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

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3 March 2011

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

Dear sirs

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

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

General Observations

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

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

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

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

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

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

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

Current issues with employee contributions in public sector pension schemes

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

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

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

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

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

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

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

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

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

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

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

Response to specific questions

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

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

Yours sincerely

P. Mason

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Annex A

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

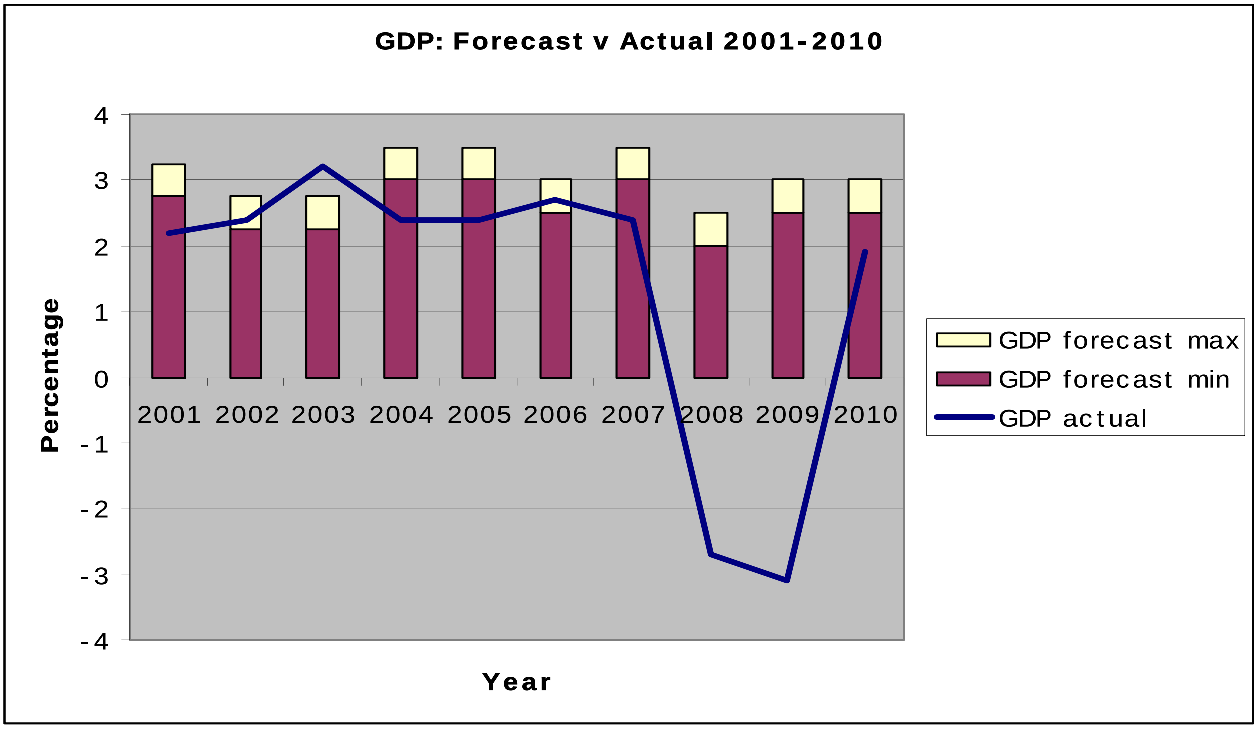
However, whilst this type of measure establishes a closer link between government spending and financing, there are drawbacks to this approach.

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

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

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

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



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

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

Option (d) – a Social Time Preference Rate

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

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

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

Overall conclusions

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

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

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

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

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

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

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

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

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

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

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

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

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