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Submitted via email to:
SCAPEDiscountRateConsultation@HMTreasury.gov.uk

19 August 2021

Consultation regarding the Public Service Pensions discount rate methodology

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above-named consultation.

The ACA is the representative body for UK consulting actuaries. Our members are all qualified actuaries – mainly Fellows of the Institute and Faculty of Actuaries. Members provide advice to thousands of employers and pension schemes with assets exceeding £1 trillion, including most of the country's largest schemes as well as thousands of smaller arrangements.

This response is submitted on behalf of the Association's Pensions in Public Services (ACA PiPS) Committee which monitors developments and makes representations on pension arrangements for those working in public services.

Our comments on specific questions raised in the consultation are set out below.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07770 392883 or at Bart.Huby@lcp.uk.com

Yours sincerely

Bart Huby
Chair, Pensions in Public Services Committee
On behalf of the Association of Consulting Actuaries Limited

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Response to consultation questions from the Association of Consulting Actuaries

Question 1: Do you agree that these are the correct objectives for the SCAPE discount rate? If not, please explain why and specify any alternative objectives that you think should be included.

Five objectives currently apply, with the first two of these prioritised:

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

The consultation proposes stablity is added to the core objectives with the other two objectives dropped and equal weighting placed on **fairness, risk and stability**.

Whilts we agree these three measures are correct, we also believe that an objective of **transparency** should be maintained as it is important that all stakeholders appreciate how the costs have been determined and their general trend over time in an objective and transparent manner.

With regards to the "Fair reflection of costs" objective, while not determined by the SCAPE discount rate itself, we do not believe it is either necessary or appropriate to adjust employer contributions to reflect past over- or under- payment of contributions in respect of prior employment periods. Contributions being paid now should be based on the expected value of benefits being earned today (with a margin for prudence – see later), the adjustment for past service being an unnecessary complicating factor which means that employment costs (in terms of employer contributions) for current employees don't always reflect the expected costs of the benefits being earned - and also generally gears up or down the impact of changes in the SCAPE discount rate.

A better way to allow for actual GDP experience would ideally be that past service benefits would be adjustable, for example by flexing the rate of future indexation to those benefits to reflect differences between anticipated and actual experience (eg if GDP growth is lower or higher than assumed). We have suggested this as, in our view, the guaranteed benefit design places limitations on the extent to which the objective of "fairness" can be delivered in practice. In order to fully achieve this, past earned pensions would need to be adjusted for differences between costs coming through and the estimation of those costs (whereas the cost control mechanism adjusts *future* benefits). This is not a judgment on the nature of the defined benefit promise provided to the public sector workers, but recognition of the limitation of the extent to which the objective can be delivered in practice.

We would therefore strongly suggest that such contingent indexation on accrued benefits be considered, but in the absence of this change it is simpler, more transparent and fairer for the State to pick up historic funding "gains or strains" resulting from actual experience varying from assumptions. There should however be regular clear statements following each scheme's valuation so that the extent of any under- or over- estimate of the actual costs over the period is clearly recognised and understood.

Question 2: Do you agree that these are the most appropriate methodologies that should be considered? If not, please specify any alternative methodologies that should be considered and how they would fit with the Government's proposed objectives.

No, whilst our conclusion is that a discount rate based around GDP growth with a prudence margin to reflect estimation risk and the cost of the guarantee being provided is, on balance, the most suitable approach given the two alternatives being proposed, in reaching that decision our considerations were initially broader and we set out below some alternative viewpoints that we believe are relevant to decision-making. This prudence margin could be varied between acceptable ranges to aid stability of contributions.

Link to Government borrowing costs

Pensions could be seen as simply a deferred obligation from Government to provide an index-linked income in retirement to employees which could be seen as analogous to paying an index-linked income to holders of index-linked gilts. By extension, it would then point towards a need for consistency between the cost of index-linked gilts and the cost of index-linked Government pensions. This approach would substantially increase the measurement of the cost of defined benefit promises.

GDP / inflation growth with prudence margins/estimation risk

Alternatively, the notional assets backing the future pensions might be seen as being "invested" in the economy, rather than "borrowed" from future pensioners. In the private sector, pension costs are based on the expected return on the pool of assets in which the pension scheme is invested, adjusted for prudence reflecting the employer "covenant", rather than the borrowing costs of the employer. Extending this to the public sector, if it is the economy that is backing these pension promises, backed up by the strong "covenant" of the taxpayer, then this would lend support for a measure based on long-term GDP growth, with a prudence margin to protect future generations of taxpayers against estimation risk and to reflect the value/cost of the guarantee being provided. This margin for prudence could also either implicitly or explicitly include an allowance for the economic risks from climate change, in a similar way as is being encouraged for Private Sector schemes in line with recent Pensions Regulator and PCRIG guidance. And, furthermore, it would be possible, with a relatively straightforward change in benefit design, to have little or no indexation guaranteed to pensions in payment and give increases to the extent that GDP growth exceeds the prudent assumption – this would enable a margin for prudence to be included without increasing contributions excessively.

Accounting standards

Consideration could be given to consistency with the cost of Private Sector pensions accounting i.e. in line with IAS19. This would currently produce costs much higher than a discount rate based on long-term GDP growth expectations but would produce lower costs than a discount rate based on index-linked gilts. This is not a view that we support in that actual Private Sector cash costs are not typically based on accounting measures and the issue is of cash funding. However, it is nonetheless relevant and the relative merits should be debated as part of the thought process for completeness.

Stochastic approach

An alternative approach could be to consider a stochastic approach to setting the discount rate, based on the range of future outcomes for long-term GDP growth (as an example) and then set the

discount rate based on a GDP growth assumption which will have a certain probability of actually being achieved. This would be more complex but would provide much greater understanding of the potential variation in output and therefore future risk faced by the taxpayer. This would also allow all stakeholders to better understand how the estimate of long-term GDP growth has been derived, which is important for the key assumption driving costs. Furthermore, by improving stakeholder understanding of the extent of the uncertainty of future economic outcomes, this could enhance the potential for agreement to be reached on incorporating an element of adjustability to past service benefits (for example by flexing the rate of future indexation to those benefits) to reflect differences between anticipated and actual experience (e.g. if GDP growth is lower or higher than assumed),

Question 3: What are the advantages and disadvantages of a SCAPE discount rate methodology based on expected long-term GDP? If this methodology is adopted, should any of the modifications (allowing for short-term GDP projections, allowing for actual experience) be considered?

Allowing for short term GDP expectations may over-engineer the approach. For example, an accurate three-year projection when combined with a sweeping 50-year long term projection may not add much value.

We think a short-term check which considers actual experience should be applied to ensure things stay on track as an economic forecaster would never suggest that they can accurately predict GDP growth over **decades**. A methodology based on long-term expected GDP growth that doesn't adjust for actual experience risks placing an inter-generational burden on future taxpayers (noting that this has been over-estimated for the last 10 years) as costs/benefits are never aligned for actual experience. Exacerbating the issue is that this burden is never properly measured. We believe a change in approach to allow for actual GDP growth in the calculation of the notional assets on the balance sheet is essential in order to bring costs back into line at the valuation, provides greater cost transparency and is much more in-keeping with the fairness objective. If necessary, any deficit from experience differences should be spread over a suitably long number of years to ensure stability. Or instead, the experience could come through on the contingent pension increases proposed above.

Question 4: What are the advantages and disadvantages of a SCAPE discount rate methodology based on the STPR? If this methodology was adopted, should any modifications (allowing for the public service pension context or allowing for long-term uncertainties) be considered?

The STPR is not a sufficiently objective measure and is vulnerable to subjectivity

- We note that there is a range of standard/reduced rate/health/health reduced rate STPR discount rates quoted in the Green Book that are also time dependent, and it appears the consultation is only referencing the highest of those discount rates. The consultation makes no references to these lower rates and these would need consideration if the STPR rate were to be used.

- Unlike GDP growth, where expectations can be compared against actual observed growth which allows for cost corrections over the shorter term, there is no comparable objective measure of actual experience for the STPR, so no mechanism for correction can be adopted. Costs could therefore go widely off track, placing a heavy burden on future generations of taxpayers.

- The objectives of the two are different: the STPR is used to support investment in long-term Government projects for social benefit and these projects can be curtailed or ceased. Pensions reflect a guaranteed commitment by Government (in practice, future taxpayers) to make index

linked payments to current employees. It may be argued that STPR is the expected return from "investing in the economy" but we believe that GDP growth is a stronger measure of this which is less subject to be manipulation.

- Whilst stability of the STPR in isolation is something to be welcomed, this comes at the material price of transparency and as noted above therefore allows for costs to go way off track over many, many years before they are brought into line, which is a major contradiction to the fairness and risk objectives.

- As noted in the consultation, a SCAPE discount rate based on the STPR would not be directly linked to the Government's future income stream, or the Government's expected ability to pay out associated pension benefits in the future. This means that despite the stability of the rate itself and stability of cost now, it results in future instability as a proportion of actual future income.

- Use of the STPR could lead to an inconsistency in cost measurement for the purpose of the cost management mechanism.

Question 5: Which SCAPE discount rate methodology do you recommend, and why?

In summary, our view is that, on balance, continued use of estimated long term GDP growth is the most suitable measure to use for the discount rate, out of the alternatives that we have considered. However, adjustment is needed for actual GDP growth experience and inclusion of a prudence margin for possible estimation and climate change risks. This could be through the stochastic approach suggested above. As we have suggested above, we believe actual experience should also be factored into the calculations by having contingent indexation on accrued benefits depending on how GDP growth has compared to the long-term estimate.

Question 6: Are there any equalities impacts of changes to the SCAPE discount rate methodology that the Government should consider?

The critical consideration is that of inter-generational fairness not just of those in the schemes but also taxpayers who aren't in the schemes. Many of these taxpayers will also have had their private sector defined benefit pensions closed due to rapidly increasing costs which were recognised in the private sector under the different approaches discussed in response 2. Stability and cost control should not be at the expense of widening the gap between these demographics.

Whilst the consultation focusses on methodology, this cannot be considered in isolation without regard for how any increases in contributions will be funded. When contributions last increased, some employers received Government funding and others didn't which created an uneven playing field.

Question 7: Do you agree with the proposal for reviews of the SCAPE discount rate to be aligned with the scheme valuation cycle?

Yes.

We would be happy to discuss our response further if that is helpful. In that event, please contact Bart Huby, Chair of our Pensions in Public Services Committee, on 07770 392883 or at Bart.Huby@lcp.uk.com

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