A Response to
HM Treasury's Consultation
on the
discount rate used to set unfunded public service pension contributions.

December 2010

Con Keating
EFFAS-EBC

Introduction

EFFAS-EBC is pleased to respond to this consultation. The European Federation of Financial Analysts Societies EFFAS, was set up in 1962 as a professional association for the various nationally based financial analysts societies in Europe. Today, the umbrella organisation comprises more than 20 national societies. Representing more than 16,000 investment professionals, EFFAS maintains its head office in Frankfurt am Main. The European Bond Commission (EFFAS-EBC) was originally set up in 1976 as a Standing Commission of EFFAS to cover bonds and related issues. The EBC, which draws upon the domestic Bond Commissions of the member country societies of EFFAS, as well as upon experts from many other places, comprises some of the leading bond and debt experts from each European country. The selection of discount rates is within its area of expertise for pensions and more widely. Further information is available from www.EFFAS.net and www.effas-ebc.org

Pre-amble

We note that this consultation arose from the interim report of the Independent Public Service Pensions Commission. (IPSPC) We address the questions posed by commencing with Question 5. To the extent possible we try to avoid repeating arguments and observations widely made elsewhere, or correcting and countering those which are evidently fallacious.

Response

For any institution which has permanence[1], the choice of a discount rate is in effect simply a choice over the timing of recognition of a future liability's cost; the ultimate cost of the liability will be whatever that proves to be. A discount rate which is too low implies higher relative current to future cost. A discount rate which is too high places more of the cost recognition into the future. From our perspective the choice of discount rate becomes first a question of which rate provides consistency over time of the resultant values returned.

We note and broadly agree with the objectives for the SCAPE discount rate, but would make the following points. Comparison with other expenditure is appropriate but does not mean that the

[1] Permanence in this context relates to the continuing ability to discharge obligations. In this regard the state differs, because of its ability to tax and issue fiat money, from private sector enterprise which may become insolvent in the course of an outstanding pension liability.

implicit expenditures of pensions should be compared using the method used for ex-ante project evaluation. The appropriate treatment of risk is also a concern addressed later. In addition we note that the rate chosen also serves as the implicit investment return on members' contributions and of independent participants[2]. The extent to which this difference between employer and member contributions is economically significant depends in part upon the current accounting for employment expense in these divisions of the public sector; in particular, whether these expenses are currently reported net or gross of member contributions[3]. We also believe that the four alternatives identified by the IPSPC are effectively exhaustive.

We also have severe reservations as to the current private sector accounting standards – see the accompanying report (Don't stop thinking about tomorrow) for some detail on that.

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

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

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

We believe that option C, a rate in line with expected GDP growth, is the appropriate and correct basis for choice of discount rate. It is time consistent in meaning and directly comparable to other current expenditure.

Our analysis is as follows[4]:

A pension is a claim on future production. The usual assets which constitute claims on future production, government obligations and private sector equity[5], and might be used to hedge or value such claims are irrelevant as these schemes are unfunded. The contributions of both employer and employee lower the current expenses of government admitting a lower rate of taxation than would otherwise be the case. All individuals benefit from this; it allows them a higher disposable income from which to consume or invest as is their wont. This is a more efficient form of resource allocation than scheme specific investment choice.

This use of funds is important; it makes it clear that that the correct discount rate is not that associated with the public sector's growth rate but rather the economy overall. In other words, the

[2] The question of the treatment of insolvency for independent entities with rights of access to these schemes is material as access to these schemes without the balance of cost underwriting of risks of standard DB is of significant value to those employers.

[3] We believe that employment expenses should be recorded and reported gross of member contributions.

[4] This is highly stylised for simplicity.

[5] These are the only assets in positive net supply. This is the reason that we dismiss as inappropriate the use of corporate bonds or derivatives such as interest rate swaps, which are in zero net supply.

pension investment is not in any notional gilt or government project or activity. This is the principal reason, among many, why option B, a rate based on the yield on index-linked gilts, is inappropriate.

To the extent that the growth rate of GDP reflects the growth in the tax base of the government this is a sustainable and unbiased estimator. Though pensions may be inflation linked using CPI, RPI or more complex formulations, the correct inflation adjustment is the GDP deflator. The rate is, of course, the expected rate of growth rather than the historic; it is a multi-year estimate and should reflect expected structural changes in the economy such as those due to demographics and perhaps those which are rooted in the political economy, such as any desire to shrink or expand the relative size of the public sector.

This is a long-term expected geometric rate; it should be revised to reflect actual experience, which suggests a periodicity of about six years for revisions. (Question 6) The geometric rate is a risk-adjusted rate in the only sense in which a discount function should reflect risk. An arithmetic series which is variable produces a geometric mean return which is lower than the arithmetic mean by one half of the variance; this is sometimes referred to as a certainty equivalent rate[6]. This also addresses the concern with the variability or risk of lower future tax receipts expressed in the discussion of objectives.

All other risks, such as longevity or those associated with inflation-related pension terms, should be dealt with in the actuarial estimation of the future pensions payable; these are the future cash-flows to be discounted.

The question of risk raises a prime concern with the current SCAPE method; the discount rate adds 1% for catastrophe risk to the expected growth rate of the economy. This seems to us to be fundamentally misconceived for pensions. Such catastrophes subtract from the expected rate of growth making pension liabilities more onerous, but raising the discount rate in this manner makes them appear less onerous. It seems to us that such events should be contained within the overall forecasts of GDP rather than an ex-post adjustment to the discount function. It is an appropriate adjustment for the appraisal of projects which may fail, where no exhaustive probabilistic analysis of project outcomes has been considered.

The social time preference rate is applicable to projects to be undertaken by the public sector; it is a measure of their desirability, expressed as a current cost, not their actual cost, their affordability or equivalently security. It is as if projects undertaken by the public sector are considered to be the use of the pension contributions, when correctly these contributions lower current taxation for all. The pure time preference adjustment can be criticised on these grounds.

We also have reservations about the use of growth in per capita consumption in the SCAPE method; it seems to us that the relevant growth rate is that of the overall economy as this represents the available base for taxation and other government revenues.

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[6] The 'risk-free' of financial theory is the situation in which geometric and arithmetic returns are equal, i.e. rates do not vary in sub-periods. This is a deterministic constant rate.

It should be borne in mind that technically the discount function is a measure and one of the prime desiderata of any measure is invariance; accordingly any change over time in the measure should have meaning in the context of the purpose of the measurement. This is clearly true when the rate chosen is the rate of growth of the economy; the current cost of a future pension is clearly lower under high rates of growth than low[7].

We consider option A, a rate consistent with private sector and other funded schemes, nonsensical. Firstly private sector accounting with respect to the discount rate for liabilities is incorrect; the rates in use lack meaning and are inexplicably volatile. It is time inconsistent. See: “Don’t stop thinking about tomorrow”.

It is possible to argue funded schemes have a degree of dependence upon market prices, even though the design of the DB pension scheme, the institution, is specifically to lower or entirely avoid this. However, for unfunded public sector schemes there is no such dependence at all and consequently absolutely no justification for the use of financial market based measures. We should not forget that the most efficient of all forms of organisation is pay-as-you-go in the absence of default risk.

It is possible that with sufficient analysis specific rates could be applied to the various schemes based upon, for example, their relative productivity. However this should be seen as a management exercise as the overall weighted rate for the public sector is constrained to the rate of growth of the economy and the analysis is probably not justified on cost grounds.

As for the level of this rate of expected growth in the economy, we have no greater insights than HMT or the Office of Budget Responsibility. However, we will note one concern relevant to this estimation, that of an ageing society and the effects of this upon growth; we strongly suspect that the commonly assumed lower growth rate will prove unfounded, as it has been historically. For a discussion of this and related issues, see: “Don’t stop thinking about tomorrow”.

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?

The rate which we believe to be applicable, long-term real GDP growth, will, by our estimate, be lower than the SCAPE rate currently in use by perhaps 0.5% - 1%. This implies that a higher immediate cost is recognised, but also lowers future costs.

Other applications of this rate for the valuation of pensions benefit from the unbiased attribute of this measure.

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 are confused by the wording of the objective of support of plurality of public service provision. If this means private sector provision of public services rather than pensions for their employees under

[7] And vice versa.

rights of access, we do not believe there is any real issue. The complaint by the private sector that these contribution costs are high is unfounded. The reality is that the private sector cannot provide pensions under private funded DB arrangements as efficiently as the state under pay-as-you-go. Equivalently secure benefits would cost far more. The lower cost private schemes are inferior in many regards; the currently popular, but cheap, individual DC, for example, leaves the pensioner with a grossly inadequate retirement income.

There is also an argument that these benefits and their associated contributions are only part of the employees' total remuneration. The market for labour is not distorted by the use of the same contribution level for public and private sectors; far from it, this is a level playing field.

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?

These have been discussed in brief in our analysis supporting the recommendation under question 5 earlier. If there are further issues of concern to HMT not covered in that discussion or issues of clarity in that analysis, we hold ourselves available to expand our discussion.

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?

Doubtless, there will be many responses advocating the use of interest rate swap rates as the discount function. We do not concur with such recommendations. As was noted in a footnote earlier, like corporate bonds, these are in zero net supply in the private sector. This means that the rates result from a mixed game, partly against nature but predominantly against others; this has the consequence that risk is partly exogenous but predominantly endogenous. By contrast, risk in the growth of GDP is a simple game against nature; risk is exogenous. There are incentive consequences associated with this difference[8].

It is possible to envisage more complex arrangements such as those based upon the productivity or revenue growth of the sectors which specific schemes cover, but it seems unlikely that these would justify their costs of computation. Moreover, such efforts are probably unjustified given the levels of uncertainty associated with the estimates of the actuarial factors which determine the pensions ultimately payable.

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 have suggested review at a periodicity of six years. This is judgemental; six years of higher or lower experienced rather than expected growth could be material in the context of a scheme which has an expected life of perhaps 40 years and a final discharge life of 80 years.

We hope that HMT finds this response to the consultation helpful; it was intended as such. We hold ourselves available for further discussion should that be desired by HMT. The corresponding author for this is: Con.Keating@FutureofPensions.org

[8] We can, if desired, elaborate the problems with swap rates at much greater length. In particular, the difference between a market for liquidity and a market for financial securities is relevant.

GMB

PROTECTING YOU AT WORK

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

- GMB Response -

February 2011

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

INTRODUCTION

GMB welcomes the opportunity to contribute to the review of the discount rate used to set unfunded public service pension contributions. We represent over 600,000 members, the overwhelming majority of whom are UK taxpayers and more than half of whom are beneficiaries, or potential beneficiaries, of one of the public service pension schemes.

As such we are in a position to offer a unique viewpoint on the issue of public service pensions. We are concerned at the apparently disjointed and unstructured manner in which the pensions system is being reviewed. The Government either does not have a current long term pensions policy or, perhaps more worryingly, has a long term view that is being consulted upon in a disjointed manner. Pensions policy in the UK needs coherence and long term stability which benefits from a broad consensus covering employers, employees and taxpayers. It does not benefit from quick fix, short-term solutions. For instance, policy announcements relating to indexation (announced in the Emergency Budget 2010) and employee contribution yields (announced in the Comprehensive Spending Review 2010) in the public services pension schemes were made before the Independent Public Service Pensions Commission has completed its work. This does not give much confidence that a well thought out coherent approach is being adopted.

GMB thinks it is important to set out the rationale behind applying a discount rate when valuing pensions in the first instance. It is also important to clarify that the value adopted has absolutely no bearing on the level of payments made in the future and ultimately the long term cost of a pension scheme. The discount rate is important in estimating the present value of future payment streams and setting contribution rates accordingly.

Along with estimates of the mortality of beneficiaries of the public services pension schemes, the discount rate adopted is probably the most important assumption made in estimating the current cost of the future pension payments. As discussed in section 1.27 of the Consultation, the long term nature of pensions means that the compound interest effect can be quite significant even if the annual rate is adjusted by a seemingly small amount.

We are disappointed that the Treasury does not seem to have recognised the cost sharing mechanisms that were agreed in many public sector schemes in recent years. The assertion (in paragraph 1.5 of the consultation document) that the risk (of increasing pension costs) is with the employer or the taxpayer does not account for the extra risks borne by employees as a result of the cost sharing arrangements.

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?
The impacts are not made explicitly clear in the Consultation.

The impact on contributions for past service states that the Government has decided that it is not appropriate for any change in past service liabilities to be reflected in future contribution rates as a result of any change in the discount rate. On the face of it this suggests that the cost of meeting any increase in past liabilities that arises is not accounted for; but this is not clear. Clarification of the intention of this statement is needed. If the intention is that increases in past service liability are ignored then it is not clear how this would be achieved.

The perceived impact of an increase in estimated scheme costs arising from a review of the discount rate is of utmost importance to the GMB. Agreed Cap and Share agreements in place have been explicit in putting in place mechanisms which mean that employees do not bear the brunt on increasing costs through changes to financial assumptions, including the discount rate. However, the consultation document is clear in stating that departmental budgets will not come under any additional pressure from any change in discount rates, and that there will be no material impact on the annual cost to the taxpayer of unfunded pension schemes.

This leaves scheme members as the sole remaining party to take on the burden of extra costs. Whilst there is no such statement in the consultation document, the perception must be that scheme members will pay for costs arising from any change in discount rate. Scheme members are already being faced with increased contributions, as announced in the Spending Review 2010; a reduction in benefits, through the change in indexation announced in the Emergency Budget 2010, and the uncertainty of the outcome of the Independent Public Sector Pensions Commission's findings. Moves to further reduce the value of pension schemes to members will be viewed with great consternation. The impact of a demotivated and disgruntled workforce, many of whom already feel overstretched and undervalued, should not be underestimated or overlooked.

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?
GMB recognises each of the objectives listed in the Consultation. Whilst we would agree that some of these are important objectives, we would express the view that a large amount of subjectivity can be applied when looking at each, and the consultation might be seen as more transparent if some parameters were attached to these objectives.

In respect of a rate that gives a fair reflection of costs; GMB wholeheartedly agrees that it is important that pension costs are estimated as accurately as possible, so as to design schemes that are fair to the public service workforce and taxpayer, both today and for generations to come. A key consideration has to be the impact that any change in pension policy has on the ability of the public sector to attract and retain the best possible workforce, as well as the impact any change would have on the culture of retirement saving amongst this workforce. Detrimental changes in either respect will increase pressure on public services and consequently on the taxpayer.

It is fair that a discount rate applied to the unfunded schemes should reflect future risks to Government income, in an analogous manner to the method of assessing employer covenant when estimating the discount rate for funded schemes. It is not clear what contingency plans are built into other policy areas to reflect the risk of lower than expected revenue, and if HM Treasury can give any clarification on this, then this would be welcome. Ultimately however, the covenant of the UK Government must be regarded as having the strongest rating in the short, medium and long terms.

GMB believes that current arrangements offer no real barrier to the provision of public services for those from other sectors. The issue arises from the fact that the covenant attached to such bodies is inevitably weaker than that of the UK Government and so a security or higher contribution is required accordingly. It seems counter-intuitive that revising the discount rate downwards would lead to a scheme that is more attractive to these providers, unless the unwritten consequence is that employer contribution rates are also reduced.

GMB fully supports the retention of a discount rate that is transparent, simple and stable, although again we note that these are subjective measures which are open to interpretation. These are key features for the retention of a model that can be easily scrutinised and is suited to weather the economic cycle. GMB rejects the claims of those who would seek to destabilise the unfunded schemes by applying thoroughly inappropriate measures to these schemes for the purposes of reducing the retirement income

Another objective which GMB believes is important in this context is for consistency across different policy areas in establishing costs. Public sector pensions are not the only area in the pensions field in which Government makes spending commitments or has to assess future payment streams. We believe it is important that a consistent approach to valuing these future payment streams is adopted.

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

Whilst GMB recognises the attraction of adopting a discount rate that can be compared with those used across the private sector there are a number of inherent differences that exist between these schemes that would make such an approach unworkable. Whilst direct comparisons of benefit structures between funded and unfunded arrangements may be made, it is entirely inappropriate to make any such comparison between the funding arrangements for these. The unfunded nature of the schemes means that there is no asset base on which a discount rate can be built. Secondly in deciding on the level of prudence that must be adopted the trustees of a funded scheme must take a view on the strength of the sponsors' covenant. The covenant of a sponsoring state employer must be assumed to be as close to infallible as possible and as such the requirement for any degree of prudence in unnecessary. Thirdly the relative immaturity of the public sector schemes in comparison with private sector schemes, which are largely closed, would also present a case for a different approach to constructing a discount rate in the public sector.

(b) a discount rate built on the yield on index-linked gilts

Again, the attraction of such an approach seems clear – this yield might be viewed as indicative of the measure of the price that Government puts on borrowing. However this is in fact not the case. Gilt yields are significantly impacted by the supply and demand of these instruments in investment markets; as such the yields are market driven and subject to significant variation as a result of government policy or developments in other areas of the investment market. This approach would be wholly inappropriate to adopt in discounting the estimated cost of public sector pensions.

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

This approach offers little to provide the stability and security required by Government, taxpayers and employees in calculating future costs of the schemes.

All of the above three approaches do not offer a stable long term solution to modelling pension scheme costs and funding. Neither do they allow the Government to exploit the competitive advantage available through both economies of scale and through the unparalleled sponsor covenant.

(d) A Social Time Preference Rate

Unlike the previous models, a Social Time Preference Rate does offer stability and the opportunity to view pension funding over a long term, and not being subjected to short term market or general economic fluctuations.

As discussed in our answer to Question 5, this rate is being adopted in costing other aspects of public pensions policy. GMB cannot see why unfunded pensions scheme contributions should be costed in any other way.

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?

The Government has to keep in mind the purpose of discounting in the appropriate context. For a funded pension scheme, a discount rate is constructed to model the risk free scenario with assumptions built on top of this to reflect risks. These include assumptions based on the timing of when the liabilities are due, the potential for additional investment return, and a prudence adjustment based on the covenant of the scheme's ultimate guarantor. The purpose of establishing discount rates in this context is to ensure that adequate funds are set aside now so as to independently meet the promised benefits due without any need for further calls on the guarantor (eg sponsoring employer).

In the unfunded schemes, the discount rate is established for a different purpose. Due to the nature of unfunded arrangements, future calls on the guarantor are inevitable. The discount rate is designed so as to best estimate the current value of the pension promised and set contribution rates accordingly. It is important to highlight the arbitrary nature of these contributions. For employees, pension contributions reflect a real trade for consumption now with consumption later; whereas for government it represents a real source of revenue now, which will be paid back later with interest, this being determined by the value put on the cost of deferring consumption by employees.

As such, GMB cannot envisage any other approach to setting the discount rate which would be more appropriate that the Social Time Preference Rate.

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?

GMB will consistently demand joined up thinking in pensions policy in the UK, and for a long term view to be maintained, in order to best suit the needs of our members in providing for their retirement.

In coming to a view on how the unfunded schemes' discount rate should be approached and what numerical value should be attached to this, we are minded to look at other areas of pensions policy.

In particular, we are mindful of the recent DWP publication "A Sustainable State Pension: when the State Pension age will increase to 66". Annex C of this document provided an impact assessment of the government's proposed policy change in this area, and a discount rate of 3.5% was adopted in estimating the present value of savings. This gives a clear endorsement to the use of this discount rate when assessing general state pension provision.

Furthermore the recently launched Pensions Bill 2011 contained a series of impact assessments that confirm that a real discount rate of 3.5% is viewed as appropriate by Government in a range of areas of pension policy including:

- State Pension (Impact Assessment for the Bill given in Annex A)
- Reforms to automatic enrolment provisions (Annex B)
- The impact to private sector defined benefit schemes of a reduction to indexation provisions (Annex C)
- The impact to the Pension Protection Fund of a reduction to indexation provisions (Annex D)

GMB can see no reason why this assumption should be any more appropriate for some areas of public pensions policy than others. As such GMB considers the retention of a discount rate of 3.5% above price inflation to be most appropriate for the purposes of valuing public service pension schemes.

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?

It is important to note that the real value of the discount rate is reviewed at each valuation depending on the prevailing level of price inflation at that time. It may also be the case that reviews of government policy pertaining to measures of price inflation used in the uprating of benefits can have an impact on the real value of the discount rate.

Regular reviews of the Social Time Preference Rate are of course feasible but this should not be subject to change as a result of short term fluctuations through the economic cycle, or for short term political capital. It is important that the long term nature of pension provision is recognised and that measures are adopted to promote stability in valuing these pensions.

CONCLUSION

GMB clearly advocates the retention of a Social Time Preference Rate in developing the discount rate used in valuing public sector pensions. We also note that this method is adopted in assessing the value of other areas of Government pension policy, and that a real rate of 3.5% has been consistently retained. As such the most appropriate real rate to be adopted by public sector schemes must also remain 3.5%.

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

Hymans Robertson's response to HMT's consultation on the discount rate

This is Hymans Robertson LLP's response to the consultation paper issued by HMT in December 2010. We welcome HMT's consultation on the discount rate used to set contributions to the unfunded public service schemes, and echo Lord Hutton's comments that the current rate appears to be at the high end of what might be considered appropriate.

General observations

In our view, the consultation is well overdue, and not merely because the rate currently in place appears high by any recent standards of comparison. Before commenting on HMT's consultation document, it is perhaps worth setting out what we believe are the weaknesses in the current approach.

The SCAPE discount rate was essentially established as a means of setting an employer contribution rate. Nevertheless, the rate is now applied for purposes for which it was never intended. For example, it was used to assess the "cost" of alternative benefit designs during the last round of public service pension scheme reforms and is used for "costing" member options. We would also call into question its use in the cap and share arrangements. A simpler approach to cap and share would have been to agree the items which would feed into employee contributions (such as longevity and other demographic factors) rather than to set an absolute cap on employer contributions; the latter approach is unnecessarily complex and requires the employer cap to be tracked and updated to allow for the effects of any experience which is not to be shared with members (which we assume is likely to include the effect of any reduction in the discount rate following the current review).

Neither government nor HMT has articulated clearly the rationale for the continued use of the STPR In particular, they have not positioned its use merely to calculate a "management charge". It is flawed as a measure of the "economic cost" of public service pensions; this has left HMT potentially vulnerable to accusations of lack of financial discipline. The current approach can also lead to poor decision making (for example when considering the case for outsourcing) due to the low employer contribution rates for the unfunded public service pension schemes being mistakenly interpreted as the "cost" of providing those pensions. This has been compounded by irrelevant arguments put forward when the rate was first introduced, i.e. that the 3.5% could be justified as being around the level of real gilt yields, when this was merely a coincidence. There was no intention to change the rate when gilt yields changed; subsequently gilt yields fell materially.

We would also challenge the assertions made in Section 2.4 of the consultation document:

The fact that the Government can bear more risk than the private sector doesn't mean that Government (and hence taxpayers) should automatically take more risk without proper risk assessment. It is not clear that taxpayers would necessarily sanction risk-taking as a means of delivering more generous pensions than are available in the private sector.

Pensions are deferred compensation. The current approach is inappropriate for assessing "total reward" and for making comparisons between public and private sector remuneration since the contribution rates it produces do not reflect the "economic cost" of providing pensions. The Government's choices on whether or not to make commitments to public service pensions must surely require an assessment of the affordability of employing public servants. In that context it is hard to argue that private and public sector salaries can be compared on open market terms but that different bases should apply to pensions (deferred compensation) between public and private sector arrangements.

We would also take issue with the statement in the consultation document that the difference between CPI and RPI should be taken as ¾%. The methodology for the index calculations and the pricing factors being measured are being amended. We believe this will narrow the gap between RPI and CPI to something closer to 0.4%-0.5%, rather than the higher figure of ¾% proposed in the consultation document. The difference between the two numbers is material (based on the Treasury's statement taken from the consultation document that ½% difference in the discount rate changes departmental contributions by between £3 bn and £4 bn).

Whatever approach is finally adopted by HMT we would suggest that the weaknesses we have identified above need to be addressed, as follows:

- HMT should be very clear when and how the "discount rate" should be used and, more importantly, in what circumstances the rate would not be appropriate. We note that the consultation documents states that HMT will take advice on its use for member options and other purposes. We support this and would also endorse the idea of independent validation of these uses by a suitably qualified body outside of government;
- If a key objective is to achieve a politically acceptable contribution rate then there should be no attempt to pass this off as being a measure of the "economic cost" of the benefits. It may, nevertheless, be entirely appropriate to us the STPR for the purpose of setting a "management charge" payable by public service employers with unfunded schemes, although we believe that, in a pensions context, catastrophe risk should result in a reduction rather than an addition to STPR.
- HMT should be wary of trying to justify any politically acceptable answer by selecting an option in the consultation document which happens to suit prevailing circumstances unless they are committed to amending the rate if things were to change – e.g. if option (a) was chosen, HMT should be clear about whether or not the discount rate would change if (say) private sector discount rates fell as schemes mature and investment strategies lead to lower risk and lower expected returns; and
- A regular review of the rate would be appropriate; the findings of the review should be made public even if the review finds that the rate should be left unchanged (we note that the consultation document asks for views on whether regular reviews should take place and how often)[1].

Response to the Consultation Questions

Q1. Chapter 1 sets out the expected impacts of a lower discount rate. Are there are any other impacts arising from a change in the discount rate?

The only other impact which we have identified is related to one which the consultation document raises:

If a reduction in the discount rate increases the contribution rate payable to the public service schemes by independent providers such as general practitioners and independent schools (ignoring the other effects such as the move to CPI or increased member contributions) then it arguably also reduces the unintended subsidy provided by government (and hence taxpayers) to those providers.

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

In our view the objectives for setting the discount rate need to be aligned to the purposes for which the discount rate is to be used. Put another way, it is the objective of the calculations which matters, not the objective of the discount rate per se. For example, a discount rate which is appropriate for setting employer contributions (the management charge) contributed by public service employers towards the cost of public service pension schemes would not necessarily be the same as the rate which would be appropriate for other purposes, such as

[1] our response below includes our suggestions for the frequency of such a review

placing a value on the members' benefits or assessing the affordability of those benefits to the Government (taxpayers).

The objectives of transparency, simplicity and stability of employer contributions seem sensible, as does the suggestion that there should be some acknowledgement of the uncertainty of future tax revenue. However, the reference to "fair reflection of costs" confuses three separate items:

1. the economic cost of the schemes to taxpayers,
2. the economic value of benefits to members; and
3. employer contributions.

In our opinion, the same discount rate is very unlikely to be appropriate for these different purposes.

We do not believe it is either appropriate or desirable to set the discount rate (or contribution rate) to support plurality of provision of public services. There are two ways of preventing pension costs distorting the bidding process for the provision of public services:

1. permit private organisations to participate in the unfunded schemes at the same contribution rate as the public sector bodies (and accept the taxpayer subsidy that this might entail, perhaps with some controls for government/taxpayers); or
2. permit private organisations to provide alternative (but not broadly comparable guaranteed benefits) by requiring the same contribution rate to be paid as that paid by public sector bodies (this would require changes to the current requirements to provide broadly comparable benefits).

In the latter case there may be some argument for setting employer contributions to public service schemes at a level which would permit decent quality pension provision by private sector bidders. This could be achieved without any reference to a public sector discount rate, e.g. a combined employer and employee contribution rate of (say) 18% could be deemed appropriate.

In our view the objective of supporting plurality of service provision would be best considered as part of the review of Fair Deal taking into account the recommendations of Lord Hutton on benefit design. Whilst we acknowledge that how the benefits are financed does have some influence on their perceived affordability (even though the cost of the benefits is not known in advance), it is the benefit design which is the main barrier to plurality of public service provision. This comes down to the relative generosity of public service pensions compared to those which are generally offered in the private sector as well as the lack of protection for private sector employers if costs rise, because the employers are liable to make up the entire balance of cost.

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?

We have not provided a full assessment of the four options put forward. Rather, we have focussed on the key reasons why we believe some options may be suitable, or unsuitable, for the purpose of setting employer contributions to the public service pension schemes.

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

This option has little merit. There are different financing mechanisms, (pay-as-you-go versus funded), together with the materially different regulatory regimes, time horizons and membership. Most defined benefit private sector schemes no longer admit new entrants or provide future accrual. There is less security of employer covenant in private sector schemes. Accordingly, there is no coherent reason to adopt this approach. It will not (nor should it) lead to the same contribution rates for similar benefits. Further, if this approach were adopted, the rate adopted by funded schemes could change materially over time. For example, the winding down of private sector defined benefit schemes is likely to continue, meaning the investment strategy is likely to change materially. There would be no rationale for such a change to affect employer contributions to the unfunded public service schemes.

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

This option is attractive if the purpose of the calculations is to assess the economic cost of providing guaranteed benefits. It is far less clear that it is appropriate as a means of setting employer contributions to the public service schemes, particularly if these contributions are merely a finance charge levied by HMT on government departments in return for HMT funding any difference between contributions made and benefits paid out. Further, the potential volatility of using an open market discount rate, and hence contributions, is unlikely to be attractive from a budgeting perspective; accordingly, this fails to achieve the stability objective.

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

To the extent that GDP can be considered as representative of the government's ability to raise finance through taxation, this option appears to have the greatest merit of those put forward. The affordability of unfunded public service pensions has generally been measured by comparing projected future GDP with pension benefit payments (an approach which we support). Consequently, assessing employer contributions by discounting future benefits in line with expected GDP growth does have an attractive symmetry. There are also benefits in adopting a long-term growth rate in the interests of stability and in recognition of the long-term nature of pension benefits. However, we believe there is a better approach which is not included among the four options in this section (see response to Q4).

Option (d) a social time preference rate

Our comments on this option very much echo those of Lord Hutton:

- the current approach does not follow the Green Book to the letter since it suggests a lower discount rate for long-term projects. Whilst the term is relative, (pensions advisers may consider pensions to be long-term but government may well be assessing benefits which are expected to emerge over a much longer period, e.g. 200 years), it cannot be argued that pensions span less than 30 years.

- it is not clear why a discount rate based on pure time preference is an appropriate basis for setting employer contributions to pension schemes. This could only be justified if the principal purpose of the calculations is to compare the value to consumers (taxpayers) of spending on public service pensions with the value of alternative spending on capital projects. Pensions are deferred compensation; they are an unavoidable part of employing public sector workers rather than elective spending on items such as infrastructure (building or upgrading hospitals, schools, rail networks, etc.). The annual cash flow relating to unfunded public service pension benefits is the difference between the amounts of benefits paid out and the amount of member contributions paid in. This is essentially driven by changes in the schemes' demographics, i.e. the ratio of contributing members to pensioners. It is not clear why it would be appropriate, or necessary, to use the STPR to calculate the "management charge" levied by Treasury on government departments whose staff participate in the public service pension schemes.

- any margin added to the discount rate in respect of catastrophe risk that may apply to development projects would be flawed in a pensions context; it would result in a reduction in the contribution rate. Allowing for risk or uncertainty in a pensions context would normally be expected to increase, rather than reduce, the contribution rate, so any margin for catastrophe risk would result in a reduction in the discount rate rather than an increase.

Q4. Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

We would set the discount rate equal to the government's long-term cost of raising real capital. In essence, this would be equivalent to a stabilised long-dated index-linked gilt yield. The rationale for this approach is that there is no intrinsic difference between the need to meet interest and capital repayments on index linked gilts and the need to meet index linked pension obligations in the future.

Nevertheless, there will be a challenge in agreeing the level of the long-term stabilised rate. We would propose a rate of 1¾% real (based on RPI). If we believe that, over the long term, the UK national debt to GDP ratio will be broadly stable, then there is some argument that international investors will demand nominal interest payments at a level which is likely to provide them with an expected real return broadly equal to the real long term rate of GDP growth. We would suggest this rate is approximately 2% real. However, investors would be expected to accept a lower yield than this when investing in index linked gilts, because of the inflation protection provided, i.e. they will accept a lower yield on index linked gilts than they would accept on nominal gilts. We cannot predict the long term future rate of GDP growth, we cannot predict the long term real yield on index linked gilts and we cannot predict the inflation protection premium that investors will accept. We suggest a pragmatic estimate in the region of 1.75% real. While it is possible to argue over the precise rate used, we would suggest that it is more important to have a rationale for the rate which is justifiable and acceptable to a wide range of stakeholders (HMT, scheme employers, members, taxpayers and independent commentators). We also believe there is merit in setting this rate at a stable level, in order to stabilise departmental budgets for pensions contributions.

We recognise the subjective nature of this rate; it does not depend on an objective measure, such as prevailing long dated index-linked gilt yields. However, it does broadly represent a median yield earned by investors in index-linked gilts since they were launched . This covers the period when index linked gilts first became available when investors in the new asset category had to work out how to assess the yield they might expect to earn; the novelty and uncertainty would lead them to demand a higher yield than might be justified by economic theory. Over the more recent period of the last 7-8 years, demand from annuity providers and pension funds to match liabilities to assets has arguably led them to accept the prevailing (low) real yields on long-dated inflation-linked bonds, not just in the UK but in other countries offering inflation linked instruments. Basing the discount rate somewhere in the middle of these two extremes feels like an appropriate and acceptable answer for the purposes of setting departmental budgets.

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 would be appropriate?

It is possible to argue that calculating a present value of future estimated benefit payments using a discount rate is an increasingly out-dated method of setting employer contributions for budgeting purposes. In our view it would be perfectly acceptable for government to determine a level of employer contribution rates explicitly without the need for discounting at all. (Long term affordability to the tax-payer would still be assessed by comparing projected benefit expenditure with projected employee contributions.)

If employer contribution rates were set explicitly, as is already the approach taken to member contributions, in order to maintain financial discipline, departmental contributions could be adjusted to take account of decisions under their control such as redundancy or early retirements, pay awards and (possibly) ill-health early retirements.

Should such an approach be taken, a discount rate would still be needed for other purposes such as member options and assessing the long term “economic cost”. Further, good governance would suggest that regular valuations should continue, even if not required to calculate an employer contribution rate, It should be noted that we do not consider that discounting is required for the purpose of cap and share. If some form of risk sharing is implemented following Lord Hutton’s final report on public service pensions, rather than adopt the current cap and share mechanism, member contributions (or perhaps, more logically, member benefits) could be explicitly adjusted to allow for experience which is to be shared with members, such as longevity improvements. This would avoid any need for calculating capital (or present) values using an artificial discount rate.

Explicitly setting an employer contribution rate may prove too radical. If HMT’s view is that a discount rate is necessary for the purpose of calculating employer contributions to the public service schemes, we believe that a rate which is consistent with the long-term cost to the government of raising real capital (the estimated long-term index-linked gilt yield above) is the most appropriate for this purpose. However, we believe the periodic valuations using this rate should also show the outcome based on the prevailing index-linked gilt yield as a more transparent measure of the economic cost of the scheme which would allow comparison with the private sector.

In the following table, we have identified the appropriateness of the options in relation to various factors. The first three factors (stability, transparency, affordability) can be considered as relevant to the objectives of the Treasury in setting departmental budgets. The remaining factors affect economic cost.

Option	Private sector rate	Prevailing IL gilt yield	Estimated long term GDP growth	Time preference	Estimated long term IL gilt yield
Stability	No	No	Yes	Yes	Yes
Transparency	No	Yes	No	No	Yes (if fixed)
Measures long term affordability	No	No	Yes	No	Yes
Measures economic cost of benefits/ value to member	No	Yes	No	No	No
Private sector comparability	No	Yes	No	No	No
Member options, divorce settlements, etc.	No	No	Yes	No	Yes

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

Yes. However, the regularity of the review would depend upon the option chosen. If, for example, the rate is based on the on the estimated long-term real cost of raising capital which we believe would be related to GDP growth then, as a minimum, it should be reviewed whenever long term expectations of GDP growth change, when the ratio of debt to GDP changes materially, or if there is a significant change expected in the long term cost to the government of raising capital. In the interests of transparency it may also be helpful for there to be a scheduled review of the methodology as well as the rate itself, perhaps every six or eight years, particularly if the current four-yearly budgeting (actuarial valuation) cycle for public service pension schemes is to be retained.

Hymans Robertson LLP,

3 March 2011

Response to HM Treasury Consultation on discount rate for unfunded public service pension contributions

7th January 2011, from: Angus Hanton, David Evans and Tom Ward on behalf of the **Intergenerational Fairness Initiative** (**contact** angus@dulwich.co.uk)

Who are we?
A group of economists and others, concerned that government policies over recent years have led to a major shift in assets, income and liabilities, and other consequences, such as climate change and resource depletion, in favour of the older generation at the expense of both the younger generation and future generations: we think these policies should be recognised and reversed for the sake of both fairness and economic efficiency. We are London-based and are in the process of creating a full-time research organisation for intergenerational issues. We would be very happy to come in and discuss this response with Treasury officials.

Q1. Are there other impacts of using a lower discount rate?

- **Intergenerational fairness is not explicitly taken into account here whereas it is considered in, for instance, the Stern report on Climate Change. Intergenerational fairness would suggest a low discount rate so as not to risk imposing unreasonable burdens on taxpayers and other citizens in the future.** Considerations of intergenerational fairness might also suggest that the discount rate chosen should also take into account the extent to which contributions have in recent years been much too low: Hutton estimates that contributions have been less than a third of what is needed to pay for the accrued benefits (exhibit 4, page 12 of his Interim report).

- **The rate chosen is likely to influence discount rates used for other government purposes. Setting this rate too high will encourage adoption of other over-high rates, resulting in understatement of other liabilities such as those in the Whole of Government Accounts (to be published in 2011). Examples are: government guarantees, commitments for funding the state pension, and other liabilities such as the Nuclear Decommissioning liability.** This tendency for rates to propagate can be seen on page 13 of the consultation document where an argument is made for adopting the Green Book approach (to STPR) purely on the basis of consistency. **This review is the largest of its sort and will be looked to in determining other government discount rates. The "hand of history" is upon your shoulders! :-)**

Q2 . Are there other objectives that should be taken into account when setting the SCAPE rate?

- **Reduced tensions between the older generation and the younger one.** This may appear an overly political consideration but if too high a rate is set and resentment at past generosity grows there is a more serious risk that these "pension promises" will be broken in the future.
- **Compensation for having used too high a rate in the past.** On balance we favour finding the "correct" rate but we do see an argument that an even lower rate than this should be used (perhaps as low as zero) to balance somewhat the earlier use of a rate that has been too high

Q3. What of the four options suggested?

(a) Consistent with Private sector and other funded schemes

- This looks like bootstrapping. For the reasons the consultation paper sets out the private sector is not really comparable (strength of covenant, ability to change terms and fully-funded schemes with real investments). The Local Government Pension Scheme is also not comparable – it is underfunded, and its rates have been shown to be too high and not even internally consistent (Hutton identifies a variation of between 2% and 4.35%).
- If consistency with the market is sought the best guide is what rate the specialised pensions market uses when it has the opportunity to take on public sector liabilities in exchange for a lump sum. This is typically the long term gilt yield **less** 0.25%. In other words much lower than the rates suggested in the consultation paper.

(b) Yield on Index linked bonds

- **This looks to be the right rate to choose. However, the estimated future pensions would be lower if they are to be adjusted by CPI instead of RPI (mainly because of the geometric rather than arithmetic ratio of application).**

(c) Rate in line with expected GDP growth:

This is a very dangerous approach for several reasons:

- **GDP growth should be accounted for separately and explicitly and not included in the discount rate. To include it is to confuse the two sides of the accounts – the discount rate works to estimate the <u>liability side</u> of the equation whilst on <u>the income side</u> you have the growth in GDP or the Tax base (if any). The purpose of the discount rate is to evaluate the liability in today's terms and <u>not to work out how affordable these liabilities will</u> be in the future.**
- **Even if the forecasts suggested were thought to be reasonable, and if one insists on incorporating it into the discount rate, it does not**

seem reasonable to hand on the risk of these growth rates not being achieved to future taxpayers. It seems bad enough to pass on the liabilities but to claim these are lower than they are because of expected increases in income gives the younger generation a double burden – to pay and to increase the pot from which they pay.

- **These growth rates are unlikely to be achieved.** The forecasters are likely to be too optimistic and there is a trend towards over-optimistic forecasting which is not adjusted for. The GDP growth rates predicted by economists may well be subject to "optimism bias" and indeed the Green Book includes some supplementary guidance on this in the context of capital projects.
  If these are real GDP projections, as suggested, what is the basis they use to reduce expected GDP growth to real growth rate: RPI or CPI?
  There is a further reason to doubt that these growth rates of the last 60 years will probably not be repeated - the end of the 20th century benefited from the "demographic dividend" of having a higher then normal proportion of the population of working age and conversely the next 30-40 years is likely to suffer from the "demographic bust" as growth rates are constrained by a higher than normal proportion of older dependents. Both these effects are the result of the baby boom working its way through the lifecycle.
- **There is also an argument that the growth of GDP will not be matched by growth in the tax base which would suggest that using GDP growth rates is overoptimistic on how much revenue will be available to pay the pension liabilities.** This is particularly true with changes over the last few years that have weakened the tax base – one high profile example is Kraft's decision to relocate activities to Switzerland which will significantly reduce the UK tax it pays. There are many similar examples in corporate tax but Internet commerce is also threatening some government revenues including VAT. In general the pressure on taxes seems even greater than the pressure on GDP as a result of various effects of globalisation.
- **The calculation of the tax base is distorted upwards:** while there is currently about £600bn pa of tax revenue a good proportion (about 18%) of this comes from Government employees and this may reduce as public sector jobs are reduced if the private sector does not replace these jobs.
- **If GDP grows by as much as is suggested life expectancies will probably increase faster than actuaries are assuming.** Higher GDP can be shown to lead to higher life expectancies, mostly because with more resources there will be medical and caring advances which extend life and these have a direct effect on the pension liability. We therefore suggest that this approach should not be considered without asking the actuaries to adjust their life-expectancy assumptions to take account of increasing projected wealth. As Lord Hutton's graph (page 11 of his Interim report) shows, life expectancies have in the past been consistently underestimated.

(d) STPR in the context of pension provision

Using STPR in the way suggested is a doubtful argument because:

- In the context of pension provision individuals' time preference is probably much lower than other STP Rates and may, surprisingly, not even be positive! It may be that to be sure of having money at retirement people would, if necessary, put in more now than they will get then (- as long as they have inflation linking, which is assumed). One recent study reported by Legal and General showed an example where contributors to pension schemes often chose options which take away their ability to access their pension funds before retirement - even when this gives them no additional financial advantage. This suggests that the STPR for pensions may be very low or even negative such that people are so keen on future (retirement) consumption rather than present consumption that they would put in more in contributions than they would expect in benefits in the future (i.e. a negative discount rate would be implied).

- Government Pension provision currently gives a form of insurance so that the individual does not need to worry about how long he/she may live – their pensions are for life so that those who die earlier compensate for those who live longer. Such an arrangement would have a significant cost in the private sector both for the risk taken on (that average life expectations will be higher than forecast) and for the administrative costs. If a STPR is to be used it should reflect this financial service which is being offered (a form of annuity). Put the other way round, if people were really investing savings for retirement, the basis for thinking about STPR, they would accept lower rates of interest in exchange for the insurance that is being provided.

- In any event the data for STPR rates used by the Green Book, and repeated elsewhere, was acquired many years ago and may not even reflect current preferences. The figures quoted in point 3.13 of the consultation look much too high even if a STPR approach is taken.

Q4 . What other approaches should the Government consider?

A discount rate of zero should at least be considered on the grounds of intergenerational fairness – this would be mildly redistributive from the older generation to the younger which would make a small contribution towards the huge transfer that has already taken place over the last few years through (a) taking too high a discount rate in the past, (b) the large increase in life expectancies, (c) other changes that have shifted entitlements towards the older generation, and (d) the consequences of

other policies which have shifted burdens to the younger and future generations.

Q5. Which approach do you recommend, and why? What actual rate do you consider would be appropriate?

The rate should be the yield on index-linked bonds and should not adjusted upwards because of a difference between two indices, otherwise the discount rate itself will be kept artificially high.
If one tries to incorporate the difference between the CPI and RPI into the discount rate it precludes the possibility of the rate ever dropping below a certain level so one should not, for example, "hard-wire" the rate to the RPI plus .75% (the current RPI index-linked gilt yield). For example, if it turns out that the RPI and CPI move in a parallel then the formula hinted at in the consultation paper will leave the discount rate .75% higher than it should be making an unintended annual transfer from the taxpayer to those in government pension schemes of as much as £10 billion.

We have studied and understood the difference between the CPI and RPI and are aware that there is considerable uncertainty about how different these inflation measures will turn out to be. It seems therefore inappropriate to frame the discussion in terms of these inflation measures: a discount rate should ideally be chosen independently of these rates. This is especially true in view of the desire expressed by the consultation paper to have a rate that is "simple and transparent" (page 19).

If one is determined to use a rate that in some way incorporates a measure of inflation then it is not clear that either the CPI or the RPI is the right rate to use alongside the discount rate. A measure that reflects the price increases faced by the retired would be more appropriate and this may well be quite different – for example that group may be less affected by housing cost increases if typically people members of that group own housing which is fully paid for or if they have older, protected tenancies.

It is not at all certain what the government's index-linked rate of borrowing is but it is this rate that should be aimed at as the appropriate discount rate. It looks as though this rate may be about 1%, or slightly below.

Q6. Regular review of SCAPE discount rate?

Yes, annually in line with government index-linked gilts as part of the annual Budget process.

The argument that the administrative costs are a concern is weak:

- the administrative costs must be tiny in relation to the amounts at stake and the importance of the issues Hutton raises (fairness to the taxpayer) and that we are raising – intergenerational fairness;
- the information available in this area is poor (as Hutton says) and therefore a regular analysis could help in keeping under review the most important factor in measuring government pensions liabilities;
- the calculations ought to be quite straightforward and in principle **the undiscounted liabilities (in total and for each year) on each of these schemes should be published to help analysts to do their own calculations.** Undiscounted liability figures are published for the Nuclear Decommissioning Authority, for example.

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

2nd March 2011

Dear Sirs

Public Service Pensions Discount Rate Consultation

I have pleasure in responding to this important Consultation and I attach a brief biography as Appendix 3.

It is crucial that the correct discount rate is used to measure and recognise the real economic cost of new public sector pension promises in the year the promises are made:

- *"What is not measured is not managed".* At the micro-level, individual public sector bodies cannot be run efficiently if pension costs, often material, are understated.

- *"No taxation without representation*". At the macro-level, the current generation of taxpayers should pay for the full cost of the services they are using, including salaries and pensions. Otherwise this cost is passed to future generations of taxpayers, which is fundamentally undemocratic.

- Using an incorrect discount rate makes it impossible to properly measure and compare the real economic savings of potential changes to public sector pensions, such as increasing the normal retirement age.

My conclusions are:

a The correct Discount Rate to measure the economic cost of new public sector pension promises is the yield on long-dated index-linked gilts (see Appendix 1 Q&A 3)

Public sector pension promises and ILGs have similar relevant characteristics: both are obligations of the UK government, both are contractually committed, legally-binding contracts and both are inflation-linked.

However, from the viewpoint of individual members, public sector pension promises and ILGs as financial assets differ in two second-order respects:

- pensions have significant tax advantages over ILGs. If a member received a cash equivalent salary it would be taxed at the marginal rate in employment, but pensions are taxed at the marginal rate in retirement, typically lower and 25% of the pension value can also be taken as a tax-free lump sum. These tax advantages suggest the economic cost should be based on a *lower* discount rate than ILGs.

- Unlike pension promises, ILGs are liquid and can be sold to third-parties, suggesting the economic cost should be based on a *higher* discount rate than ILGs.

It is difficult to estimate the impact of these second-order effects, but as a practical matter, it is reasonable to assume they cancel each other out.

A discount rate based on private sector pensions would understate the annual cost - unlike public sector pension promises, funded private sector promises carry the credit risk that the sponsor becomes insolvent with inadequate pension assets to pay the pensions.

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A discount rate based on expected GDP growth or the Social Time Preference Rate would understate the annual cost – just like discounting future gilt payments at the expected GDP growth or STPR would understate the economic liability when issuing a gilt.

The official cost of unfunded public sector pensions, based on a real yield of 3.5%, is around £15bn a year, but the real economic cost, based on an ILG yield of 1%, is double at £30bn.

b The correct Discount Rate must be the same for all public sector schemes, whether they are funded or unfunded

The Consultation Document excludes funded public sector schemes, especially the Local Government Pension Scheme, from its scope (1.23).

Since the LGPS is set up under the same legislation as unfunded public sector schemes, the credit risk is the same, and the discount rate, of ILGs, must be the same. The LGPS credit risk may be considered to be *lower*, since its members would have recourse to financial assets in the event of a default.

c The correct Discount Rate should be used primarily to measure and recognise the economic cost of new pension promises in the financial accounts of individual employers (see Appendix 2)

Public sector financial reporting is based on accrual accounting, not crude cash accounting, so it is important to ensure individual financial accounts recognise the economic cost. Cash contributions will be similar to the P & L cost over a number of years, but need not be the same in any one year.

Please feel free to ask any questions.

Yours sincerely,

John Ralfe

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Appendix 1

Questions & Answers

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 covers all the expected impacts of a lower discount rate.

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

Chapter 3 covers all the objectives which should be taken into account.

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 <u>A discount rate consistent with private sector and other funded schemes</u>

The Consultation Document suggests that regular contributions for private sector schemes are based primarily on the fund's asset allocation and represent the real economic cost of new pension promises.

However, UK companies derive their pension costs under IAS19 or FRS17, with the cost of new pension promises based on a high quality or AA corporate bond rate, regardless of the pension fund's asset allocation.

Furthermore, the FRS17/IAS19 service cost should be considered not simply as "an accounting cost", but a reflection of the real economic cost of new pension promises.

This view was recently reinforced by Ofcom, which examined whether the annual pension cost it allows BT to charge its customers should continue to be the IAS19 cost or should be its annual cash contribution.

In the December 2009 Consultation Document, Ofcom said that *"BT's ongoing cash contributions are less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and its Trustees".* [1] *(9.54)*

This conclusion was repeated in Ofcom's July 2010 final response, *"the cash contribution measure is less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and the pension scheme's Trustees".* [2] *(4.21)*

An FRS17/IAS19 discount rate, based on a AA or high quality corporate bond, reflects the credit risk that the corporate sponsor will become insolvent, with inadequate pension assets to pay all the pensions. Since there is no such credit risk in public sector pensions, backed by the government, an FRS17/IAS19 rate would understate their economic cost.

Pension costs for private sector schemes may also be moving towards using a risk-free rate. The international Discussion Paper from January 2008 led by the UK Accounting Standards Board [3], suggests the pension discount rate for corporate pensions should be the risk-free rate, not high quality corporate bond rate, which was reaffirmed in the Summary Paper of January 2009 [4].

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[1] http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/summary/pensions.pdf
[2] http://stakeholders.ofcom.org.uk/binaries/consultations/751766/summary/pensionscondoc.pdf
[3] http://www.frc.org.uk/images/uploaded/documents/PAAinE%20January%202008.pdf (4.28)
[4] http://www.frc.org.uk/images/uploaded/documents/Pensions%20Redeliberations%20Report1.pdf (3.4.4)

The Consultation Document reprints part of the Interim Report of the Independent Public Sector Pensions Commission, which suggests that the economic cost to a company of a (pension) promise depends on the assets it holds to pay that pension. A £100 promise payable in 10 years time, could cost £67.56, if it holds gilts or £46.32, if it holds equities (p4).

This is a fundamental misunderstanding of the economic cost of long-term (pension) promises, which depends on the credit risk of the promise. If the promise is just the unsecured credit risk of the company, the discount rate is the company's marginal borrowing cost. If the (pension) promise is backed by assets, the credit risk is reduced, because of the security provided, the discount rate is lower and the cost is higher.

Under GAAP the present value of an unsecured long-term payable would be discounted at the company's marginal borrowing cost. The present value would not be reduced if the company earmarked a portfolio of assets to meet the payable.

b <u>A discount rate based on the yield on index-linked gilts</u>

Public sector pensions should be discounted at the yield on ILGs, because they share similar relevant characteristics.

- Both public sector pensions and ILGs have the same credit risk- they are obligations of the UK government.

- Both public sector pensions and ILGs are contractually committed payments, which the government can only avoid by defaulting. Not paying the promised public sector pensions would be a breach of contract, and end up in the Courts, exactly like missing a gilt payment.

- Both public sector pensions and ILGs are inflation-linked, subject to the differential between RPI indexation in ILGs and CPI indexation in public sector pensions.

Public sector pensions are deferred pay earned by public sector employees, the equivalent of giving ILGs to be redeemed at retirement. This means annual public sector pension payments are financing payments, like paying interest and principal on gilts.

c <u>A discount rate in line with expected GDP growth</u>

The Consultation Document explains that the rationale for discounting public sector pensions in line with expected GDP growth is to *"reflect the fact that pensions from the unfunded schemes will be paid for out of future tax revenues, not a fund of assets".* (3.9)

It could also be argued that gilt interest and principal payments *"will be paid for out of future tax revenues*", so that government debt issued in any year should be valued by discounting future payments in line with expected GDP growth. But gilt payments are financing in nature, so the correct discount rate is the market gilt rate for the relevant maturity.

The Treasury produces forecasts of categories of age-related spending projections, including public sector pensions, as a percentage of forecast GDP for 50 years.[5] The Treasury seeks to forecast and manage each spending category so that it remains *"affordable and sustainable*" as a percentage of forecast GDP, taking into account expected productivity growth and demographic changes.

The other categories - education, health, long term care and even state pensions - are all forms of discretionary payments to citizens, the same as "operating expenses" for a company. To maintain "affordability" of any of these a government can, subject to the ballot box, reduce this spending, including state pensions by, for example, increasing the pension age.

Unlike health, education or state pensions payments, a government cannot reduce public sector pension payments to maintain "affordability".

[5] http://collections.europarchive.org/tna/20100407221114/http:/www.hm-treasury.gov.uk/d/pbr09_publicfinances.pdf

Public sector pensions are not discretionary payments to former public sector employees, but deferred pay earned by them as part of their legally binding contract of employment.

d <u>A Social Time Preference Rate</u>

The Consultation Document explains that the rationale for discounting public sector pensions at the STPR is that *"it represents the alternative public sector investment opportunities for the funds used to pay public sector pensions"* (3.11)

It could be argued that the STPR *"represents the alternative public sector investment opportunities for the funds used to pay gilts",* so government debt issued in any year should be valued by discounting future payments at the STPR.

A future government can choose to spend more on health and less on education, based on a cost benefit analysis using the STPR, but it cannot choose to spend less on repaying gilts, which are contractually committed.

Because public sector pension payments are also financing payments, like gilt payments, it is grossly misleading to value the cost of new pension promises by discounting projected pension payments using the STPR.

The STPR is the equivalent in the private sector of the company's cost of capital and is used in cost-benefit analysis to compare future positive net cash flows, (income or costs saved), with Present Value costs, to establish if a particular public sector project has a positive NPV.

To arrive at a proper NPV, and correct investment decision, the net positive cash flows must only include operating cash flows and exclude all financing cash flows. Repaying gilts, and paying public sector pensions are financing, not investment, in nature.

4. Are there further approaches to setting the SCAPE discount rate that the Government should consider?

There are no further approaches which the Government should consider.

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

The annual cost of new pension promises should be calculated by using the long-dated ILG rate, adjusted for the CPI/RPI differential. The Commission suggests the RPI yield is 0.8%.

The cost of new pension promises should exclude any expected salary growth, as recommended in the ASB Discussion Paper of January 2008, [6] with the cost of salary increases recognised only when the salary increase is awarded. If public sector schemes move to Career Average benefits this will become irrelevant.

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

To reflect the annual economic cost each public sector scheme should calculate its annual pension charge, as a percentage of salary, based on the ILG rate, which would be reviewed each year. Like the current calculation of FRS17 costs, it would be based on approximate "roll-forward" of the position at the latest Valuation, and there would be no marginal work involved. The annual percentage of salary would be communicated to each employer to include in its annual accounts.

The SCAPE discount rate of ILGs to set cash contributions should be reviewed at each Valuation, so the economic cost recognised and cash contribution may differ in any particular year.

Appendix 2

The correct Discount Rate should be used primarily to measure and recognise the economic cost of new pension promises in the financial accounts of individual employers

To increase transparency and consistency, financial reporting for all government bodies is now based on Generally Accepted Accounting Principles and the Financial Reporting Advisory Board was established to apply GAAP to government accounts. Moving from crude cash-accounting to GAAP enhances accountability for the financial performance of individual entities and ensures all costs, which, like pensions, may not be paid for some time, are recognised as they are incurred. [7]

By focusing on the cash contribution, not the economic cost of new pension promises recognised in individual employer accounts, the Consultation Document seems to be encouraging a move from accrual accounting back to cash accounting.

The cash contribution should be similar to the economic cost over a number of years, and is likely to change at each periodic valuation, will not get far out of line with the annual economic cost.

The Consultation Document may be focusing on cash contributions because of the technicalities of FRS17 accounting. [8]

At the moment each public sector pension scheme calculates an annual percentage cost of pensionable salary and an overall FRS17 cost for new pension promises, based on a AA corporate bond rate.

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[7] See for example: http://www.public-audit-forum.gov.uk/PAF%20Accruals%20Paper.pdf

[8] NB The Author was a Consultant to the ASB on FRS17

But individual public sector employers do not show these costs in their annual accounts, since they are responsible for paying only the required annual pension contributions and, unlike corporate pension schemes, have no further liability beyond this – the government, not employers, is responsible for paying pensions, including any shortfall.

Under FRS17 employers therefore account for their pension costs on a cash basis, based on the SCAPE methodology, even though the pensions are defined benefit - their *"contributions are set in relation to the current service period only (ie are not affected by any surplus or deficit in the scheme relating to past service of its own employees or any other members of the scheme)"* (FRS17 para 9a)

The NHS accounts, for example, explain that its pension cost equals its cash contributions, *"employees are covered by the provisions of the NHS Pension Scheme...[which]… is accounted for as if it were a defined contribution scheme: the cost to the NHS body of participating in the scheme is taken as equal to the contributions payable to the scheme".* [9]

[9] http://www.official-documents.gov.uk/document/hc1011/hc04/0410/0410.pdf

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Appendix 3

John Ralfe is an independent consultant advising company and trustee boards on pensions.

Until 2002 he was Head of Corporate Finance at Boots and was instrumental in moving the £2.3bn Boots Pension Fund to 100% AAA long dated sterling bonds, followed by a Company share buyback. This was described by The Economist in 2006 as a *"landmark".*

His clients include several FTSE350 companies, with pension liabilities from £200m to £2.5bn, as well as non-quoted companies, and the Trustees of one of the UK's largest University schemes. In 2010 he completed a Report to Ofcom on BT's pensions, on behalf of BSkyB, TalkTalk and Cable & Wireless and also appeared as an expert witness for a local authority examining its pension scheme.

He is a vocal contributor to the debates on the economics of company pensions and reform of pension regulation and is a regular contributor to the Financial Times and the BBC Today Programme, as well as appearing on the BBC News at Ten and Channel 4 News. He was also a consultant to the Accounting Standards Board on FRS17 and the International Accounting Standards Board on share options and worked with Harvard Business School to develop Boots Pensions as a Case Study.

Prior to joining Boots he spent 11 years in banking and consulting with Chase Manhattan, Warburgs, Swiss Bank Corporation and Ernst & Young Corporate Finance. He obtained a First in PPE in 1978, from Balliol College, Oxford and also studied economics at King's College, Cambridge.

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

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

The LGE is pleased to offer its comments on the HM Treasury consultation on the discount rate used to set unfunded public service pension contributions. Our response comments on matters of policy rather than technical detail.

We agree that the appropriateness of the discount rate being used should be reviewed periodically.

However, the potential impacts of this review seem to be being considered in isolation from:

- the Chancellor's announcement in last year's Spending Review concerning an increase in employee contributions,
- the potential outcomes from the Independent Public Service Pensions Commission's final report, and
- the cap and share arrangements.

In other words, the exercise appears to be being conducted as if the discount rate, contribution levels and benefit levels are mutually exclusive issues, which they clearly are not.

The consultation paper acknowledges that a reduction in the discount rate by 0.5% per annum could increase the calculated total contribution required for pension benefits being earned by an average of about 3% of pay bill. The paper also notes that:

- any change in the discount rate would have an impact on the contributions paid by public service employers, but the Government's intention is that departmental budgets set in the Spending Review will not come under additional pressure due to a change in the discount rate
- the split in respect of how much of any increase in contributions is paid by employers and how much is paid by employees is a question of pension scheme design that is beyond the scope of this consultation
- the discount rate used to determine contribution rates will not have a material impact on the annual cost to the taxpayer of unfunded public service pension schemes.

Given the impact that even a 0.5% reduction in the discount rate could have we are concerned as to how any change to the rate will be implemented. We would therefore find it helpful if the consultation findings were to set out:

- further details in relation to the statement that although any change in the discount rate would have an impact on the contributions paid by public service employers, the Government intends that departmental budgets set in the Spending Review will not come under additional pressure due to a change in the discount rate

- how any change to contribution rates as a result of the consultation will interact with the Chancellor's intention to increase employee contribution rates as announced

- if employee contribution rates are to be raised beyond those already announced by the Chancellor, to what extent the impact of a potential increase in employee opt out rates will have been taken into account

- how the outcomes from this consultation will feed into the outcomes from the Independent Public Service Pensions Commission's final report

- how the outcomes from this consultation will interact with the cap and share arrangements.

Yours faithfully

TBEdwards

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MERCER

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

3 March 2011

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

Dear Sir or Madam

We welcome the Government's decision to consult on the discount rate used to set the cost of unfunded public sector pension schemes.

Mercer Limited is a global leader for HR and related financial advice and services. In the UK, our client base includes employers and trustees providing occupational pension schemes to employees in all sectors of industry, including the public sector. We provide pensions advice and services to companies in the FTSE100, but we also have a large proportion of clients that are employers classed as "Small to Medium sized Enterprises", or trustees of pension schemes with sponsoring employers in this class. We advise roughly 35% of all Local Government Pension Scheme (LGPS) funds in the UK.

The increasing disparity between pension provision made in the private and public sectors risks distorting how employment markets operate. So, it is important that the employers in both sectors are subject to similar cost disciplines and incentives in terms of the way they remunerate their employees; the way contributions to pension schemes are calculated is part of this. However, in our view the current consultation on the SCAPE discount rate methodology used for the unfunded public sector pension schemes takes a somewhat narrow view of the issues.

Assessing the cost and value of pension benefits should take into account the degree to which the associated payments are guaranteed and inflation proofed, or subject to discretion. In other words, any assessment of value or cost must depend on the degree of risk shared between, in the case of public sector schemes, employers, tax payers and the schemes' beneficiaries. The recently implemented change from the Retail Prices Index to the Consumer Prices Index for determining public sector pension increases is an example of how risk can be shared, since members' (whether reasonably or not) will have had strong expectations that their benefits would have continued to receive RPI linked inflation proofing. An outcome of the Independent Public Service Pensions Commission review, being undertaken by Lord Hutton, must be full transparency as to the fundamental nature of the public service pension guarantees, with the balance of risk and uncertainly in the benefit promises communicated clearly to members as well as to tax payers.

We suggest, therefore, that attempting a review of discount rates without reference to the future risk sharing balance of the schemes is putting the "cart before the horse". Any assessment of the delivery costs, or the value of the pension scheme to the members, must include the degree to which the benefits promised are guaranteed or otherwise are variable. Understanding the ability of the Government to vary the pension promise is an essential prerequisite to considering appropriate discount rates. This variability can arise either directly through Government intervention (for example, increasing state pension ages without reference to protection of any "accrued" benefits) or through the new risk sharing arrangements expected to be introduced. Conversely, if to an extent benefits are provided on a targeted or best endeavour type basis, for example pension increases are conditional on certain funding targets being met, then this "risk" can be reflected in discount rates and funding strategies.

Actuarial techniques and funding approaches, particularly regarding cashflow modelling, are also now more technically sophisticated and can give greater clarity in indentifying and allocating costs and risks.

Approaches to setting discount rates, and reserving and accounting for public service pensions, should therefore reflect the nature of the benefits promised. We explore this further in the next few paragraphs by considering the following simple question.

Question: Once awarded, are public sector pensions 100% secure as promised, and non-variable? True or false?

Option 1 – "True", pension benefits are 100% guaranteed as promised

The quantum of the pension benefit, and related pension increases etc, will be delivered exactly as stated in the scheme documentation and can't be varied. If benefits are indeed fully guaranteed once accrued, they would then be taken outside of the SCAPE mechanism and recognised as a genuine long term liability of the UK Government. As such they would be accounted for on that basis in whole of government accounts consistent with other such long term commitments.

Regarding the financing of future accrual, each year the cost of reserving on the long term liability basis would be charged to the employers. In addition, if there was any uplift in value of accrued benefits, for example if final salary linking for accrued service was maintained under new arrangements, then the cost of that uplift would also be appropriately charged to employers. This approach, technically known as Current Unit Method, fits with the accruing guaranteed benefits being fully secured on a year by year basis.

There are then two possibilities for dealing with the cost of ongoing accrual of new benefits:

a) continue with the guaranteed but unfunded promise approach for the new accruing benefits, in which case costs charged to employers should reflect the government's views on a fair exchange for accepting the annual increase in the "debt" for pension liabilities, or
b) move to adopting a self-financing funded basis, with either a notional or real investment return structure, and with further risk sharing between employers and employees (but not with tax payers). The terms for that financing basis would be set, monitored and reviewed adopting processes and approaches similar to those under the LGPS "Notional fund" structure, and also as is being taken forward elsewhere – the recent consultation on proposed changes to USS is an example.

Option 2 – "False", public sectors benefits are not 100% guaranteed, but may be variable

Any part of the benefit that is considered 'guaranteed' and the remaining part that is subject to risk sharing must be determined and transparently communicated to the scheme membership: the part that is not guaranteed would be delivered on a 'best endeavours' basis. Rules and mechanisms will be needed for deciding, from time to time, whether to award in full, in part or not at all the discretionary elements: these in turn would be taken into account when determining how the cost of provision should be assessed.

Following this model, provision of full target benefits would be the basis for determining employer (and employee) contributions but the discount rate adopted would include allowance for the discretionary nature of part of the benefit elements.

Only having determined the underlying benefit's security, can the approach to setting a discount rate be determined, taking into account some of the considerations raised in your consultation document.

We would be happy to discuss our views with you.

Yours sincerely

Paul Middleman FIA
Principal

Chris Hull FIA
Partner

NAPF
Securing the future of pensions

NAPF Response

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

1 About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector. We are grateful for the opportunity to respond to HM Treasury's consultation.

2 Summary

The focus of our response is on the four options set out in Chapter 3 of the consultation paper. We do not attempt to answer the individual questions posed in the consultation paper. Instead we set out general principles for assessing the four options. We conclude that the use of a discount rate based on the yield on index-linked gilts would be incorrect as it would lead to an excessively volatile contribution rate. This does not reflect the economic reality of the public sector's pensions liability, which – like that for the private sector – changes only slowly over time in line with scheme demographics. Nor would it be seen as in any way credible by contributors, thus undermining the Government's intention that contribution rates should provide an indication of the value of the public service pensions to its employees. The contribution rate should be stable (implying a stable discount rate) but the discount rate should be reviewed (say, every five years) to ensure that it continues to be realistic.

3 NAPF response

3.1 *General principles*

There is no discount rate that will provide an incontrovertible measure of the value of future pension benefits. Instead the Government should adopt a pragmatic approach to measuring future pensions that reflects both the value of the benefit and the cost of providing it. Value to the recipient is a difficult concept, but it is clearly linked to the cost of providing it; unless properly costed, benefits – of all kinds – tend to be either over- or undervalued both by those providing them and by those receiving them. Decisions about public service pensions need to be based on a realistic assessment of their cost, especially as unfunded public sector pensions represent a claim on future tax revenues. To be credible, contributions need to be relatively stable from one year to the next. This also reflects the economic reality of an obligation that changes only gradually over time in line with the scheme's demographics.

NASUWT
The Teachers' Union

CONSULTATION RESPONSE

HM Treasury
Consultation on the discount rate used to set unfunded public service pension contributions
3 March 2011

1. The NASUWT welcomes the opportunity to comment on Her Majesty's Treasury's consultation on the discount rate used to set unfunded public service pension contributions.

2. The NASUWT is the largest teachers' union in the UK representing teachers and school leaders.

3. The vast majority of NASUWT members will be active, deferred or retired members of the Teachers' Pension Scheme (TPS) in England and Wales, the Scottish Teachers' Superannuation Scheme (STSS) or the Northern Ireland Teachers' Superannuation Scheme (NITSS).

GENERAL COMMENTS

4. The NASUWT notes the Coalition Government's intention to review the discount rate used to set unfunded public service pension contributions and its decision to accept, as grounds for doing so, the recommendation in the interim findings of the Independent Public Service Pensions Commission (the Commission) that the discount rate should be reviewed.

5. The NASUWT further notes the finding in the Commission's Interim Report that 'initial work by the Commission suggests that the current discount rate is at the high end of what is appropriate'.

6. By this definition, in the view of the Commission, the current discount rate remains appropriate, albeit towards the high end of the spectrum of appropriate rates, and does not necessarily need altering. The NASUWT is disappointed, therefore, that the option to leave the discount rate unchanged is not one of the options in the consultation document.

7. Some might conclude from this that the Chancellor's announcement in the Comprehensive Spending Review of the Coalition Government's intention to review the discount rate on the basis of the Commission's findings – that the current rate is at the high end of the range of what is appropriate but nonetheless appropriate – was driven by expediency in a desire to raise revenue as part of its response to the current budget deficit and not by a proper appraisal of the facts.

8. The NASUWT notes that the Commission 'considers that getting the discount rate right in setting contribution rates is key to assessing the cost of benefits being provided in each of the schemes ... and enabling those costs to be appropriately divided between employer and employee...' The Commission also stated that 'any increase in contributions resulting from this change would need to be fairly distributed between employees and employers (representing the taxpayers' contribution.'

9. In this respect, the NASUWT notes that the split in respect of how contributions are shared between employers and employees is outside the scope of this consultation (paragraph 1.20) but believes any resulting change in employee contribution rates should be the subject of collective bargaining and implemented only by agreement with the unions representing the workforce. For the Coalition Government to do otherwise would be to make presumptions about fairness and smacks of an ideological approach to public service provision.

SPECIFIC COMMENTS

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. The NASUWT believes that the Coalition Government is being disingenuous in its references to the impact of changes to the discount rate on employee contributions.

11. It states that, other things being equal, a lower discount rate would result in higher contribution rates (paragraph 1.25) although, 'the split in respect of how much of these contributions are paid by employers and how much are paid by employees is a question of pension scheme design that is beyond the scope of this consultation' (paragraphs 1.20 and 1.33).

12. It also declares (at paragraph 1.31) that although 'any change in the discount rate would have an impact on the contributions paid by public service employers, 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.'

13. Therefore, in the event of reduction in the current discount rate, which the document acknowledges would result in an increase in contributions payable, the latter statement would seem to preclude consideration of anything other than an increase in employee contributions.

14. Under the terms of the current 'cost sharing' arrangements introduced as part of the tripartite review of the TPS following the Public Services Forum Agreement of October 2005, increases or reductions in cost pressures identified at a pension scheme actuarial valuation are shared equally between employees and employers, up to the value of a cap on employer contributions. However, under the terms of the cost sharing agreement, the effects of changes in financial assumptions such as the discount rate

used for the purposes of Superannuation Contributions Adjusted for Past Experience (SCAPE), would fall outside the cost sharing arrangement.

15. Therefore, if the cost sharing agreements for the teachers' pension schemes are adhered to, any increase in costs arising from a review of the SCAPE discount rate could result in an increase in employer contributions. Even if any increases were shared equally between employee and employer contributions the result, before any cap is applied, would be that the Government of the day would have to spend as much in additional (employer) contributions as it saves from additional (employee) contributions – with no additional revenue being raised by a review of the discount rate.

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

16. The NASUWT notes that the consultation document suggests five potential objectives against which the SCAPE discount rate can be evaluated, as follows:
    - To provide a fair reflection of costs;
    - To be transparent and simple;
    - To reflect future risks to Government income;
    - To provide stability in employer charges;
    - To support plurality of provision of public services.

17. The Union also notes the view in the Commission's Interim Report that the 'cost' of pension schemes is a difficult concept to define and measure, especially where the schemes are unfunded, and believes that the objectives, and the objective of providing a fair reflection of costs in particular, must recognise that unfunded public sector schemes are, by definition, different to funded schemes and there is no logic in treating them as though they were the same.

18. In this respect, it must be recognised the unfunded public sector pension schemes have an inherently strong employer covenant, do not hold assets and, unlike private sector employers or private individuals, the Government does not face the investment risks, or incur the costs of meeting those risks, that arise for funded pensions in the private sector. In fact it would be a waste of public funds to provide a method of funding public sector pensions and pay for a level of risk protection that is simply not required.

19. The NASUWT does not believe that the objective of supporting plurality of provision of public services is in any way a priority in determining the discount rate for funding pensions and rejects any suggestion that a desire to support the plurality of public service provision should drive the level of public sector pension costs or the setting of the discount rate.

20. The consultation document quotes the level of employer contribution rates, calculated using the current discount rate, as a barrier to greater plurality of public service provision, stating that 'a discount rate more in line with those used in funded schemes could promote a more level playing field for independent sector organisations when bidding to provide public services.' But a lower discount rate 'more in line with funded schemes' would only put up contribution rates for public service pensions, making their provision even more expensive for employers (unless all the extra cost is presumed to fall upon the employees).

21. In so far as lower pension costs in the public sector represent a significant advantage over service providers in the private sector, any disparity should be addressed by extending eligibility for public service pension provision to those public service providers from the private sector at a realistic cost, rather than seeking to artificially determine the cost of pension provision in the public sector.

22. The Union does, however, believe there is another objective that should be taken into account when setting the discount rate, which is consistent

with the policy in the Coalition Government's Programme for Government 'to help reinvigorate occupational pensions', and that is to support and encourage the provision of high quality pensions for all employees.

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?

23. The NASUWT rejects the first option of a rate consistent with private sector and other funded schemes for the reasons set out above. As noted in the consultation document (paragraph 2.2), in setting unfunded public service pension contributions, it is important that 'employers pay a charge that is appropriate for public service pension schemes, just as private sector employers must pay contributions that are appropriate for funded pension schemes'. This will not be same for both and what is appropriate for one will not be appropriate for the other.

24. As the consultation document also notes, the discount rate used to set contribution rates for funded pension schemes in the private sector is generally set with reference to the return expected from the assets held by the pension scheme, adjusted to allow for the employer's financial strength and long-term commitment to the scheme (known as the employer's covenant). As pointed out in paragraph 18, above, this does not apply to unfunded public service pensions and the discount rate, therefore, should not be based on investment returns.

25. For similar reasons, the NASUWT does not believe there is any logic in basing the discount rate on the yield on index-linked gilts, whose availability and returns will vary considerably over time, and there is no advantage in treating long-term unfunded public service pension promises as though they were invested in index-linked gilts.

26. As the consultation document concludes, 'a different approach is therefore needed to choose a discount rate for the unfunded public service pension schemes' and choices about commitments on public service pensions require comparisons with other forms of future public spending (paragraphs 2.4 -2.5).

27. For this reason, the NASUWT endorses the current use of the social time preference rate (STPR) for the setting of the SCAPE discount rate as it provides a consistent approach to estimating the cost of a wide range of long-term public spending liabilities. Any change to the current rate would raise doubts about the estimated cost of many other spending projects with wider cost implications for Government.

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?

28. The NASUWT is not aware of any suitable alternative approaches to setting the discount rate.

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?

29. As the Commission notes in its Interim Report, the SCAPE discount rate used for unfunded public service pension schemes was designed to be a stable, notional rate that is not referenced to a specific set of investments. When it was set at 3.5% this was in line with the Government's 'social time preference rate' (STPR) and a view was taken at the time on what the very long-term cost of Government borrowing might be. Presumably, it would not have been adopted by the Treasury if it was inappropriate.

30. The NASUWT does not believe there is a case for a change to the current rate and no case has been advanced to suggest that the liability to pay

unfunded public service pensions is in some way different from other long-term public funding projects.

31. The NASUWT further believes that the use of the STPR for the setting of the SCAPE discount rate provides a consistent approach for estimating the cost of a wide range of long term public spending liabilities.

32. The NASUWT believes that, given the unique position of the Government as a pension provider and the inherent strength of the employer covenant, the current rate of 3.5% above Retail Prices Index (RPI) inflation remains an appropriate discount rate for this purpose.

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?

33. The NASUWT notes from the Treasury roundtable discussion on the discount rate (28 January 2011) that the provisions of the Treasury's *The Green Book: Appraisal and Evaluation in Central Government (2006),* on which the discount rate is based, are, in effect, under permanent review. The Union does not believe, therefore, if the rate is being continually monitored in this way, that reviews of the discount rate on a regular basis are necessary.

Chris Keates
General Secretary

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NHS Pension Scheme Governance Group

Response to HM Treasury's "Consultation on the discount rate used to set unfunded public service pension contributions"

Submitted by the Governance Group of the NHS Pension Scheme

1. Introduction

This response is submitted by the Governance Group to the NHS Pension Scheme ('the NHSPS'). The Governance Group is a social partnership between NHS Employers and national NHS Trades Unions and acts under the authority of the NHS Staff Council. The Governance Group is also attended by the Department of Health acting as observers. A full description of the role of the Governance Group is included as Appendix 1.

The Governance Group welcome this opportunity to provide its thoughts on the discount rate to be used in setting the contribution rates for the unfunded public service pension schemes.

As an over-riding observation, the Governance Group is concerned about the piecemeal manner in which major changes to public service pensions in general are being consulted on. It is difficult to imagine a scenario in the private sector where an employer, or the trustees of the employer's defined benefit pension scheme, would consider the discount rate, contributions and benefit levels as mutually exclusive issues. This appears to be what the Government is doing and the Governance Group believes it is difficult for both employer-side and staff-side representatives to have a meaningful discussion about any of the three issues independently of one another, as Government appears to require. In forming a robust pensions strategy that will stand the test of time, the Governance Group believes that all the issues need to be considered in the round.

A full rationale is set out in the remainder of this paper but it might be helpful to open with a statement that the Governance Group does not believe any compelling case has been put forward for a change in the discount rate. The Governance Group therefore believe that a real discount rate of 3.5% pa should be retained for the funding valuation of the NHS Pension Scheme.

2. General Points on the Discount Rate

It is worth stressing one point, which was not included in the consultation document, that is that the actual cost of benefits is independent of the discount rate used to value the benefits. The actual 'cost' of benefits is simply the sum of the cashflows paid to members. The discount rate has no effect on the requirement to pay a certain cashflow to a certain member at a certain point in the future. Whilst this applies to both private sector and public sector schemes, there is a significant difference which should be noted. In paragraph 1.5 of the consultation document, the typical situation in the private sector is described where if the eventual cost of the benefits turns out to be more than the contributions reserved plus investment returns less expenses, then additional money will be needed to pay the benefits. The paper suggests that the situation is similar in the public sector with any additional money needed coming from the taxpayer. But in reality, it is not possible to identify a similar shortfall in the public service where funds to pay for benefits are not separately identified.

This is not to say that benefits should not be priced rationally. Whilst the discount rate does not affect the eventual cost of benefits, it is important in that it affects:

- the level at which benefits are set;
- the way in which costs are shared between employees, employers and central government; and
- the way in which resources are allocated between different competing calls for resources and between different generations.

Initial work by the Independent Public Services Pension Commission ('IPSPC'), as set out in its Interim Report in October 2010 suggested that the current SCAPE discount rate was towards the high end of what the IPSPC would deem as an appropriate range. The clear suggestion was that a lower discount rate should be adopted and that currently benefits are valued on a basis which underestimates real costs i.e. that employers and employees in the public sector are currently not paying enough for the benefits that are provided. The Governance Group would argue that this is not necessarily the case. The fact that the IPSPC stated the current rate was at the high end of what was appropriate does not make the current rate inappropriate and in need of revision. The Governance Group would also ask what type of scheme the current rate is at the high-end for? One could suggest the IPSPC is comparing against discount rates used for **funded** private sector arrangements. Again, the Governance Group would challenge whether this comparison is either fair or appropriate.

Under the current cap and share policy, agreed in a spirit of partnership and co-operation preceding the currently suspended round of valuations, any change in the discount rate would be an un-shared cost and therefore the cost of any change fully met by NHS employers[1].

The Governance Group appreciates that discussion of Cap and Share itself is beyond the scope of the consultation but it is important to be aware of this issue as background.

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

a) Impact on past service liabilities

The consultation document correctly identifies at 1.28 that a change in the discount rate would affect the value placed on past service benefits. A decrease in the discount rate would increase the value put on past service benefits. So a reduction in discount rates would mean an increase in the deficits when compared with valuations, currently on hold, using the current 3.5% pa real discount rate.

Government has decided that it is not appropriate for the impact of any change in the discount rate on past service liabilities to be reflected in future contribution rates. The mechanism for insulating employees and employers from these costs has not been made clear.

The Governance Group would be interested to learn more detail on how Government intends to address the additional past service liabilities 'created' through a move to a more prudent discount rate, if indeed this is the outcome of the consultation. The

[1] Government could protect NHS employers from any such increase in costs by increasing the amount of funding Government provides. However, this is not a requirement under the cap and share mechanism.

Governance Group would argue strongly that there should be no effect on the contribution rates paid by employees or on the finances available to employers for service delivery as a result of the effect on past service liabilities caused by a change to the methodology, of which the discount rate forms part.

b) Impact on future service contributions

A decrease in the discount rate would, all other things remaining unchanged, increase the value placed on benefits accruing in the future. In the absence of more information about the level or type of benefits to be provided in the future, and the manner in which costs are shared between employees, employers and the taxpayer, it is impossible to say with any certainty whether this will mean an increase or reduction in contributions or whether this would be acceptable to either staff-side or employer-side representatives on the Governance Group.

c) Impact on potential new independent providers of public services

The IPSPC in its Interim Report stated that it wished to look at ways of increasing plurality of pension provision and promote efficiencies by using independent providers of public services. The consultation, at 1.32, appears to suggest that this objective could justify a reduction in the discount rate to make it more expensive for existing public bodies to provide pensions thus levelling the playing field. An alternative approach to this issue would be to ensure that all employees undertaking NHS funded work should be allowed access to the NHS Pension Scheme and the Governance Group would broadly support this access.

If this approach is not followed, then it has to be accepted that Government has a competitive advantage in being able to provide pensions cheaper than other providers[2]. Given the pressures for public bodies to act more like profit making organisations, it seems odd to ask that Government surrender this commercial advantage. Indeed to increase the costs of all work done in the public sector in order to level the playing field would seem to be a significant detriment to the interests of tax payers. It should also be noted that larger private sector employers can provide pensions more cheaply than smaller private sector employers so significant distortions would continue between private sector employers.

d) Impact on future Government expenditure

There is no explicit connection between the discount rate and the level of benefits paid to members of the scheme. The benefits are defined in regulations and as the Government provides a guarantee to all of the unfunded public service pension schemes, benefit payments are paid irrespective of whether the schemes are cash-flow positive (as the NHSPS currently is) or negative.

But as noted earlier, the value placed on pension benefits is considered by Government and employers in setting the level of benefits, the rate of member contributions and indeed the pay and benefits package overall.

As a lower discount rate would increase the overall value placed on the benefits, it would perhaps inevitably lead to a renegotiation of the benefits in the scheme.

In the short-term, changes in future service benefits have little impact on government expenditure as the vast majority of cash outflow arises from benefits already accrued. However in the long-term, a renegotiation of benefits triggered by a change in the discount rate would reduce government expenditure. It should however be

[2] For a full discussion of this point, see Con Keating "Don't Stop Thinking About Tomorrow: The Future of Pensions" ISBN: 978-0-9546207-3-8

noted that a renegotiation of benefits could be caused by other factors – indeed the recent negotiations have resulted in reduced benefits which will according to the National Audit Office (NAO) "reduce annual costs to taxpayers in 2059-60 by 14 per cent compared to what they would have been without the changes"[3]. (Note that the percentages quoted here are percentages of actual cash cost in future years and not as a percentage of the discounted value of the benefit.)

An unknown factor is the extent to which changes in the pensions package would have an impact on the overall benefits package sought by public service employees. If potential savings on pension benefits are outweighed by the additional costs of compensatory changes negotiated by employees, the overall impact would be difficult to judge. Compensatory changes might mean higher salaries, seeking other add-on benefits or less explicit changes.

If compensatory changes are not made, then a lower pensions benefit package would mean public service jobs could be less attractive. The indirect costs in terms of lost opportunities to recruit staff, retain them or encourage them back to work are difficult to measure, making an assessment of the effect on government expenditure almost impossible.

It is also difficult to predict how any reduction in public service pension benefits would affect the future benefits bill and in particular the extent to which it might result in more pensioners claiming means-tested benefits. Another offsetting point to note is that many pensioners in receipt of public service pensions will be tax payers.

Changes in employer contribution rates are largely cost neutral to Government. The vast majority of employers in the NHS Pension Scheme are funded by Government so the costs of the scheme need to be taken into account when setting budgets. In addition, contributions from employers (and employees) are used first to pay for benefits currently in payment to existing pensioners of the scheme.

If members in the NHSPS pay higher contributions in the future due to a renegotiation of benefits triggered by a reduction in the discount rate (whether or not this is partially or fully offset by reductions in benefits) then less will be required to be funded by the taxpayer thus freeing Government resources. But there is, of course, the risk that increasing member contribution leads to increased levels of opt-outs from the NHSPS thus reducing the flow of contributions to Government. In the short-term, this would have the opposite effect of increasing Government expenditure.

Finally on the impact on Government spending, it is important to consider how any change in the discount rate could affect the way in which benefits in the scheme are valued outside the valuation. Three issues are worth considering specifically although there could also be other less significant effects. These issues are the calculation of individual transfer values, bulk transfer values and member commutation factors. In paragraph 1.16 of the consultation, it is noted that the SCAPE discount rate affects some but not all of the factors used in schemes. The consultation explains that advice will be taken from actuaries on these issues if the SCAPE discount rate changes. But it would be naive to imagine that a change in the discount rate would not cause some pressure for changes in the three calculations listed above. As an example, if the discount rate were changed to a rate similar to index-linked gilt yield, this would imply that Government believed that such a reserve indicated the actual value of the benefits promised. It would then be difficult for Government to resist pressure from the private sector to offer bulk transfers in TUPE

[3] NAO " The impact of the 2007-08 changes to public service pensions" 2010. Page 21

scenarios which were significantly less than index-linked gilt based reserves. If any large transfers of staff were made into the private sector under the current requirements where bulk transfers must be available, this could mean an immediate call for large cash bulk transfer payments to be made out of the scheme. Similar points apply to individual transfer values. If much larger index-linked gilt based transfer values were available to members, IFAs would be very much more likely than at present to advise members to transfer benefits out of the scheme – again this could mean significant calls for actual cash to pay transfer values. The issues on commutation factors are more nuanced. Whilst members tend to place a high value on cash (that is members have a very high internal discount rate – although they will also be motivated by the differential tax treatment), the greater the difference between the commutation amount offered and the value attributed to it by the scheme, the less members (and their IFAs) might be minded to take cash commutation. This could reduce the immediate cash call on government but would be likely to increase the costs of the scheme long term as the scheme would no longer profit from members commuting.

4. 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 Governance Group, while appreciating that among any set of objectives there is likely to be conflicts, supports most of the objectives listed in Chapter 3 of the consultation document both independently of one another and jointly.

a) Fair Reflection of Costs

In particular, the Governance Group believes that a discount rate that generates a 'fair' reflection of costs is of paramount importance. Of course the definition of 'fair' is a subjective one but the Governance Group would suggest that 'fair' in this case should be a rate that:

- Employers and employees see as setting a contribution rate that provides them with benefits that reflect a reasonable rate of return on their contributions; and

- Government can justify to the electorate as a reasonable way to place a value on one possible use of expenditure which allows it to judge whether taxpayers' funds could have been used more productively elsewhere.

b) To reflect future risks to Government income

The Governance Group agrees that there is a risk that expected future Government income may not materialise, leading to the, very low, possibility that the Government may not be able to meet its obligations. However it is difficult to imagine a circumstance where Government would say the limits to its ability to pay public service pensions are different to its ability to pay for other calls on its resources. As all Government expenditure is transferable, a future Government would need to weigh up all the calls on its resources – there is no mechanism which automatically promotes public service pension payments as an item to be cut before other spending.

c) Support plurality of pension provision in the public sector

As noted earlier, Governance Group do not believe that it is sensible to pursue this element of Government policy via a manipulation of the costs of pension benefits.

d) Transparent and simple

The Governance Group supports this objective wholeheartedly. It is important at all levels that those concerned understand the methodology used to value the benefits provided by the NHSPS. The Governance Group also supports consistency in the discount rate used between public service pension decisions and other long-term Government projects. Pension provision is, at the end of the day, another decision to be made by Government on the use of economic resource (e.g. whether a hospital or an aircraft carrier should be built). Consistency between the discount rates used to discount future cash-flows is hence paramount in allowing fair comparisons to be made between different uses for the same competing resource.

e) To provide stability in employer charges

Again the Governance Group believes this is an objective of utmost importance. Stability is crucial for the long-term planning requirements of employers who are aiming to deliver a service efficiently.

f) Attraction and retention of staff

The Governance Group believe that this objective is of particular importance to the NHSPS given the nature of the NHS workforce. Given the highly skilled nature of many of the roles in the NHS, and correspondingly high costs of training people for those roles (nurses and doctors being the most obvious examples) the Governance Group feel it is necessary that access to the NHSPS can be used as a method of not only attracting those individuals into the NHS in the first place, but then retaining them. Encouraging the high number of individuals who take a break from their careers in the NHS for various reasons (raising children being the most obvious example) to return after the break is equally important.

As public sector employers do not have the flexibility in terms of remuneration structures that private sector employers have (e.g. they are unable to offer bonus awards, share-schemes and flexible benefits) it is paramount that those benefits they can offer, the pension scheme being the most important, are attractive.

The Governance Group recognise that attraction and retention should not be a primary driver when setting a discount rate, but this is another example where other effects should be considered when setting the discount rate.

5. 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

One of the reasons that it is accepted that most public service pension schemes are unfunded is that their ultimate sponsor, the Government, is deemed to be a sponsor with an infinite covenant. Should tax and contribution revenues ever be insufficient to pay the benefits promised then additional taxation would be raised in order to make up the shortfall. Most radically, if it is not possible to raise taxation then the Government has the final option of simply printing the money it requires – an option that should not be taken lightly due to the known knock-on effects elsewhere in the economy.

In contrast, in the private sector, sponsors have a limited covenant. Some private sector sponsors, of course, are very strong and therefore deemed similar to the Government (e.g. those with AAA-AA credit ratings), but no private sponsor has taxation or money printing powers. As such there is considerably more risk to members in private sector schemes, a risk that requires the sponsors of their schemes in the vast majority of cases to fund for benefits in advance in a manner that protects benefits should the sponsor ever cease to be solvent.

b) Rates used in the private sector

One important point to make prior to providing a response here is that given the NHSPS is unfunded, to attempt to derive a discount rate which reflects the return on a non-existent portfolio of assets is somewhat academic. Given the strength of the sponsor covenant of unfunded schemes the Governance Group remains confident that an unfunded approach remains the most suitable. Having an unfunded scheme means that the taxpayer does not have to meet the costs of administering a fund or the significant costs associated with paying investment managers to invest the assets. It also means that the fund is insulated from the volatilities associated with holding assets which are traded and which can have very volatile swings in value. However the following paragraphs consider some arguments based on the assumption that a discount rate based on a notional asset portfolio is legitimate.

For funding purposes, legislation required the trustees and sponsors of schemes in the private sector to calculate the value of their liabilities (called technical provisions) on a **prudent** basis. The easiest way to understand what this means is to first consider what is known as a 'best-estimate' basis.

A 'best-estimate' basis sets liabilities at such a level that if the corresponding contributions are paid over the period from when the benefits are promised to when they first come into payment, then there will be a 50/50 chance that sufficient assets will be available to fully meet the expected cost of the payment of the said promised benefits.

A prudent basis therefore increases the chances of having sufficient assets. Whilst prudence can be introduced into a basis in many different areas (such as in the mortality or inflation assumptions), it is common practice to take this margin in the discount rate. This means setting a discount rate lower than best-estimate – one that presents higher liabilities and therefore requires more contributions earlier.

Whilst prudent bases must be used for long-term scheme funding purposes, in the private sector best-estimate bases are used in situations where only a fair value of benefits should be provided. Interestingly, the new Technical Actuarial Standards which specify the advice that actuaries must give to clients requires consideration of a 'neutral basis' in addition to the prudent funding basis. 'Neutral' in this context is taken to mean best-estimate. The requirement to advise on a neutral basis means that information will soon be available on the discount rates actuaries consider appropriate if a margin for prudence is not included. Unfortunately reliable evidence on this is unlikely to be available within the timescale for this consultation.

The level of prudence required in the private sector is dictated by the strength of the employer covenant. Where an employer is deemed to be strong, then it can be argued that the trustees have less to worry about and can therefore take a less prudent view, safer in the knowledge that the sponsor will be available in the future to meet its obligations.

As the covenant of the sponsor weakens, trustees are obliged to consider the level of prudence in their basis and strengthen the basis, setting a higher value on the liabilities.

Applying this private sector approach to public service schemes such as the NHSPS, given the ultimate sponsor of the NHSPS has an effectively infinite covenant; would imply that very little prudence should be used in setting a discount rate. To go further, given that it would not seem logical to ask the taxpayer to over contribute to the costs of public service pensions now to cover the possibility of default, the discount rate used to value benefits should be a best estimate.

In initial comments on the level of the discount rate, it is not clear whether the IPSPC considered that discount rates in the private sector and in LGPS valuations included a margin for prudence and employer failure when using them to suggest that the SCAPE discount rate was towards the top of the range of acceptable assumptions.

To reiterate the point of principle which applies to both this approach and the index-linked gilts approach considered in the next section: as public service schemes are unfunded, there is no need to consider an approach based on notional assets. Instead it is entirely legitimate to use a Social Time Preference Rate (STPR) as discussed later.

c) Rate based on the yield on index-linked gilts

There are two potential rationales for this approach. One is the assumption that unfunded schemes are “notionally” invested in index-linked gilts as employees and employers have “lent” their contributions to Government. The problem with this rationale is that if Government were to issue sufficient index linked gilts (which would need to be CPI rather than RPI based) to match the public sector liabilities, this would have a significant impact on the yields available. Using current yields in such an approach would not therefore seem logically correct.

The other rationale for this approach is that if individuals wanted to replicate the occupational pension benefits they hold in public sector schemes in a form which had equivalent security, they would need to purchase index-linked gilts on their own account. In other words, the value to the individual of the benefit would be assessed on this basis.

But this last point signals the main problem with this approach. What matters to the tax payer is how much it costs Government to provide the benefits. Government is in a unique position where it can provide unfunded pension benefits due to its very strong covenant. To argue that it should impose artificial costs on itself cannot be sensible for tax payers, employees or Government itself.

There is a significant lobby which argues that public bodies should operate more in line with profit centred businesses. If a profit making organisation failed to exploit a significant advantage it had, it would be subject to significant criticism. It does not then seem sensible to argue that where Government has a competitive advantage as a supplier, it should not make use of this advantage. A non-pensions example may make this clearer. There has been some debate recently about the fact that banks with a UK Government guarantee have been able to borrow money in the market at a lower rate than those without and that this has added to profits. But it has not been argued that these banks should pay the higher rate for credit so as to neutralise the competitive advantage they have. Arguing that taxpayers and employees should pay for pension benefits in a way which discounts the advantage they have in being able to provide pensions cheaply would mean applying a non commercial approach.

The Governance Group notes that using the IPSPC’s estimate that index-linked gilt yields are currently around 0.8 per cent above inflation measured by the RPI, that adopting such a discount rate would decrease the current discount rate by 2.7 per cent (3.5 less 0.8) which would in turn, against using the IPSPC’s estimate as quoted in 1.28 of the consultation document, increase the calculated total contribution required for pension benefits earned by an average of about 16 per cent of pay bill.

d) Rate in line with expected GDP growth

Extending the line of thinking that members and employers effectively lend their contributions to Government knowing that they will be invested in the economy in the form of the various capital projects the Government undertakes each year, then it would not be unreasonable to expect a rate of return on those payments at least equal to the growth in the country's output as the economy benefits from the Government's investment in it. There are clear problems associated with identifying an agreed measure for expected future GDP growth. Given the fact that GDP growth would only ever act as a floor to a discount rate and the problems of measurement, the Governance Group does not believe this is a useful avenue to explore.

e) Social Time Preference Rate ('STPR') that makes allowances for the particular context of pensions

The Governance Group agrees that the current manner in which public service pension benefits are paid for (on a pay-as-you-go basis) means that there is a transfer of wealth between the current and previous generations with the current working generation having no guarantee that the same, or even similar, levels of benefits will be available to them when they retire in 10, 20, or even 40 or 50 years time.

Since the STPR approach is the primary method of seeking to use discount rates to price such transfers of wealth, the Governance Group feel it is a particularly justifiable approach to use – so long as the individual elements are appropriate.

A key element of the STPR approach is that it is consistent so the argument in the consultation document for a Social Time Preference Rate ***that makes allowances for the particular context of pensions*** would seem questionable.

As no clear evidence has been presented to challenge the make up of the STPR currently in use from catastrophe risk, pure time preference and growth in per capita consumption, the Governance Group do not believe significant discussion on the issue is necessary. However, three points are worthy of comment.

First, questions have been raised as to the appropriateness of the use of a catastrophe risk in the build up of the STPR for pensions. It is important to note that the theory on which the catastrophe risk approach is built does not imply that this risk should vary according to the type of project being considered. If this were the case, then different risks would apply to transport projects than to nuclear decommissioning for example. The idea floated in the IPSPC report that catastrophe risk should not apply to public sector pensions would not therefore seem to be sensible.

Second, a_criticism of the 3.5% pa real discount rate often made is that it "feels" too high compared to market rates. In a paper presented to the Institute and Faculty of Actuaries in January 2011, Cowling et al note that "STPR's do not necessarily need to be based, ***even loosely***, on current market discount rates, if the Government believes that these would lead to inappropriate outcomes based on more "fundamental" criteria"[4] (emphasis added).

[4] Cowling, Frankland, Hails, Kemp, Loseby, Orr and Smith "Developing a framework for the use of discount rates in actuarial work" 2011

Third, the Governance Group is aware that in other projects, the discount rate used is reduced for long-term projects of over 30 years. To date this reduction in the discount rate has not been used in pension scheme valuations for public service schemes. It has not been possible to find an explanation of the reason for this. In the private sector, some schemes have moved to using a term dependent discount rate but this is associated with a term dependent inflation rate which can mitigate the effect of the term dependent discount rate.

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

The Governance Group do not believe alternative approaches need to be considered.

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

The Governance Group do not believe that any convincing evidence has been presented to suggest a move away from the present level of discount rate. In the introduction we set out the reasons why the discount rate is important. These were that it affects:

- the level at which benefits are set;
- the way in which costs are shared between employees, employers and central government; and
- the way in which resources are allocated between different competing calls for resources and between different generations.

Taking the first two elements together, the consultation seems to be premised on an assumption that a lower discount rate will be used and that employers and central government will be shielded from the effects of this change. This inevitably means that scheme members will be left to meet the costs. Coming on top of the already announced imposition of an additional circa 3% member contribution, the switch from RPI to CPI, the uncertainly about benefits which has been the result of the IPSPC and the effect on high earners of tax changes, this significantly undermines the confidence of members in the NHS Pension Scheme. This in turn is causing significant problems for employers in retaining staff and therefore in maintaining a high level of service delivery which is particularly difficult given the other changes taking place.

The Governance Group would not argue that members should never be asked for additional contributions. Indeed working in partnership, the Group delivered additional member contributions as a result of the previous round of changes to the Scheme. In addition, had the cap and share valuations and associated negotiations continued, it is likely that the yield from member contributions would have seen another increase or that benefits would be decreasing.

Whilst the consultation document tries to separate out the discussions on the discount rate from the debate around benefit levels and how costs are shared, in the real world, these issues are intertwined. There is no one "correct" answer for the appropriate discount rate and the Governance Group are concerned that a seemingly technical discussion on the discount rate is being seen by some as another way to undermine public service pensions.

At the macro level, a universal discount rate is vital so that society can have consistent bases of valuation which allow rational decisions to be made between competing claims on resources from different areas or different generations. Whilst the need for consistency applies across the board, a similar area where costings are needed is in assessing the cost of State benefits. Governance Group notes that in the recent DWP paper "A sustainable State Pension: when the State Pension age will increase to 66"[5], costings of the changes in the date of payment of State pension benefits are all based on a real discount rate of 3.5%. As no argument has been made for why public service pensions are different to State benefits (and indeed reduced spending in one area could mean increased spending in the other), it is imperative that these competing resource calls are valued consistently. When discussing the impact of a discount rate change earlier, the effect of replicating the change in all other costings was not considered but clearly this would be a massive undertaking.

8. 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?

From both employee and employer points of view, it is important to have stability in the level of benefits and the cost of those benefits.

Given that unfunded pension schemes are only notionally funded, there seems little to be gained from reviewing the discount rate regularly. What should be in place is a discount rate that provides a fair long-term reflection of the cost of benefits accrued and accruing and that should stand the test of time. Anything else would leave members and sponsors in fear of political interference.

It is the Governance Group's view that the SCAPE discount rate should be reviewed only when necessary in order to maintain public confidence in the system.

This is not to say that other assumptions used in the valuation (such as mortality) should not be regularly reviewed.

9. Further Issues

The Governance Group have already raised concerned about whether the discount rate can and should be considered independently of the other decisions currently being made around the future of public service pension arrangements. The Governance Group would like to bring to HM Treasury's attention a number of practical issues that are neither part of the consultation nor specifically excluded. These are:

- A change to the discount rate means that the current actuarial factors need to be revised. Any change has implications in terms of re-drafting of member literature and re-programming of calculation systems. It is important that the costs and time scales associated with any changes are recognised.
- The NHSPS is currently part of the way through the Choice Exercise where members are being asked whether they wish to move to the new section of the scheme set-up in 2008. Depending on how the cost implications of any change to the discount rate are assigned to members, employers or the tax payer, those who have already made a choice may feel they did so incorrectly given information that may come to light in the near future. Of course this argument is not restricted to the consideration

[5] DWP "A sustainable State Pension: when the State Pension age will increase to 66" 2010

of the discount rate but equally applies to any of the changes to public service pension arrangements the Government is currently considering.

- Again, the Governance Group stresses that it would like further information on how the changes to the discount rate, and in particular any additional costs that arise as a result of a reduction in the current discount rate methodology, will interact with the existing cap and share arrangements. The Governance Group believes that in order to maintain staff and employer confidence in the management of the NHSPS in the future that the existing framework should remain in place, and any change to the discount rate not fall into the shared cost area, if at all possible.

The Governance Group would be happy to present further evidence if requested or to respond to any queries on this document if it would be helpful to the Treasury.

Appendix 1

NHS Pension Scheme Governance

The role of the NHS Pension Scheme Governance Group is to monitor the development and operation of the NHS Pension Scheme and seek to make agreed recommendations to the Secretary of State that take into account the interests of all Stakeholders including employers, scheme members and taxpayers.

The Governance Group has been set up and its role agreed on the basis of discussions between NHS Employers, Trades Unions and the Department of Health.

Formation of the Group

The Governance Group is a social partnership between NHS Employers and national NHS Trades Unions and acts under the authority of the NHS Staff Council. The Group is also attended by the Department of Health acting as observers.

As cost sharing is now a feature of the NHS Pension Scheme, consideration was given to asking the group to perform a fiduciary role similar to that in a private sector scheme, with members having responsibility to all stakeholders. However both employer and trade union representatives on the group have clear responsibilities to their own constituencies and it is questionable whether it is reasonable to claim they could act in a trustee like manner.

Nevertheless, the experience of the scheme review did give members confidence that the group could act in a way which gave consideration to all stakeholders in the scheme, given that many past decisions during the scheme review process had been made on the basis of principles of fairness, mutuality and cost. There is an advantage to both employers and staff representatives in demonstrating to government and others their commitment to managing the NHS Pension Scheme sustainably.

Detailed Duties of the Group

The group will:

- advise the Secretary of State on cost sharing. The cost sharing regulations indicate that "the Secretary of State shall consider any advice relating to [cost sharing] from such employee and employer representatives as appear to the Secretary of State to be appropriate". The group would be the source of this advice
- advise the Secretary of State on the assumptions to be used in the actuarial report. The regulations require that the actuarial report prepared by the Scheme Actuary should be "based on actuarial assumptions determined by the Secretary of State after taking advice from…such representatives of employees and employing authorities as appear to the Secretary of State to be appropriate". The group would be the source of this advice
- ensure that the NHS Pension Scheme continues to meet the needs of employers and employees long term whilst recognising the need for value for money for tax payers
- ensure that recommendations made by the review partnership are implemented at the administration level by Employers and administrators
- provide input into consultation with members on any scheme changes

- consider whether the Regulations correctly state the way in which the scheme should work and pass any observations to the Secretary of State
- make any comments it considers helpful on communications issued on the scheme
- ensure that the Equalities Agenda is met by considering issues such as red circling and the results of data analysis on the equality impact of different benefit provisions
- gather and analyse any data it considers useful in improving the operation of the scheme.

Resources Needed by the Group

In order to operate successfully, the Group will need the following resources:

- access to training on issues such as the valuation, best practice in the private sector and legal issues
- access to independent actuarial [and legal] advice
- support services for arranging meetings and minutes
- authority to approach and request disclosure of information from parties such as the scheme's administrators.

Given the need for these resources, consideration should be given to establishing a budget (and budgetary control) for the group.

Operation of the Group

There will be a chair and vice chair of both the employer representatives and the union representatives. Chairing of meetings of the Group will rotate.

A meeting schedule will be agreed annually with at least two weeks' notice given of all meetings. Minutes will be circulated within 1 week of the meeting date.

It is up to the employer and union representatives to determine how their members of the group should be selected and who of their group will act as chair and vice chair. However each group will select [10] members.

The following points apply in the operation of meetings:

- Any meeting is only quorate if there are at least 2 attendees from each group.
- Members may attend meetings by teleconference.
- Non members of the group may attend as observers if agreed by the chair and vice chair.
- If the chair cannot attend, the vice chair of the appropriate group will chair the meeting. In the event of neither the chairs nor vice chairs being present, the attendees will elect a chair at the start of the meeting.
- Group members will decide whether advisers need to be present at meetings.

The Group will at all time proceed on the basis of reaching a consensus decision after appropriate discussion and after undertaking any required analysis and taking any advice considered necessary. If agreement cannot be made, issues will be referred to the Staff Council.

Limits of Authority of the Group

The group's role is not to take decisions that have implications for public expenditure beyond its own operational budget. The group's formal authority is limited to making recommendations to the Secretary of State for Health.

As well as the NHS Pension Scheme the group may also consider other related employee benefits at the request of the Staff Council or the Secretary of State.

The group's role relates only to arrangements in England and Wales.

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SW1A 2HQ

24th February 2011

Dear Sir

NUT RESPONSE TO DISCOUNT RATE CONSULTATION

The National Union of Teachers is the largest teachers' union in the UK and represents over 250,000 serving teachers. The vast majority of our members are covered by the Teachers' Pension Scheme, and we also have members within the Local Government Pension Scheme.

The NUT is a member of the Teachers' Superannuation Working Party and provides the Secretariat to the Teachers' Side. We endorse the Teachers' Side submission which considers the questions posed in the consultation document in detail. As an affiliate of the Trades Union Congress, we also endorse the TUC submission.

Yours faithfully

Christine Blower

CHRISTINE BLOWER
General Secretary