JOHN RALFE CONSULTING

Ms Niki Cleal
Director
Pensions Policy Institute
King's College
26 Drury Lane
London WC2B 5RL

5th November 2012

Dear Ms Cleal

PPI Report on public service pension schemes of 23rd October 2012

I am writing to you about the recent PPI Report on the costs of public sector pensions.[1]

I am an independent pension consultant and have written on many aspects of public sector pensions, in the Financial Times and elsewhere, as well as being interviewed several times on the Today Programme and Channel 4 News. Please see my attached biography.

The PPI Report reaches three conclusions:

a. the Coalition government's changes to NHS, TPS, Civil Servants and LGPS pensions have reduced the overall cost to taxpayers by a third from around 23% of salary to 15% of salary.
b. The average private sector DC cost, including contracting into SP2, is 10% of salary, so the new public sector pension terms are only 5% more generous than the majority of private sector pensions.
c. The average private sector DB cost, for the small percentage of employees still in a DB scheme, is 23% of salary, so existing private DB schemes are significantly more generous than the new public sector terms, and indeed the same as public sector pensions before the current changes.

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[1] http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=332

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However, I believe the PPI's conclusions are seriously flawed:

a. The PPI's costings of public sector pensions, which repeat the government's own figures, are grossly understated. The total real cost of public sector pensions, before member contributions, remains at around 31% of salary, even after the changes. The saving from the higher retirement age has been offset by the higher rate of pension earned each year.
b. The cost saving for taxpayers is due to the increase in member contributions of around 3%. The increase from just over 6% to just over 9%, reduces the real cost to taxpayers from around 25% of salary to 22%, a much smaller saving than calculated by the PPI.
c. This in turn means the new public sector pensions at a cost of 22% of salary, versus 10% in private sector DC, are much more generous than suggested by the PPI - 12%, not 5%, more generous.
d. It is not clear how the PPI calculates the cost of a DB private sector pension. If the 23% calculation is correct, then this means that the private sector DB pension is about as generous as the new public sector pension and not much more generous, as the PPI concludes.

The Report's preface says, "*The objective of the report is to aid understanding about the potential impact of the Coalition Government's proposed reforms to the public service schemes*." I believe that as currently written, the Report fails in this objective.

Understating the real cost of public sector pensions, both in absolute terms, and in relation to the private sector, discourages proper, informed debate on this crucial issue, and undermines the credibility of the PPI as a trusted, independent and authoritative organisation. At the macro-level, it allows the current generation of taxpayers to continue to pass on an economic cost to be paid by future generations, which is inherently unfair.

As mentioned in a footnote to Appendix 2, (p39) the PPI costings, which are similar to those produced by the Government Actuary's Department, and which I have obtained under the Freedom of Information Act, uses a methodology set down by the Treasury, which discounts expected pensions at forecast GDP growth, fixed at CPI + 3%.

The correct discount rate should be based on the yield on long-dated index-linked gilts, (adjusted for the difference between consumer price inflation and retail price inflation), since public sector pensions and ILGs share similar characteristics. Both are obligations of the UK government, both are contractually committed, legally-binding and both are inflation-linked**.**

I attach a letter to George Osborne in April 2011, signed by 23 pension experts from the UK, US and Australia, including me, arguing for the use of the ILG yield, not forecast GDP growth. You will have seen the extensive press coverage of this letter and I attach two articles from the Financial Times and Robert Peston's blog.

The ILG costings I quote above are based on a real ILG yield of 1%, significantly higher than the current yield, so there is an argument that even these costs are understated.

Using ILG yields to calculate annual pension costs and liabilities is not an academic exercise – it is precisely the method used to value the liabilities of the House of Commons Members' Fund which makes payments to former MPs and dependents with little or no pension under previous arrangements.

The latest valuation by the Government Actuary in September 2006 uses "*a market-related approach such that the interest rate used to discount the liabilities falling due in future years is* ***the real yield available in the open market, on the reporting date, on investment in a medium-dated index-linked gilt portfolio.*** *Accordingly, a discount rate of 1.5% a year net of price* *inflation has been used to value the Fund's liabilities*" (para 6.3) [2]. The rate in 2003 was 1.86% reflecting higher gilt yields.

Furthermore, the Bank of England uses ILG rates to calculate its annual pension costs, which were as 54.5% of salaries in the 2008 valuation.

The total cost of public sector pensions calculated by the PPI, bears no relationship to the market cost of individual or bulk annuities or deferred annuities.

The PPI Report contains no discussion of the discount rate issues, which have received much coverage in the last few months, or even any acknowledgement of the debate.

I ask the PPI to publish a revised version of the Report, which:

a. discusses the discount rate issues outlined here and in the attached letter to Mr Osborne from 23 pension experts, which have been well aired in print.
b. includes costings based on ILGs, as well as on the official CPI + 3%.
c. explains the different conclusions which these ILG costings entail.
d. explains the costings of private sector DB. It is not clear how the total cost, including member contributions, of a private sector DB pension is 28% of salary versus only 24% for the new public sector pension, when the underlying terms are similar. (The higher retirement age in the public sector, versus the private, is offset by the higher accrual rate).

If the PPI agrees that the correct method of discounting is that set by the Treasury, the Report should justify this, independently of the government, and address the issues outlined in this letter.

If the PPI does not agree that the correct method is that set by the Treasury, but chose to use it as the method fixed by the Treasury, it should explain how this approach demonstrates the PPI's independence.

[2] http://www.publications.parliament.uk/pa/cm200607/cmselect/cmfund/985/98507.htm

I believe a revised Report is necessary to demonstrate the PPI's independence and intellectual rigour, which, sadly, is in danger of being undermined by the incompleteness of the Report as it stands.

I would be very happy to discuss these issues with you and I look forward to receiving your reply.

I am copying this letter to the Members of the PPI Council and the Nuffield Foundation.

Yours sincerely,

John Ralfe

JOHN RALFE CONSULTING

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, described by The Economist in 2006 as a *"landmark".*

His clients include several FTSE100 & 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.

Following a report to Ofcom in 2010, in 2011 he wrote an expert witness report on BT's pensions for the Competition Commission, on behalf of BSkyB and TalkTalk.

He has written over 70 research notes and articles on all aspects of pensions, including a series of 50 notes sponsored by RBC Capital Markets. He 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.

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26th April 2011

Rt Hon George Osborne MP
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London SW1A 2HQ

Dear Mr Osborne

Public sector pensions discount rate

You announced in the Budget that the annual cost of new public sector pension promises would be calculated using a discount rate of expected GDP growth above inflation and the formal reasons for this were published on April 6th.

We are writing to ask that you re-consider this decision which we believe fundamentally misrepresents the economics of public sector pensions and has serious pernicious consequences.

In our view the correct discount rate should be based on the yield on long-dated index-linked gilts, (adjusted for the difference between consumer price inflation and retail price inflation), since public sector pensions and index-linked gilts share similar characteristics. Both are obligations of the UK government, both are contractually committed, legally-binding and both are inflation-linked.

The Consultation suggests the argument for using expected GDP growth is that pensions are "*paid for out of future tax revenues*".

But gilt interest and principal payments are also paid for out of future tax revenues. This clearly does not mean that new gilt issues should be valued by discounting payments in line with expected GDP growth, rather than the market gilt rate.

In using expected GDP growth, the Treasury has not explained how an obligation to pay a public sector pension differs from an obligation to pay gilts. If there is no difference, then pensions should be discounted at the gilt rate. The other possibility, that gilt payments should be discounted at the expected GDP growth rate, is immediately contradicted by the market.

The government's approach implies that it is cheaper for it to promise an inflation-linked pension payment to a public sector employee than it is to pay the coupon and principal on an index-linked bond.

By overstating the discount rate we understate both the current economic cost of public sector pensions and the real economic savings from the Hutton Report's recommendations. It also means that the efficiency of individual public sector bodies is overstated, as employment costs are understated and at the macro-level, the current generation of taxpayers is passing on an economic cost to be paid by future generations.

We must be clear that public sector pensions are not discretionary government spending, like health or education, which, subject to the ballot box, can be reduced to maintain affordability. They are deferred pay earned as part of a legally binding contract of employment, the equivalent of giving gilts to be redeemed at retirement and we believe their true cost should be properly measured.

In light of this we ask you to re-consider this decision.

Yours sincerely,

NB This letter is signed in a personal capacity and any institutional affiliation does not imply endorsement by that institution.

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http://www.ft.com/cms/s/0/7b7e80ec-703c-11e0-bea7-00144feabdc0.html#axzz2ACJ79WKF

Financial Times

"Rethink urged on future pension bill"

By Norma Cohen, Economics Correspondent
April 27 2011

The cost of public sector pension promises is to be calculated using a method that significantly understates the cost of benefits as they build up – despite reforms aimed at giving taxpayers greater transparency about the sums involved, according to a group of leading US and UK actuaries and economists.

In a letter sent on Tuesday to George Osborne, 23 pension and finance experts have asked the chancellor to think again. The group includes nine members from the US, where public sector pension schemes are also under fire for using an actuarial methodology that understates the actual cost.

"We ask that you reconsider this decision which we believe fundamentally misrepresents the economics of public sector pensions and has serious pernicious consequences," the letter said.

At issue is a matter somewhat arcane even to many finance experts but central to calculating the expense of projects where costs and benefits run over very long periods of time: the discount rate. This is an estimate of the time value of money and determines the rate at which the future benefit to be paid is eroded by the long time horizon involved. The higher the discount rate, the lower the final value of future benefits when they are presented in today's money.

Lord Hutton, chairman of the Public Sector Pensions Commission, noted that the discount rate used for the nation's biggest unfunded pension schemes – those for teachers, the NHS, civil servants and uniformed services – is unrealistically high and makes future benefits appear more affordable than they really are.

Following a separate consultation on the discount rate, the report prepared by Lord Hutton recommended lowering the rate that has been in use since 1997 – 3.5 percentage points above the retail price index – to 3.0 percentage points above the rate of inflation as measured by the consumer price index. The commission recommended using 3.0 per cent because it represents the best estimate of long-term growth in gross domestic product.

However, the group of actuaries takes issue with the philosophy behind this rate, noting that the obligation to pay inflation-linked pension benefits is as legally binding as the requirement to make interest payments on the Treasury's long-term index-linked bonds. Therefore, the group argued, the discount rate used to calculate the value of pension promises should be the same as the rate on index-linked bonds.

The letter noted that future benefits were "paid for out of future tax revenues" which should grow in line with the economy overall. "We must be clear that public sector pensions are not discretionary government spending, like health or education, which, subject to the ballot box, can be reduced to maintain affordability," it said.

http://www.ft.com/cms/s/0/b78f585c-7282-11e0-96bf-00144feabdc0.html#axzz2ACJ79WKF

Financial Times FTfm

"Bean counters ignored over discount rates"

By Pauline Skypala May 2nd 2011

Here is an advance warning: this column is about discount rates, specifically the appropriate discount rate for UK unfunded public sector pension schemes.

Why, you may ask, would anyone want to discuss such an arcane topic? Who cares? Well, if you have to ask, you haven't been paying attention to pension issues in recent years. Discount rates are key to determining how much members and employers need to pay into schemes. The rate used is effectively the return needed to ensure the pensions that have been promised can be paid. The higher the rate, the lower the cost of providing pensions appears to be.

The UK government announced in the March Budget it has decided to use a discount rate for unfunded public sector schemes of expected gross domestic product growth above inflation, following a consultation. This has annoyed a bunch of accountants and actuaries, who have written to George Osborne, UK chancellor, to complain.

They think the discount rate should be based on the yield on long-dated index-linked gilts, because public sector pensions are inflation-linked and guaranteed by the government – just like linkers.

They dismiss the argument put forward in the summary of responses to the consultation paper that expected GDP growth is the right number because pensions are paid for out of future tax revenues. Gilts are paid out of those revenues too, says the letter, which was organised by John Ralfe, an independent pensions expert. Pensions are debt the government is committed to pay, just like gilts, so how can the future liability be discounted at different rates?

Using expected GDP growth will understate the true cost of providing pensions, with "serious pernicious consequences", the letter claims.

The government has settled on 3 per cent as the figure for expected GDP growth. This compares with a yield on 2035 index-linked gilts of 0.76 per cent, according to Friday's FT. Valuing pension liabilities using the latter figure would see them balloon to unaffordable dimensions. The government would have to demand much higher contributions from members, or slash future benefits, or both – not an easy deal to sell to trade unions. No wonder it prefers to fudge the figures.

The 3 per cent figure is lower than the 3.5 per cent currently in use, but still far too high for those who insist on financial correctness. Neil Record, one of the signatories to the letter and author of several publications on pensions, points out in a blog on the Institute of Economic Affairs website that "average real GDP growth in the UK over the past 20 and 40 years has been about 2 per cent pa".

He is more worried, though, about the unfairness the government decision will perpetuate. Public servants will continue to enjoy “the best type of pension”, while private sector workers will have to make do with defined contribution schemes, which he believes will bring “huge disappointment, anger, poverty and taxpayer-burden”.

The government has opted for political expediency over transparency and fairness, he concludes.

Transparency is partly what did for DB pensions in the private sector. Most are now closed to new entrants and some to existing members too. Accountants succeeded years ago in forcing schemes to use the double A corporate bond rate to discount liabilities, at least for the purpose of reporting deficits on company balance sheets. Triennial actuarial valuations are often based on gilt yields, or the swap equivalent. Before these reforms, pension schemes used the expected return on their assets to calculate the level of contributions required. In the bull markets of the 1980s and 90s, when schemes were heavily invested in equities, this allowed employers to take long contribution holidays.

It didn’t matter much if the sums turned out to be wrong, as employers could dump their pension liabilities relatively easily. Regulation put a stop to that in 2003.

The government is taking a similar approach to measuring costs as private sector schemes did in the old days. But it cannot avoid paying up if its sums are wrong. Why should it be able to calculate its costs differently?

The government argues that it need not account in the same way because public sector schemes are unfunded. There is a strong suspicion the consultation was for show, and it was a waste of time responding as the decision on the rate had already been made.

Tellingly, a freedom of information request by Mr Ralfe for the briefings given to ministers on the subject was turned down, on the basis that the public interest in withholding the information outweighed that of disclosing it.

It looks like the bean counters will not get their way this time.

http://www.bbc.co.uk/blogs/thereporters/robertpeston/2011/05/is_the_treasury_understating_p.html

Is the Treasury understating pension liabilities?

Robert Peston | 17:18 UK time, Tuesday, 3 May 2011

Belatedly, I've got round to looking at the Treasury's recent decision to change how it calculates the necessary contributions that have to be made to cover the future costs of unfunded public service pensions.

My interest was sparked by a letter sent to the chancellor by 23 pension experts, organised by the consultant John Ralfe. They argue that the Treasury has made a mistake in its choice of a new so-called discount rate.

If you think this is tedious abstruse stuff that has no relevance to you, think again. The aggregate public-sector net liability for pensions is so huge - perhaps £1 trillion - that it matters to all of us as taxpayers, especially those likely to be paying tax in 10 and 20 years time, that the government has a reliable and accurate valuation of pension promises.

Pensions represent, to coin the phrase, a massive off-balance-sheet debt. And as we've all learned to our cost from the financial crisis of 2007-8, it is a bad idea to carry on blithely pretending off-balance-sheet liabilities don't exist.

So what is this blessed discount rate? Well in the private sector it can be seen as the number used to translate into today's money a commitment to pay £650 a week pension (for example) for 30 years or so to a retired employee (till he or she dies), so that we can see whether there's enough money in the pension fund to pay that employee (and all the other employees) during his or her long retirement.

The point of the discount rate is to assess whether there's enough money in the pension fund - or whether it needs to be topped up.

Which is all very well, except that for most of the public sector, there are no funds or pots of money to pay for future pensions. Most of the pension promises are unfunded, payable out of employees' current contributions and out of general taxation.

That said, since public sector workers are increasingly expected to make a contribution to the costs of their own pensions, it would presumably be sensible for that contribution to be set at a level that is rationally related to the value of promised pensions.

So what is the best way of measuring the cost today of new pension promises?

Well the government has decided to "discount" those promises by the rate at which the economy is expected to grow.

Now there is some logic to that: the growth rate of the economy should determine the growth rate of tax revenues; and the growth rate of tax revenues will have a direct bearing on whether future pension promises will bankrupt us all or not.

But here's the thing. Any private sector chief executive might well be sent to prison if he or she decided to use the equivalent discount rate for a company, which would be the expected growth rate of that company's revenues or profits.

The reason is that although it might be possible to remove subjectivity (or in a worst case, manipulation) from any long-term forecast of the growth of GDP or of a company's turnover, it is not possible to remove considerable uncertainty.

To illustrate, the Treasury has chosen a GDP growth rate of 3% per annum as the discount rate for public sector pensions, which is considerably above the rate at which the UK economy has grown for years or indeed may grow for many years.

If we were growing at 3%, we would in practice be less worried about the off-balance-sheet liabilities of public-sector pensions, because the on-balance-sheet debt of the government would not be growing at an unsustainably fast rate.

To put it another way, in choosing its view of the long term growth rate of GDP as the discount rate, the Treasury is arguably understating the burden of future pensions to a considerable extent.

So what discount rate do companies use?

Well they are obliged to discount the liabilities at the yield or interest rate on AA rated corporate bonds.

Which may not be ideal, but has some advantages: there is a market price for AA corporate bonds, so the yield or discount rate is difficult to manipulate by unscrupulous employers; and it tells the company how much money would need to be in the pension pot, on the basis that all the money were invested in relatively safe investments (AA corporate bonds).

Now Ralfe and his chums believe that the discount rate for public sector promises should be the yield on long-term index linked gilts (gilts are bonds or debts of the British government) - partly because this too has a difficult-to-manipulate market price and because an index-linked government bond is a very similar liability to a public sector pension promise (both are protected against inflation, both are in effect debts of the government).

They point out that gilt interest and principal payments are paid out of future tax revenues, just as future pensions are. So if the value today of future pensions should be discounted at the GDP rate, that's how index linked gilts should be value on the government's balance sheet - which would be bonkers.

Anyway, if you've read this far (and many congratulations to you if you have), you may take the view that it would not be rational to impose a tougher discount rate on the government than on private-sector companies - which is what Ralfe et al seem to want, in that the yield on index linked gilts will always be lower than the yield on AA corporate bonds (because HMG, even with all its debts, is deemed to be more creditworthy than any British business).

But for a government and for a chancellor who have made it a badge of honour to bring transparency and prudence to public-sector finances, prospective GDP growth does look a slightly rum discount rate for valuing those enormous pension liabilities.

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