30th November 2012

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

Dear Ms Cleal

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

As economists and pension experts from the UK, US, The Netherlands and Australia, we are writing to you about the recent PPI Report on public sector pensions. [1]

This calculates the cost to taxpayers of public sector pensions using a methodology set down by the Treasury , and discounts expected pensions at forecast GDP growth of CPI + 3%. The Report implies that the cost to taxpayers is the same as the annual benefit to public sector employees.

In our view the correct discount rate for calculating the cost to taxpayers, and the value of an employee's pension benefits, 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 the obligation to pay public sector pensions and the obligation to pay index-linked gilts share similar characteristics. Both are obligations of the UK government, both are contractually committed, legally-binding and both are inflation-linked.

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

It seems clear that the PPI calculations understate the value of public sector pensions to individual employees. Suppose the Government were to move from a DB to a DC pension, with employer contributions fixed as the percentage of salary calculated by the PPI; employees could not use this, plus the contribution they currently make, to buy the same inflation-linked pension promised under the current DB pension. To do so would require a much higher employee contribution.

Indeed the Chief Secretary to the Treasury, Mr Danny Alexander said in as Commons statement in November 2011 that, *"For a public service worker to buy a similar pension on the private market they would typically need to contribute around one-third of their salary every year*". [2]

We attach a letter to George Osborne from April 2011, signed by 23 pension experts from the UK, US and Australia, arguing for the use of the index-linked gilt yield, not forecast GDP growth. This received extensive press coverage and we also attach two articles from the Financial Times and Robert Peston's blog.

To maintain its position as the independent and authoritative voice on pensions, we believe the PPI should publish a revised version of the Report, which:

a. discusses the discount rate issues outlined here and in the attached letter to Mr Osborne.
b. includes costings based on ILGs, as well as on the official CPI + 3%.
c. explains the different conclusions which these ILG costings entail.

We would be grateful if you would copy this letter to the Members of the PPI Council and the Nuffield Foundation.

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[2] http://www.hm-treasury.gov.uk/press_120_11.htm

Yours sincerely,

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

Full personal addresses are available on request.

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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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