PENSIONS POLICY INSTITUTE

PPI

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Dear John,

Thank you for your letter of 5th November 2012 regarding the PPI's latest report on the public service pension schemes that the PPI published on 23rd October 2012. Firstly, I would like to reiterate the purpose of the PPI's recent report – its aim is to assess the implications of the Coalition Government's proposed reforms to the public service pensions for the comparative value of the pension benefit that members of the public service pension schemes will receive expressed as a percentage of the scheme member's salary. The report published on 23rd October does not attempt to quantify the cost to the taxpayer of providing the public service pension schemes.

In order to calculate the value of the pension benefit available to members of the public service schemes the PPI has calculated the Effective Employee Benefit Rate (EEBR) of the four largest public service pension schemes. The EEBR takes account of the main characteristics of the public service pension schemes such as whether the pension benefit is linked to final salary or career average salary, the accrual rate and indexation arrangements and the extent of member contributions that are required.

In order to compare the value of pension schemes that pay out benefits over different timescales, future pension payments need to be discounted back to a present value. As you note in your letter, the Government undertook a consultation exercise on the discount rate that should be used to set employer contributions to the public service schemes during 2011. The PPI provided a response to the Government's discount rate consultation exercise which was published in March 2011 and which is publicly available on the PPI's website www.pensionspolicyinstitute.org.uk.

The PPI's consultation response proposed that the discount rate that the Government should use in setting the rate of employer contributions to the public service schemes is one which approximates the expected return on the assets which underpin the public service pension schemes. In the case of

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unfunded public sector pension schemes, the assets which effectively pay for the future pensions of public service workers are expected future tax revenues. As tax revenues are linked to the growth rate of the economy as a whole, PPI proposed that the Government adopt an approach to the discount rate which approximates expected GDP growth. As you note in your letter, this is the approach that the Government ultimately adopted, with the Government's latest estimate for the discount rate on this basis of CPI + 3%.

In the PPI's latest research to assess the value of the pension benefit to public sector employees after the Government's reforms we have used a discount rate of CPI + 3%. This approach ensures that the discount rate used in valuing the public service pension schemes in the research is consistent with the rate that is used to set employer and employee contribution rates in the public service pension schemes in reality. Our approach to setting the discount rate for this project was reviewed and agreed by the PPI's methodological advisory group which had a broad membership including representatives from actuarial firms, unions, public service pension funds, academics, PPI Council and the Government. No member of the group suggested that we should be using a discount rate linked to index-linked gilts for this project. As a result, the PPI does not propose to update the report using a discount rate linked to index-linked gilts.

The calculation for the private sector defined benefit comparator scheme also uses a discount rate of CPI + 3%. This is because we are seeking the value of the scheme to a public sector worker <u>if they were to be offered a final salary defined benefit pension scheme in the public sector</u> that had similar scheme characteristics to the defined benefit schemes most commonly offered in the private sector. The full details on the private sector DB comparator are set out in Table A6 in Annex 2 of the report.

I would be very happy to discuss this matter further on the telephone or face-to-face. I have circulated your letter to the PPI Council and have copied my reply to the Nuffield Foundation and to members of the PPI Council.

Yours sincerely

N.L. Cleal

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Director

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