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

Dear Sirs

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

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

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

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

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

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

Overview

The choice of discount rate in the valuation of any future cashflows or liabilities depends primarily on the question that the valuation is seeking to answer.

Different valuations of the same assets or cashflows or liabilities are entirely justifiable as the valuation of any assets or liabilities depends on circumstances.

The consultation primarily deals with future cashflows or liabilities in relation to unfunded pension schemes and the key question is what discount rate should be used to assess employers' contributions.

However the assessment of employers' contributions in unfunded pension schemes can be made for many different purposes as is the case in funded pension schemes. Again, the key question is, for what purpose is the level of employer contribution being assessed.

The natural starting place in considering the discount rates for assessing employer contributions in unfunded pension schemes is to first of all consider the discount rates that are adopted in funded pension schemes and then decide if these are relevant or appropriate for unfunded schemes.

In funded pension schemes, the questions that tend to be asked that then require consideration of the appropriate discount rate are typically:

Accounting Valuations

If I was a company and wanted to assess how much I would need to borrow to finance my pension liabilities then how much would I need to borrow? This is essentially the question that is being asked under the accounting standard FRS17 or its international equivalent IAS19.

This then leads to adopting a discount rate based on corporate bond yields.

Funding Valuations

The question that pension scheme trustees might ask is, given we are accumulating assets to meet future pension liabilities and have agreed a certain investment strategy with assumed levels of investment return, what discount rate should we adopt in assessing how much we need to fund existing liabilities and the level of contributions for liabilities accruing in future.

The discount rate then tends to reflect an overall rate of expected future investment return, usually with some element of prudence or risk adjustment based on employer covenant included.

Cessation Valuations

Trustees and sponsoring employers might also ask the question – if we were to buy out our pension liabilities with an insurance company or other buyout provider, what discount rate should we use to assess how much would be required. Discount rates underlying buy out costs depend on many factors but typically the discount rate would be close to gilt yields.

In current economic conditions discount rates under the 3 different scenarios might be typically

Scenario	Example Discount Rate
Accounting	**5.5% per annum**
Funding	**6.0% per annum**
Cessation	**4.5% per annum**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Below we have set out our comments of the usage of the 4 alternatives proposed.

Approach	Comments
A rate consistent with private sector and other funded schemes	Many would advocate adopting approaches that are consistent with the approaches adopted in the private sector to make it "fair". However the public sector is quite different to the private sector in many regards. Public sector bodies can borrow money more cheaply than the private sector. The private sector can invest money with many fewer restrictions than the public sector. There is no level playing field and so we do not believe that trying to establish one for the purpose of comparing pension costs should necessarily be an overall objective. However even if this route was pursued then given the strength of covenant of the Government compared to private sector employers we would still anticipate that a higher discount rate could be justified by the Government compared to private sector companies. There is also the problem that there is a range of different approaches towards financing pension provision in the private sector with assumptions depending on the employer's covenant strength and the scheme's investment strategy.
A rate based on the yield on index-linked gilts	There are of course a number of advocates of the "cost of borrowing approach" that underlies accounting standard FRS17. So if the question is – how much money would the Government have to borrow to finance these liabilities, then this would be a valid approach. However we believe this is not really the question that should be asked in the first place. In particular, the liability to meet future unfunded pension payments does not have to be financed immediately and will be met out of future tax receipts or equivalent national income. If a gilt yield based approach was adopted then this leads to the anomalous situation where the Government has to reserve more assets on its balance sheet for future pension liabilities compared to a private sector company. However with its tax raising powers the Government arguably has the strongest covenant of all and so is the least likely to default on its pension obligations but then would have to reserve more assets than a more risky employer.
A rate in line with expected GDP growth; and	There are some who advocate funded public sector schemes for all. Of the major public service pension schemes it is only the Local Government Pension Scheme that is financed on a funded basis. There are many benefits of funded schemes including greater transparency and recognition of cost. There are also disadvantages such as investment risk and potential loss from which unfunded schemes are immune. However it can be argued that whilst no external assets have been set aside for the unfunded schemes and future pension liabilities, there are national assets that are effectively the assets of the unfunded schemes. Had these schemes been funded from outset then part of our national income would, at least in theory, have been paid into these schemes rather than having been invested in schools, hospitals, infrastructure etc. Thus whilst there is no external investment in assets there has effectively been internal investment. There is therefore a case we believe that the

discount rate that is used to value unfunded public sector pension liabilities for at least some purposes should reflect the expected return on these internal assets. This does lend itself to adopting a discount rate linked to our expected increase in national wealth.

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

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

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

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

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

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

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

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

These seems to be 3 key reasons

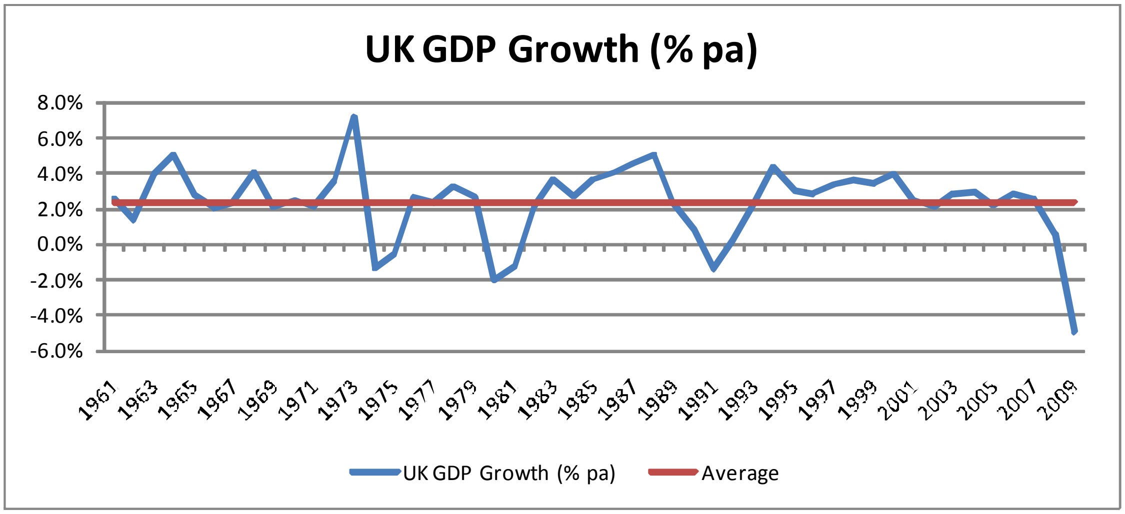
- Deciding the value of the pensions package and then allocating the cost between employee and employer
- The amount that public sector employers should be charged to represent a “fair reflection” of the cost of the benefits being provided (arguably for internal charging purposes)
- As above but for bidding against private sector organisations for public sector contracts.

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

Of the 4 proposals put forward we would favour the expected growth in GDP approach as the liabilities will be met from future national income. We would still anticipate that this produces a higher discount rate than might be typically adopted in the private sector but we believe can be justified on the grounds that the Government is more able to underwrite risk.

In terms of an actual number then we could consider past experience as a starting point.

The following chart shows changes in UK GDP over the last 50 years (Source: World Bank).



Whilst there is considerable year on year variation due to economic cycles, the long term average is 2.3% with a slightly reducing trend as the UK economy has matured.

Thus if the assumption was to be based on the historic long term average then an appropriate discount rate assumption of 2.0% to 2.5% in excess of RPI or 2.5% to 3.0% above CPI could be justified.

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

All actuarial assumptions should be reviewed on a regular basis but with the objective of having a stable rate for a reasonable time period. On balance we would advocate a review every 5 years or so.

We hope that you find our comments of assistance. As we indicated earlier in this response, we are available to meet with you to build on these comments ahead of your final report and recommendations.

Yours sincerely

Graeme D Muir FFA
ACA Main Committee