for further actuarial advice should be considered if discount rate assumptions are required for other purposes.

The emerging costs of future benefit payments for unfunded public sector pensions are met from revenue streams which fundamentally depend on the UK's gross domestic product. For the narrow purpose of selecting a discount rate for setting contributions for unfunded public sector pensions a discount rate that is closely related to the estimated growth in GDP would therefore seem appropriate. As mentioned above, the discount rate may well be inferred by some to be appropriate for other purposes such as the comparison of economic costs of employment between the public and private sectors. A discount rate selected using a similar approach to that used for funded private sector schemes might be more appropriate for that narrow purpose.

We consider that the use of discount rates to calculate present values of future cash flows inevitably introduces simplifications and ignores many of the complexities in the timings of those cash flows and their inherent uncertainties. Considered decisions about matters concerning future public sector pension payments should take account of information about the nature of future cash flows, including estimates of their amounts, timing, and the degree of uncertainty.

Our answers to the questions posed in the consultation paper are set out in the appendix to this letter.

Should you wish to discuss any aspect of this response, please contact me or Robert Inglis on r.inglis@frc.org.uk.

Yours faithfully

Jim Sutcliffe
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APPENDIX: RESPONSES TO SPECIFIC QUESTIONS

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?

Paragraph 1.27 notes that reducing the discount rate by 0.5% could increase the contributions required by £3bn to £4bn pa. However a change in the discount rate neither directly changes the amount of benefits being paid nor directly affects the cost of financing the benefits (except for certain participating employers).

Paragraph 1.15 lists areas in which discount rates are used. If a lower discount rate is used for SCAPE and this rate is also used for these areas then there may be further implications. For example, the level of transfer values might increase and divorce settlements might be affected.

Lowering the discount rate would make the cost of benefits appear higher. Management decisions and actions might be affected by the apparent cost of benefits. For example, management decisions on matters such pay levels and early retirements may be influenced by the perceived higher costs. Using a lower discount rate might also make it more likely that a reduction in benefits for members in public sector schemes is triggered under cap or sharing arrangements.

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?

We have no specific comments on the objectives which should be taken into account other than to note that we support the objective to be transparent.

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

Some might argue that this approach is attractive because it would allow the cost of public and private sector schemes to be compared on a like for like basis. This could be of value, for example, in comparing employment costs in industries in which both private and public sectors operate. However, that is not the purpose for which the discount rate is being set. We therefore do not consider that a comparison of the cost of public and private sector schemes should be a major driver of the selection of the discount rate for the purpose outlined in the consultation.

Although the same broad principles should apply to how the discount rate is selected for public and private sector schemes, the resulting rates might be very different. This is because public and private sector schemes have some fundamental differences which affect the choice of the discount rate - in particular the governance arrangements and the underlying legislation are very different. The Scheme Funding regime brought in by the Pensions Act 2004 puts constraints on trustees of private sector schemes which do not apply in the public sector. Furthermore legislation and practice in the private sector can and will change.

This approach could also lead to considerable volatility in costs which runs counter to the stability objective.

A rate based on index-linked gilts

The advantage of this approach is that it is objective and transparent. However the market in index-linked gilts is not deep and it is possible that the high demand can lead to the yield being lower than in a deeper market. A further consideration is that although index-linked gilt yields are more stable than yields on many other asset classes there have been significant movements in yields in recent years. This might therefore lead to unnecessary and inappropriate volatility in the discount rate.

A rate in line with GDP growth

An important attraction of this approach is that GDP growth is an independent and transparent measure which might provide a reasonable level of stability. Smoothing (for example by taking the average of a number of measurements) might provide further stability. This approach is consistent with the expected growth of tax revenue which finances the liabilities.

A Social Time Preference Rate that makes allowances for the particular context of pension provision

If a social time preference rate is to be used then each of its elements should be justifiable and should be reviewed regularly. We understand that the component for current consumption is based on research that is over 30 years old. Moreover, the indefinite growth assumption should be kept under review given the uncertainty over future growth and matters such as the imbalances between European and BRIC countries and increases in life expectancy in developed economies.

The 1% allowance for catastrophe risk does not appear to be justifiable for inclusion in a discount rate for setting pension contributions. The allowance reduces the calculated contributions whereas we would expect that any allowance for risks would, if anything, increase the contributions.

In general, we observe that the SCAPE rate requires specialist knowledge to understand its context, and that this makes its analysis difficult for many. Our experience with actuarial assumption setting generally indicates that this can lead to misunderstandings about the implications in various circumstances.

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?

A further approach would be to use some or all of the four proposed approaches to establish reference points which would be disclosed. Other reference points could be established using measures such as the yield on corporate bonds. A judgement could then be made about where within the reference points the balance should be set. Such an approach would acknowledge the different philosophies and avoid the appearance of unwarranted certainty. The associated disclosure would increase transparency and credibility.

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?

We have no comments other than to note that we consider that it is important that actuarial assumptions should be appropriate for their purpose and that the assumptions chosen and used should support the underlying objectives.

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?

We consider that it is important to review any actuarial assumption which might have a material impact on decisions or actions on a regular basis. Reviews could take place on a regular basis (such as every 3 to 5 years) or could be triggered by changes in financial conditions. Whichever approach is adopted, we suggest that transparency would be enhanced by setting out the criteria which are used to trigger a review. We note, however, that a review need not necessarily lead to changed assumptions.

British Dental Association

Response to

Her Majesty's Treasury consultation on the Discount Rate used to set unfunded public service pension contributions

Introduction

The British Dental Association is the professional body representing dentists in the United Kingdom. It has 20,000 dentist members and 4000 student members. The vast majority work in the National Health Service and are members of the NHS Pension Scheme. Others are employed by the Ministry of Defence and are in the Armed Forces Pension Scheme; yet others work in academic institutions and they are members of the Universities Superannuation Scheme.

In principle

We appreciate the opportunity to contribute to your consultation on the discount rate used to set unfunded public service pension contributions. We also took up the opportunity to attend a round table discussion with your representatives and others on 11 February at which many of the issues were discussed.

The proposals in the consultation document could represent a further assault on dental pensions following on from recent announcements on forthcoming changes to public sector pensions. These include:-

- The announcement in the June 2010 Budget that increases to state benefits and public sector pensions would in future reflect increases in the Consumer Price Index (CPI) rather than the Retail Price Index (RPI). Pensions for General Dental Practitioners which are calculated by adding each year's dynamised (uprated) income together and multiplying it by 1.4% are also further affected because the Dynamising Factor-, which is used to revalue earnings, will be based on CPI plus 1.5% rather than RPI plus 1.5%.
- The Independent Public Service Pensions Commission, chaired by Lord Hutton, is currently undertaking a fundamental structural review of public service pension provision and will produce a final report in time for the Budget in 2011.

Detailed comments

We accept that, if all other assumptions are kept unchanged, a lower discount rate would result in higher contribution rates at the next scheme valuations. The timing of a reduction in the discount rate would be particularly unfortunate if it led to a further increase in contribution rates, in addition to those already recommended by the Hutton Commission and could lead to an increase in the opt-out rate from members of public service pension schemes.

We have been asked to consider different approaches to setting the Superannuation Contributions Adjusted for Past Experience Discount rate – SCAPE - in the light of the following objectives:-

- Fair reflection of costs
- Reflect future risks to Government income
- Support plurality of provision of public services
- Transparent and simple
- Stability

Although we accept the importance of all of these objectives, we believe that, at the present time, the overwhelming objective ought to be stability. The only constant at present appears to be change, and further changes that could threaten the participation of members in the public sector schemes would be most unwelcome.

The consultation document has suggested four options for a new approach to setting the discount rate:-

- A rate consistent with private sector and other funded schemes - Option A
- A rate based on the yield on index-linked gilts - Option B
- A rate in line with expected GDP growth - Option C
- A Social Time Preference Rate – STPR - that makes allowances for the particular context of pension provision - Option D

Question 1 - are there any other impacts arising from a change in discount rate

If by change is meant a reduction in the discount rate, this would give rise to an increase in contribution rates for future service. The net result of this could be an increase in the opt-out rate with both the lower-paid opting out on the grounds of affordability and higher-paid members deciding to make pension savings through other routes.

Question 2 - are there other objectives that should be taken into account?

It is difficult to think of other objectives beyond the five listed above. As previously indicated, we believe that stability should be the key objective and associated with this should be the determination to maintain participation by the current membership of public service pension schemes. Of the other objectives listed, that of supporting plurality of provision of public services we regard as least important.

Question 3 - what are the advantages and disadvantages of the four options identified by the Commission for the approach in setting the SCAPE discount rate?

It is not our role to identify advantages and disadvantages of particular options identified by the Independent Public Service Commission for setting the discount rate. That is surely a matter for the Commission itself. We will, however, in our response to Question 5 indicate our preference as to the discount rate that we consider would be most appropriate.

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

A recent research paper entitled *Developing a framework for the use of discount rates in actuarial work* by CA Cowling and others, issued by the actuarial profession in January 2011, sets out current practice and make a number of recommendations as to approaches in the future.

While the recommendations relate in the main to insurance companies and the private insurance market, mention is made of pension liabilities and assets. The paper sets out two main approaches, namely 'matching' and 'budgeting'. Both matching and budgeting approaches ultimately involve applying time value adjustments to future monetary cash flows.

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 appropriate?

The approach that we prefer would be to retain the existing SCAPE approach but, if that is not possible, we would wish to see the Social Time Preference Rate that makes allowances for the particular context of pension provision.

The reason that we prefer this approach – STPR - is that it is the one closest to the existing SCAPE approach. It will ensure a measure of stability and will avoid the volatility of a market driven approach.

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?

We accept that there should be a more regular review of the discount rate. It might be ideal to do so every 6 years at the midway point between quadrennial valuations of schemes. However, a shorter time gap between reviews would seem inappropriate.

Conclusion

We would prefer to avoid any change in addition to the decisions of Government on the recommendations of the Hutton Commission but, if the discount rate has to alter both in terms of methodology and amounts, we would prefer the Social Time Preference Rate approach as the one which is closest to the existing SCAPE approach and since it is the one most likely to lead to a measure of stability.

BSA - The Business Services Association

<u>www.bsa-org.com</u>

<u>**Consultation response - discount rate**</u>

1. This paper is the response of the BSA - Business Services Association - to the HM Treasury consultation on reform of the discount rate used to set unfunded public sector pension contributions.

2. The BSA represents leading companies providing business and outsourced services across the public and private sectors. Although they are some of the largest government contractors, our members as a group derive almost three quarters of their business from contracts with private sector employers.

3. This cross-sector activity gives BSA members an almost unique position with a view of both sides of the public/private sector provision regime. They have pensions within their organisations which range from defined benefit occupational pension schemes providing final salary and career average benefit structures through to occupational defined contributions schemes and stakeholder arrangements.

4. Many of our members have access to pension arrangements which are certified by the Government Actuary's Department as being broadly comparable to the public service pension schemes the Commission is considering. Others participate in the public sector schemes which allow such participation like the Local Government Pension Scheme.

5. The discount rate affects certain commercial issues for BSA members. However, we feel that the impact of changing the discount rate as the HMT consultation document recommends needs more consideration in light of the final report of Lord Hutton's Independent Public Service Pensions Commission (the 'Commission') which is not published for another week after the closing date of this consultation. Although we are expecting the Commission's report to contain broad principles rather than specific detail, we believe these will have implications for the discount rate and therefore it is difficult to give an exact position at the present time.

   With this in mind, we would like to make the following key points:

   - The discount rate should be reformed to achieve a level playing field for employee recruitment
   - The treatment of past service liabilities must also be addressed to enable a level playing field
   - We would support a rate consistent with private sector and other funded schemes.

The discount rate should be reformed to achieve a level playing field for employee recruitment

6. The Commission recognises that the current discount rate is set at a level which produces employer contributions that are too low. This means that public sector employers have an advantage in recruiting employees as they are able to offer employees a similar level of pay at an overall lower cost than a private sector employer. The taxpayer effectively meets this subsidy. The BSA seeks a level playing field for private sector and public sector employers and

the removal of this subsidy. This can be achieved by an alternative approach to setting the discount rate.

The treatment of past service liabilities must also be addressed to enable a level playing field

7. The consultation document sets out that the review of the Fair Deal policy will be informed by the review of the discount rate and the final report from the Commission. As noted in paragraph 1.32 of the consultation document, currently public service providers have an advantage when bidding against private sector organisations to provide public services as the effective cost of pensions is lower for the public sector employer. The public sector does not need to account for pension liabilities, nor pay the full ongoing cost of providing employee benefits (due to Treasury subsidy), which operates to the disadvantage of the private sector which is otherwise able to demonstrate operational efficiencies on the contracts.

8. The current position, despite its intentions, does not protect employees' benefit expectations. In practice many employees choose not to transfer their past service benefits (which are underwritten by the government) to a scheme dependent on the continuing support of a private sector employer (local government transfers may offer participation in the local government pension scheme which can help to alleviate this concern). If this transfer does not occur, then the employees' past service benefits will be based on pay at the time of transfer rather than final pay.

9. The BSA proposes changes to the current position which would stimulate the outsourcing market, opening this up to more bidders and enabling more competitive bids whilst also providing better protection for employees' benefit expectations. The key thrust of this proposal is that the responsibility for managing the pensions liability relating to service prior to the award of the contract would remain with the existing employer.

10. Contractors would not therefore need to factor this into their bids, so avoiding the additional cost allowance for worst-case outcomes. The government in turn would not need to provide immediate finance for the transfer of pension liabilities as these would remain in the public sector to be paid in future years as the employees retire.

11. The contractor would, however, provide additional benefits for future salary increases based on all service in its scheme. This means the benefit expectations would be protected for all transferring employees, including the most vulnerable who may not have elected to transfer their benefits. This is a positive development for employees compared with the current position.

12. The BSA also proposes an amendment to pension terms that apply on contract termination. The main thrust of this change is that any deficit relating to benefits earned during the term of the contract would continue to be funded evenly over future years by the remaining viable employer group, rather than needing to be immediately funded by a lump sum at the time of termination - which can be a crippling liability. Any 'old' liability at the point of contract termination would therefore remain with the 'old' employer group, but would be funded by them over a longer period. Again this change would assist the flow of new entrants to the outsourcing market, whilst fully retaining the level of employees' benefit expectations.

13. As things currently stand there is also an obligation to provide a bulk transfer option. The consultation document does not specifically mention bulk transfer issues. If however a lower discount rate was to be used for calculating future contributions, it is expected this would also be reflected in a lower discount rate for bulk transfer values, meaning contractors would receive relatively higher bulk transfer values, which in turn would require less initial deficit funding in the contractor's scheme. This should enable more competitive bids thereby improving the contracting process. *(although not the overall cash flow implications for the Government)*

We would support a rate consistent with private sector and other funded schemes

14. Paragraph 2.13 raises the issue of setting a discount rate consistent with the private sector and other funded schemes, along with some other approaches. This would help to provide a level playing field although the method should be transparent and simple and this would necessarily involve some model approach being used.

15. Paragraph 1.28 sets out that the Government has decided it is not appropriate for a change in discount rate to affect the value placed on benefits accrued relating to past service. This resource is not however available to private sector employers: a lowering of the discount rate will tend to create a past service deficit that needs to be funded. This issue should be considered in more detail (with the associated issue of how to periodically review the discount rate) to help provide a level playing field for the future.

CBI
THE VOICE OF BUSINESS

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

1. The CBI welcomes this opportunity to respond to this important consultation on the discount rate used to set unfunded public service pension contributions. We believe that transparency around costs is a crucial component of the broader debate around the long-term sustainability of pension provision in the public sector.

2. Defined benefit (DB) pension schemes have time horizons and a scale of funding that most people find difficult to engage with. Public sector schemes taking young employees into membership today, for instance, are reasonably likely to still be paying those individuals' pensions in 2080 and beyond. Sustainability in such long-term plans is therefore absolutely vital. It is essential for members to have confidence that their pension scheme is affordable for the employer and can be relied upon to see them through retirement.

3. The unfunded nature of public service schemes means that without an appropriate discount rate the sustainability debate does inevitably become an abstract one. CBI members believe that the current rate of discount for contributions in public service pensions significantly understates the size of contributions needed to fund ongoing public service liabilities and that this should be urgently reviewed. Any review, however, should be seen in conjunction with other ongoing reviews around public service pensions, namely the review of the Fair Deal regulations and the work of the Independent Commission chaired by Lord Hutton.

4. In this response we set out that:
   - public service pensions costs are understated...
   - ...this is because the current discount rate methodology is not fit for purpose
   - a discount rate using private sector experience or index-linked gilt yields could increase volatility unnecessarily
   - On balance, a discount rate in line with expected GDP growth would be advantageous.

Currently, public service pensions costs are understated...

5. Most public service pension schemes take the form of unfunded pay-as-you-go schemes. Unfunded schemes are found in the NHS, civil service, school teaching and the uniformed services. In these schemes the government collects contributions from public sector employees and charges their public sector employers a notional contribution intended to cover the cost of the future pension benefits earned each year. That money is then used to pay benefits to current pensioners. The sums involved amount to a substantial proportion of payroll – for example in

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one civil service scheme the average employer contribution rate is currently 19.4% of salary – but this still does not take account of the true costs.

6. Historically, the government has published the total unfunded public service pension liability on a regular basis. The figures made available from March 2008 put the total liability at £770bn – already equivalent to almost 50% of GDP[1] – down from £810bn in 2007.[2] But this impression of improvement in recent years is misleading.

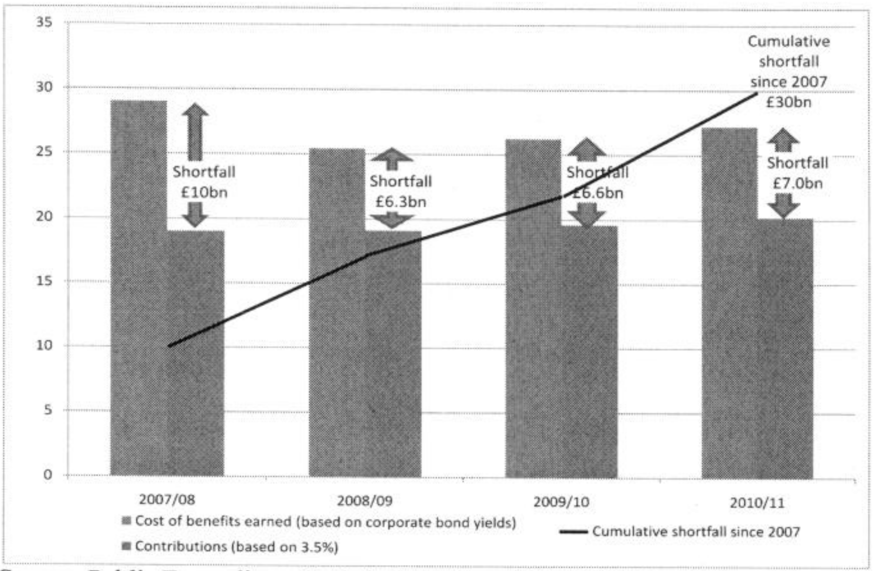
7. Currently, the government uses different discount rates in different parts of its liability calculation. This is important because the higher the expected rate used to discount the cost of benefits, the lower amount of money you need to collect today to pay for a set level of benefits in the future. In other words, the higher rate chosen, the lower the contributions that need to be collected from employees and their employer.

8. To keep an unfunded scheme in balance, the contributions required from employers and employees should be roughly equivalent to two things: (i) the calculated cost of paying current benefits each year and (ii) the value of the benefits accrued for the future by those paying contributions. The first of these tests is met fairly easily by schemes currently, primarily because of the cohort of current public sector workers being so much larger than the cohort of pensioners – due to the increase in size of the public sector in recent years. The second however, is demonstrably not being met. The government's own figures suggest that, while the unfunded public service pension benefits earned in the year 2007/08 were around £29 billion (using a discount rate of 1.8% based on corporate bonds), only £19 billion was collected in contributions (based on the more optimistic Social Time Preference Rate (STPR) of 3.5% that has applied since the late 1990s) from public sector employers and employees – a shortfall of £10 billion. While this figure dropped in 2008/9 due to scheme changes, it began to accelerate again immediately. A similar effect might be expected from the recent switch to CPI indexation. To meet this high real cost, expenditure on public sector pensions overall is forecast to increase from 1.5% of GDP to 2% of GDP by 2027[3] – an increase of around £7 billion per year.

9. The shortfall is a cumulative process, amounting to some £30 billion over the four-year period from 2007/08 to 2010/11 according to government estimates.

The mounting shortfall in pension contributions

[1] *An assessment of the Government's reforms of public sector pensions*. Pensions Policy Institute, October 2008
[2] *Long-term public finance report: an analysis of fiscal responsibility*. HM Treasury, December 2009
[3] *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, March 2008



Source: Public Expenditure Statistical Analyses (PESA) 2008 report

10. Estimates of the total scale of these liabilities are widespread. In 2008, the CBI calculated that a figure of £915bn was about correct. This was based on updating government figures and making allowance for more accurate mortality and discount rate assumptions. We revised this figure in April 2010, allowing for improvements in schemes' mortality practice that had taken place, and new accrual. At that point, the estimate stood at £1.01trn, although this figure will drop as a result of the switch to CPI for the indexation of pension benefits.

11. These figures clearly show that the discount rate currently used for setting contributions is at the heart of the problem.

...this is because the current discount rate methodology is not fit for purpose

12. CBI members believe that the main reason for the understating of the size of the contributions needed to fund public service pension schemes is that the current methodology used to set the discount rate for scheme valuations is inadequate. While the STPR is an appropriate method to appraise and evaluate expenditure in public project investment, most of its features are not applicable to public service pensions.

13. The STPR 3.5 per cent rate is calculated using three main components: catastrophe risk (one per cent), pure time preference (0.5 per cent) and growth in per capita consumption (two per cent). While some form of pure time preference is desirable to reflect the preference of individuals for consumption now, rather than later, we do not believe catastrophe risk and growth in per capita consumption are relevant to public service pensions.

14. Adding a one per cent for catastrophe risk into the discount rate is from our perspective completely inappropriate for the purpose of setting public service pension contributions. In some areas of public investment some events could eliminate all returns from policies, programmes or projects. However, in the case of pensions, such catastrophes subtract from the expected rate of growth making liabilities more onerous, not less. CBI members therefore believe that a revised discount rate should not include a catastrophe risk component.

15. The STPR methodology also adds two per cent to the discount rate for growth in per capita consumption. We believe that growth in the overall economy (GDP growth) reflects more accurately the source of funding for future pension liabilities. While growth in per capita

consumption is indicative of growth in government revenue, GDP growth more accurately represents the actual or expected available base for taxation and other government revenues. We will develop this argument further later on in this response.

16. Therefore the STPR's two main components, accounting for three per cent of the total 3.5 per cent rate, are clearly not fit for the purpose of setting public service pension contributions. They have led to an overtly optimistic discount rate that is masking the current imbalance between contributions and liabilities in public service pension schemes pointed out earlier – £7 billion in year 2010/11 alone. Such an opaque system leads to public service employees undervaluing the benefit of a pension and public service employers overlooking their real cost to their budgets. In the meantime, it is the taxpayer that bears the burden of the future cost of the growing funding gap.

17. There is already a precedent that illustrates the impact of discount rate reform in a public service scheme, albeit a funded one. The Bank of England changed the discount rate used to set up the contributions for its DB scheme to index-linked gilts in 2005. This led to an increase in contributions of up to 44.3 per cent of pensionable pay for scheme members. There have also been other challenges to the one-size-fits-all use of STPR in public policy-making. The 2006 Stern Review recommended the use of a zero discount rate for the purpose of its specific analysis into the economics of climate change. A new and more accurate discount rate is needed for public service pensions.

A discount rate using private sector experience or index-linked gilt yields could increase volatility unnecessarily

18. The consultation document proposes using either a discount rate based on private sector funded schemes or the yield on index-linked gilts as possible alternatives to the current STPR. CBI members believe both of these options would not be appropriate for the purpose of setting contribution rates for public service pensions.

19. The CBI has long argued that private sector marked-to-market accounting (both FRS17 and IAS19 standards) fails to take into account the long-term nature of pension liabilities. We believe that the fact that the dynamic nature of pensions – for instance longevity changes – and the long life of a scheme, make such a method unsuitable. Marked-to-market makes assumptions that cannot reasonably assumed to be right, basing a view on liabilities payable 80 years hence on a single day market snap-shot.

20. During the recent financial crisis, FRS17 and IAS19 inserted massive volatility onto the corporate balance sheet. This volatility has been damaging to firms, as it risked giving a misleading impression of the state of the fund, to users of the accounts, who do not receive accurate appraisals of its position. The methodology was so inappropriate that, in 2007 and 2008 deficits were dropping at the same time as the markets because of movements in the discount rate, based on the returns from AA corporate bonds.

21. Basing the discount rate on the yield of index-linked gilts would not be appropriate either. At the moment, FRS17 uses corporate bonds to discount liabilities in private sector schemes. However, it seems illogical that the government has to use a more conservative bond yield than the private sector does, despite being substantially better secured.

22. CBI members believe that using private sector accounting practices to calculate the discount rate for public service pensions would make them extremely volatile unnecessarily. It is also

important to note that while funded schemes do have a degree of dependence upon market prices, unfunded schemes do not. Moreover, there is no risk of default in public service schemes. These two features of public service pension schemes mean that there is no justification for the use of financial marked-to-market based measures. Such measures would only make these schemes and their sponsoring employers financially less efficient by forcing them to use more conservative assumptions than needed.

On balance, a discount rate in line with expected GDP growth would be advantageous

23. CBI members support the consultation document proposal for a discount rate in line with expected GDP growth to replace the STPR. We believe this is the best option because it is time consistent and links contributions to the growth of the tax base of the government, putting fiscal sustainability at the heart of the new model.

24. As outlined above, STPR is used to assess the desirability of a public project by calculating the current cost of that project to the public finances. In contrast, pension contributions are a future cost. Higher pension contributions would mean a lower rate of taxation for government. Therefore, linking the size of employer contributions to the growth in the overall tax base of the government would make the whole system more sustainable.

25. Moreover, using expected GDP growth for public service pensions would, in practice, produce a similar assessment method to the one used to set contribution rates in the private sector, but adapted to its unfunded nature. The unfunded nature of public service schemes means that government is able to direct the capital it would have to lock up in a funded scheme towards other public projects. If we treat government as a private sector firm, 'UK plc', the funds UK plc would have to use to fund its scheme, it can instead invested in its business, growing the UK economy. Such growth is measured through the GDP index. Therefore, the government is, as any private pension scheme, investing its capital in exchange for a return. In the case of private pension schemes returns are achieved through the market, in the case of the government through GDP growth.

26. Both, the Independent Public Service Pensions Commission and the consultation document estimate that a discount rate based on this approach may be around two to 2.5 per cent above RPI inflation. We believe this rate to be reasonable to help increase the transparency around the cost of public service pensions. It represents a reduction of one to 1.5 per cent over the current STPR rate of 3.5 per cent. This would increase total contribution required by an average of about six to nine per cent of pay or £8 to £12 billion a year. The rate would also need to be reviewed periodically to ensure it remains accurate over time.

27. Using this approach would not only better reflect the true cost of public service pensions, helping rebalance risk between the employer and employees and the taxpayer, but it would also ensure that the efficiencies related to the unfunded nature of the schemes remain intact.

Employment Affairs Directorate
February 2011

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CIPFA response to the HM Treasury consultation on the discount rate used to set unfunded public service pension contributions

March 2011

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INVESTOR IN PEOPLE

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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 sirs

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

CIPFA is pleased to offer its comments on the HM Treasury consultation on the discount rate used to set unfunded public service pension contributions.

General Observations

As a key financial assumption underpinning the price of public sector pensions, it is no more than sound financial management practice to periodically review the strength assumptions that stand behind the discount rate used in public sector pensions.

In our responses to the specific questions posed in the consultation paper, we have concluded that a revised approach to SCAPE offers the most appropriate solution as to what should be the discount rate for public sector pensions.

However having reached this conclusion we are concerned as to how any change to the discount rate will be implemented. We would therefore find it helpful if the review findings were to set out:

- How the outcome of the review and any subsequent impact upon contribution rates relates to the Chancellors intention to increase employee contribution rates as announced?

- If the intention is to raise contribution rates beyond those already announced, what account has been taken of the possibility of increased employee opt out rates?

- How the findings of this review will feed into the findings of the Independent Public Service Pensions Commission final report, particularly given that the Commission is due to report just one week after the conclusion of this consultation?

In our response we have also assumed that the findings of this review will have no impact on the process of setting discount rates in the funded Local Government Pension Scheme (LGPS). The funded nature of the LGPS presents a very different funding dynamic to the unfunded schemes and consequently the arguments put forward here are not directly relevant to discount rate setting in this sector.

Current issues with employee contributions in public sector pension schemes

A lower discount rate would indicate that the total contributions yield in public sector pension schemes should rise. However we note from the consultation paper that it is the Government's intention that "departmental budgets set in the Spending Review will not come under additional pressure due to a change in the discount rate". This would seem to suggest that the burden of any contribution increases would fall upon employees. However the timing of such action is critical.

In 2008-09, UK public sector employees contributed over £6 billion into the unfunded public sector pensions arrangements across the UK. These contributions were used to defray the £22.5 billion cost of paying today's public sector pensioners – around 27% of the total cost. By the time we reach 2014-15, employee contributions will have risen to approximately £9.4 billion (based on the 2010 Budget and Spending Review figures).

The Autumn 2010 spending forecasts placed a great deal of emphasis on this employee contribution remaining intact throughout the course of this Parliament to avoid the contributions/expenditure gap widening further and therefore placing greater strain on the public finances. Indeed, this is further emphasized by the Chancellor's decision to seek to increase the contributions yield from public sector pension scheme members by a further £3.7 billion by 2014-15[1], the equivalent to an average 50% increase in employee contributions. On average this would push the average employee contribution rate for teachers and NHS employees to between 9% and 10% and for Police and Firefighters to 13& to 14%.

At the same time the government expressed the wish that the low paid be protected from the worst effects of the rate increases and that the increased contributions yield be implemented in such a way as to minimise scheme opt-out rates. Therefore in practice the increase in contributions rates will not be applied proportionately across the scheme membership but will fall wholly or largely upon those outside of the "low paid" bracket. In practice therefore large parts of the scheme membership could be facing significantly more than a 50% increase. Indeed the recent letter from the Local Government Association to the Chancellor indicated that many members in local government could be facing 80% to 100% contribution increases, although the precise detail of how schemes plan to implement the contributions rise will not be known until later this year.

In the policy costings that accompanied the 2010 spending review, the Treasury took the view that "it is possible that a small number of individuals will choose to leave their pension scheme as a result of these changes, though given the generosity of the schemes there is little economic rationale to do so, and policy will be designed to mitigate these impacts." Consequently the costings assumed that opt-out rates would increase "equal to one per cent of total paybill".

In isolation, this assumption may well have held. However in view of the other pressures on personal incomes in the public sector (pay restraint, benefit reductions,

[1] The figure of £3.7 billion is broken down as follows: a previously budgeted £1 billion from "cap and share" arrangements in the unfunded schemes; a further £1.8 billion to come from the unfunded schemes announced in the Spending Review; and £900 million to be raised from an equivalent increase in the funded Local Government Pension Scheme.

tax and National Insurance increases, the reduction in contracting-out rebates, inflation forecast to reach 5% in the near future and the prospect of interest rate rises before the end of 2011), many public sector employees, may already be considering whether they can afford pension scheme membership, even at current contribution rates. When planned contribution increases are taken into account, recent surveys suggest that opt-out rates could exceed 50% if contribution rates were to double.

If pension scheme membership were to reduce significantly, and beyond that already assumed in the Spending Review forecasts, the sizeable contribution from employees which at present is supporting the cost of today's public service pension payments could be reduced, potentially quite significantly.

Reductions in public sector pension scheme membership could also have longer term adverse consequences for the public finances. Should public sector employees judge scheme contributions to be unaffordable or perceive that schemes no longer offer value for money if the Hutton review were to conclude that the benefits structure be substantially reduced, there is the possibility that they will, as many in the private sector have done in the last 15 years, abandon pension saving altogether. This presents the risk that many more pensioners will be reliant upon on a greater amount of state support in retirement.

This review of the discount rate was prompted by the Independent Public Service Pension Commission's interim report into public sector pension schemes. We would suggest therefore that its conclusions are fed into this process so that its implications can be taken into account when the Commission issues its final report. Such action would avoid the risk of the discount rate being considered in isolation from the wider conclusions on the future of public sector pensions and in the wider context of what is already planned for employee contributions as set out above.

Response to specific questions

Specific comments on the questions for respondents are attached in Annex A.

I hope that you find these comments a useful contribution to the discussion on the discount rate for public sector pension schemes. If you have any questions regarding any of our comments, please contact Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

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Annex A

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?

Chapter 1 of the consultation document captures the direct effects of a change in discount rate i.e. lower discount rate would manifest as higher contributions. However it is important that that the review process recognise the secondary impacts of higher contributions on both public sector employers and employees.

As we have noted above, there is growing concern at the effect that the already planned employee contribution increases may have on public sector pension scheme membership levels, and the short and long-term implications for the public finances should membership levels fall.

However it is equally important that the long-term effect on employer contribution rates is not underestimated.

Whilst the consultation document intimates that publically funded organisations would not face any budgetary impact within the Spending Review period, beyond this protected period the impact of higher employer contributions would manifest itself as further pressure on the public finances.

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?

The consultation document sets out five key objectives when setting the discount rate:

1. It should reflect costs fairly;
2. It should reflect risks to future government income;
3. It should support the plurality of public services;
4. The process for setting the contribution rate should be transparent and simple;
5. The application of the discount rate should not result in fluctuations in contributions that do not reflect actual changes in the expected future cash costs.

This is a comprehensive list and covers a very broad range policy objectives. This in itself poses challenges. In isolation each of the objectives appears reasonable. However when taken together, there are potential tensions.

For example a discount rate setting process that fairly reflects costs and the risks to future tax income would not necessarily result in the same outcome as a process designed to support the plurality of public services which would see the discount rate driven by the approach taken in the private sector. Equally a simple and transparent approach would not necessarily lend itself to long-term stability – a point explored further at Question 6.

It is important therefore that the review ensures that the correct weight is afforded to each of these 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?

Option (a) – a discount rate consistent with private sector and other funded schemes

As set out in Chapter 2 of the consultation paper, the discount rate used for setting contributions in private sector schemes is determined by a combination of factors that have particular relevance to private sector organizations: employer assets; the expected return on assets and the strength of the employer covenant.

Whilst this may be directly relevant to the private sector, the structure of government financing is fundamentally different, as is the financial relationship between government and its pension schemes. The employer covenant in government is far stronger because the risk of default is remote (the ability of governments to borrow more easily and cheaply than the private sector, and more importantly raise finance through taxation, remove the default risk). The other key difference is that unfunded schemes hold no assets. Future pensions are instead paid from future tax revenues. This weakens the case for a discount rate based upon expected return on assets.

A discount rate based consistent with the private sector, whilst going some way to meeting the concerns that pensions costs act as barrier to entry in public service provision, would fail to meet the key objective of recognising public sector funding risk.

Option (b) – a discount rate based on the yield on index-linked gilts

There is a logic to the argument that as pension contributions are being used to finance current Government spending (on pensions), pension liabilities should be discounted at the market rate of Government borrowing, as measured by the yield on index-linked gilts. Such an approach also has the benefits of being simple and transparent as it is derived from established market data.

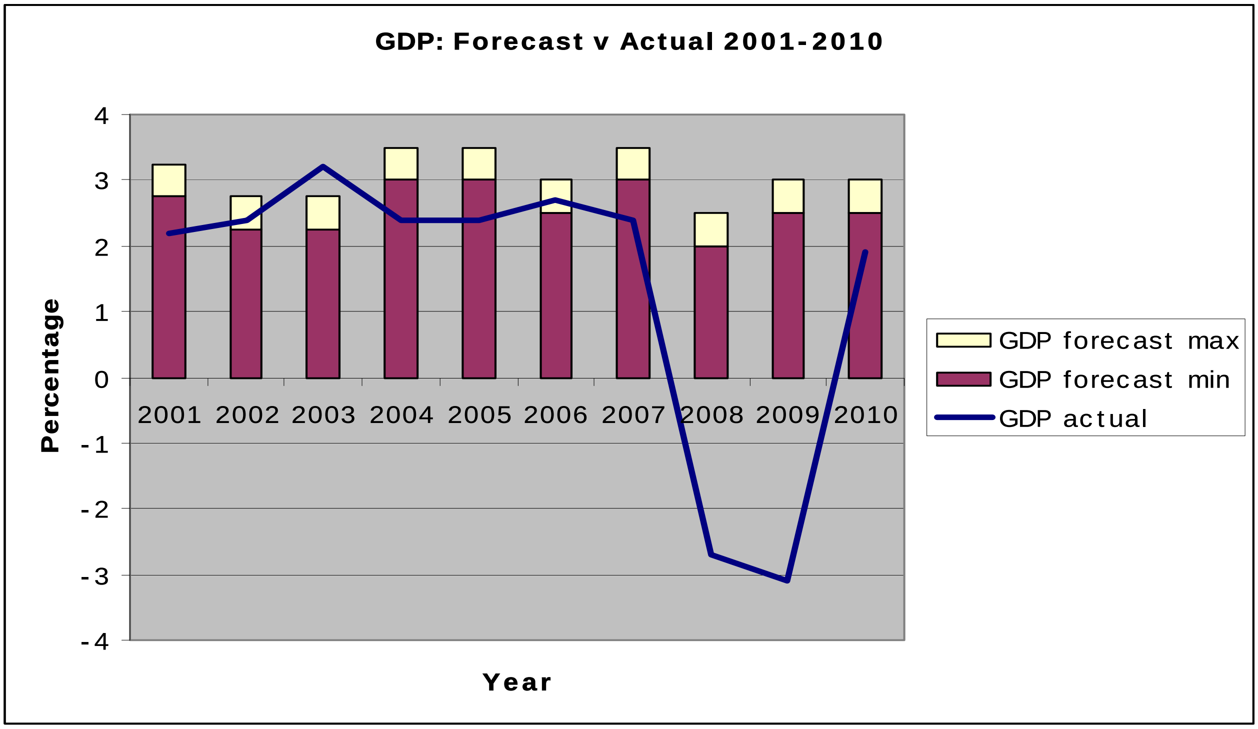
However, whilst this type of measure establishes a closer link between government spending and financing, there are drawbacks to this approach.

As a market-traded financial instruments, government gilts (and the associated yields) fluctuate in accordance with market movements. The use of a discount rate based on a snapshot of gilt yields at a particular moment in time would not necessarily reflect the long-term economic realities of public sector pension funding and may introduce market instability into contribution rates that is not reflective of genuine changes in the expected future cash costs.

Such an approach also fails to reflect the fact that in reality both current and future government expenditure will not be financed entirely from borrowing but from a mix of borrowing and taxation. There is therefore a danger of pricing into the discount rate an (albeit small) element of default risk, which again would run contrary to objective 2 (above).

Option (c) – a discount rate in line with expected GDP growth

There is considerable merit in setting the discount rate in line with GDP growth. This would reflect the fact that pensions will be paid for out of future tax revenues and we would agree that an appropriate proxy for the long-term growth rate of tax revenues is the long-term future rate of GDP growth. As with the gilts methodology outlined above, it is simple and transparent and would be closely aligned with future government income.



Sources: Budget data 2000; Budget data 2003; Pre-Budget report 2007: ONS

However our main concerns in using GDP growth forecasts is that, whilst they are an economic forecast, they are also of huge political significance and may therefore be subject to political influence to instill public and financial market confidence (in seven of the last ten years, actual GDP has fallen below the lower range of government forecasts and only once exceeded the forecast). We would add that the use of forecast data may introduce unwelcome instability into the discount rate in the form of forecasting error, totally unrelated to genuine changes in the expected future cash costs.

Option (d) – a Social Time Preference Rate

The Social Time Preference Rate (the current method for determining the public sector pensions discount rate) retains a number of advantages over the alternatives suggested here.

It reflects the alternative use of funding used to pay for public sector pensions. It also has the advantage that, as it is not linked to one specific measure, forecast or index (as are the alternatives), it can be structured in such a way as to reflect the long-term nature of public sector pension liabilities, in much the same way as the discount rate used in the local government schemes. For example the rate can be adjusted for very long-term liabilities (such as pensions) where the discounting effect can have a distorting and material impact on the present value. The Hutton Commission's interim report cites the Green Book example where appraisals are materially dependent on discounting effects, a lower discount rate could be used for the longer term: 3.5 per cent is given for the period of 0-30 years, with 3.0 per cent for 31-75 years.

However, we do agree with the Commission's suggestion that the application of catastrophe risk is questionable in the context of STPR for public sector pensions and would suggest that this be reviewed. However we do believe that pure time preference remains a relevant factor, as the way in which current public sector pensions are paid for suggest an inherent inter-generational imbalance.

Overall conclusions

All of the possible alternative methods to setting the public sector pensions discount rate have some attractive features. Equally each has some drawbacks, particularly when viewed through the prism of the five objectives set out earlier.

In seeking a revised methodology, there may be a temptation to over-engineer a solution in order to give the "illusion of certainty" to a financial assumption which will always be subject to uncertainty in the long-term.

We believe therefore that an amended approach to the STPR offers as good a solution to the question "what should be the discount rate be" as any of the suggested alternatives, with the added benefit of it being designed to be tailored to the unique circumstances of public sector pensions, their liabilities and their financing.

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?

We believe the consultation document has captured the most relevant alternate bases for setting the discount rate. Whilst other methodologies clearly exist (such as the use of corporate bond yields as used in FRS17/IAS19 valuations of scheme liabilities), we do not believe that any of these offer a more appropriate approach to that set out above.

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?

As noted above, we believe that a suitably modified version of the current approach to SCAPE remains the most appropriate methodology for setting the public sector pensions discount rate.

Given our conclusion that the catastrophe risk is not appropriate in the context of the pensions discount rate (although it may remain so for discounting purposes elsewhere in the public sector), this would suggest that the SCAPE rate be set at between 2% and 3% above RPI.

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?

As noted earlier, as a key financial assumption underpinning the price of public sector pensions, it is no more than sound financial management practice to periodically review the strength assumptions that stand behind the discount rate used in public sector pensions.

The review intervals should be such that the discount rate remains relevant and the process should be open and transparent. Ideally, in order that the most up-to-date iteration of the discount rate is in use for scheme valuations, the reviews should coincide with the scheme valuation timetable. However as in practice scheme valuation dates do not all fall due in the same financial years, a fixed 3 or 4 yearly review period should be instituted.

This would allow regular re-evaluation of the component parts of the STP rate, particularly the inflation forecast where we have seen significant divergence between the long-term assumption and short-term experience (in 8 of the last 11 years, actual RPI has exceeded the long-term RPI assumption). Forecasting inflation over a shorter-time horizon should improve the accuracy and bring the assumption closer to actual experience.

Such an approach may require sacrificing some long-term stability. However in return more frequent reviews will result in greater transparency and relevance. It would also bring central government into line with the local government where the discount rate used for setting contributions in the Local Government Pension Scheme is set at each valuation.

COSLA

Pensions Discount Rate Consultation

Introduction

1. COSLA welcomes the opportunity to respond to HM Treasury consultation on the discount rate which is used to set the unfunded public sector pension contributions.

Background

2. The Convention of Scottish Local Authorities (COSLA) is the representative voice of Scottish Local Government. It is a membership organisation and includes membership from all 32 Scottish Local Authorities. COSLA also acts as the employers' organisation on behalf of all Scottish councils.

3. HM Treasury will be aware that as a membership organisation representing all Scottish Local Authorities, this includes the entire local government family, including Police, Fire and Teachers. Whilst the Local Government Pension Scheme in Scotland would affect the large majority of the local government workforce, other public sector pension schemes where our workforce would have a vested interest in includes the Scottish Teachers' Superannuation Scheme, Fire-fighters Pension Scheme and Police Pension Scheme.

4. Whilst COSLA is aware that the Treasury has asked for views on a range of specific questions, many of these questions are technical in nature and are are best answered by professional experts who have the detailed technical pensions knowledge. COSLA however would wish to provide HM Treasury with an outine of some issues which it hopes that will be considered as part of any conclusions on the future discount rate.

Current Public Sector Pension Landscape

5. COSLA is aware that there is an increased interest in public sector pensions, largely as a result of the establishment of the Independent Public Service Pensions Commission (IPSPC) to conduct a fundamental review of public sector pensions provision. At the time of writing this submission, we are still unclear as to the definitive recommendations arising from Lord Hutton's review, however we are aware that the findings identified within the interim report has already recognised the need for public sector pension reform.

6. We recognise the changed financial and political landscape which we are all now faced with since the most recent round of reforms across the public sector pension schemes, and the need to engage in a debate with all key stakeholders about any future pension reform.

7. In addition to Lord Hutton's review of public sector pensions, we are also aware of the UK Government's proposal to increase employee contributions to public sector pension schemes by an average of 3.2% of pay by April 2014. We recognise the long term nature of pensions and firmly believe that any potential changes to the current schemes should be considered as part of the overall wider review to ensure that public sector pension schemes remain both affordable and sustainable into the future. We do not believe that

these elements should be considered in isolation, and should not be used as a means solely to generate savings for the UK Government in the short term.

Potential Change to Current Discount Rate

8. We are aware that the Independent Public Services Pension Commission has suggested that the current discount rate is at the high end of what is appropriate and has recommended this to be reviewed. We accept for the need to consider the overall affordability of public sector pension schemes going forward, and clearly for unfunded pension schemes the discount rate has a big affect on the overall contribution rates which are paid.

9. Whilst professional pensions experts are best placed to provide the Treasury with an indication as to the preferred approach which should be used in setting the discount rate going forward, COSLA would wish to stress the importance of ensuring that there remains an element of stability in the level of contribution rates, and ensure that there remains minimal volatility across a short period of time. Given that the nature of pensions is long term, the discount rate, and subsequently contribution levels, should be set with a degree of certainty to allow for appropriate budgetary planning on the levels of contributions to be paid in the short term. This is particularly important given the current economic climate and reducing public resources.

10. In addition, we would ask the Treasury to consider the implications which any change to the current discount rate would have on the overall levels of contribution rates. As previously indicated, we do not believe that any area of public sector reform should be considered in isolation, and any potential change to the discount rate and indeed to the overall levels of contribution rates must take into consideration the wider proposals around future pension reform, the implications of the current cap and share arrangements and potential additional increase in employee contribution rates if cap and share agreements are in place.

11. We would also ask the Treasury to consider the administration requirements of the number of changes which are being proposed outwith any consideration of future pension reform, and the impact that this will have on scheme adminstrators, as well the impact that the level of current proposals and potential changes will have on the members of the public sector pension schemes and the potential implications that these proposed changes will have on the scheme opt out rates.

Timescales for Future Review

12. Again, pensions experts and actuaries would best place to advise the Treasury as to the most appropriate timeframe for any future review of the discount rate. However COSLA would wish to ensure that the Treasury take into consideration the long term nature of pensions, and that any potential changes which may impact on the overall level of contribution rates may not be realised over the short term, and indeed even into the next Spending Review period. Given this, it would seem appropriate to ensure that the timeframes for review would be long enough to take into consideration any potential impact which may have an affect on the overall level of contribution rates which would be required.

Future Engagement

13. COSLA would be happy to engage with the Treasury and key stakeholders around any proposals arising from their review and indeed future public sector pension reform.