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Public Service Pensions: Consultation on the discount rate methodology

I am writing as the Chair of the Firefighters' Pensions (England) Scheme Advisory Board (SAB) in response to HMT's consultation on the SCAPE discount rate methodology. Thank you for the opportunity to respond. The SAB has already submitted a number of technical questions to HMT for the engagement session held on 28 July 2021 and this response should be read in conjunction with those questions. I have attached these questions as an appendix for ease of reference.

The SAB recognises the advantages of having stability of the discount rate used for funding purposes and note that this has been a feature of the Social Time Preference Rate (STPR) to date. We would therefore support a move back to a STPR-based discount rate, perhaps modified to ensure that it is suitable for pension scheme funding.

Our responses to the individual questions are set out below.

I hope the responses are helpful; if you have any questions, please do not hesitate to contact me.

Yours faithfully

Joanne Livingstone
Chair of the Firefighters' Pensions (England) Scheme Advisory Board

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Response by the Firefighters' Pensions (England) Scheme Advisory Board

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.

We agree that the objectives reflect the issues which need to be considered. We welcome particularly the increased emphasis on stability. This latter objective can be tangibly measured, unlike the other two and we think that Fire and Rescue Authorities (FRAs) need this stability in their operational budgets. Frequent reductions to the SCAPE discount rate pose considerable challenges to budgeting, for example the 8.1% rise in employer rate which took place for this reason from the 2016 valuation. If this were to continue it would be vital that appropriate levels of funding are provided to avoid significant cost pressures on employers resulting in inevitable reduction in frontline services.

We are concerned that the 'transparent and simple' objective is no longer present as an explicit objective in the proposed objectives as it was in the 2010/2011 SCAPE review. While we understand that there are overriding principles for this transparency and simplicity elsewhere, it is important that the review of the SCAPE discount rate methodology is conducted bearing these wider objectives in mind.

This is particularly important if future SCAPE rates are based on STPR (which is set by Treasury) rather than being based on GDP (which is set by the OBR), not least from a presentational point of view.

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.

We have no further comments on the use of a GDP-based or STPR-based SCAPE rate for the discount rate.

However, the SAB believes that consideration should be given to the principle that if the discount rate changes at this review, or any subsequent review, this should be reflected by a rebasing of the notional assets for the public service pension schemes.

Previous increases to the value of past service liabilities arising from falls in the discount rate have led to the creation of notional deficits, which has

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contributed significantly to the volatility of contribution rates. Rebasing the assets to allow for changes in the discount rate would reduce this effect. In the private sector, pension schemes can use “matching” assets to hedge liability movements arising from interest rates changes – rebasing the notional assets in public service pension schemes when the discount rate changes would replicate this immunisation.

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?

There are some advantages to having a GDP-based approach, such as its perceived objectivity and the fact that expected long-term GDP growth can be considered a proxy for the growth in the future tax base.

However, the above advantages are potentially outweighed by the areas where the approach fails the stated objectives:

- It is unstable (as evidenced by three changes over the last decade), which has an immediate impact on the ability of FRAs to plan, budget and to deliver key services.
- Whilst a GDP-based discount rate could be argued to produce a more accurate financial appraisal of the costs than a STPR-based discount rate, the instability inherent in a GDP-based discount rate has resulted in employers paying significantly different costs for the benefits accruing depending on the time at which the benefits were accrued. This does not appear to meet the objective of being a fair reflection of costs from employers and scheme members perspective.
- As mentioned in our response to Question 2 above, when the discount rate is changed this leads to the creation of notional deficits (or surpluses if the discount rate increased), which has contributed significantly to the volatility of contribution rates. Changes to the SCAPE discount rate appear to happen more frequently under a GDP-based discount rate than was previously the case with the STPR-based discount rate.
- Although the SCAPE discount rate is not scheduled to change until 2024, based on current forecasts of GDP, retaining a GDP-based discount rate would likely mean a significant increase in the costs of the public service pension schemes, with current GDP forecasts suggesting that the SCAPE discount rate should reduce from 2.4% pa above price inflation to 1.8% pa above price inflation – this could increase costs for the FPS by over 20% of pay.

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- Despite the link to the tax bases, it is not clear that the GDP approach delivers against the objective of "reflecting the future risks to Government income". The GDP approach does not contain any element of time preference, unlike the STPR approach. We note that in the 2010/2011 consultation respondents did not believe that the time preference element was inappropriate.

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 SAB recognises that there are some potential disadvantages to the STPR approach:

- Potentially less aligned with expected growth in the future tax base (although the STPR does contain a GDP element).
- STPR is set by HMT, so is potentially less independent than the current GDP-based discount rate which is set by the Office for Budget Responsibility (OBR).

However, the SAB believes these are outweighed by the advantages, primarily:

- It meets the primary objective of stability. STPR has remained at 3.5% pa for over 20 years.
- Consistency with the discount rate used to appraise other uses for long-term public spending (including State Pensions).
- It was the methodology used before the 2010/2011 SCAPE review, before being replaced by the GDP-based discount rate partly because this method was deemed to be a better reflection of costs. However, it is not clear that an approach used for financial appraisal is the most appropriate way to balance the various objectives for this review. We note that the STPR is currently 3.5% pa above price inflation, reducing to 3.0% pa for cashflows after 30 years and 2.5% pa after 75 years. Allowing for this, and the proposed removal of the catastrophic risk element, would result in a SCAPE discount rate of around 2.4% pa – which is broadly the same as the current SCAPE discount rate. This consistency of the SCAPE discount rate in absolute terms with the current SCAPE discount rate is desirable, but any modification of STPR to ensure it is suitable for pension scheme funding (for example, removal of the catastrophic risk element) needs to be transparently justified.

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In addition, we believe that the margins between the modified STPR and the long-term GDP approach should be kept under review to ensure that the use of the modified STPR rate is not unfairly disadvantaging different generations of taxpayers. We do not think that this would be the case at the current time based on the latest OBR estimates and the current need to finance the legacy schemes.

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

Our view is that the advantages of the STPR-based discount rate outweigh the disadvantages, and we are therefore supportive of a STPR-based discount rate going forwards.

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

The interaction between the SCAPE discount rate and actuarial factors is an important issue for the SAB, given its potential impact on member benefits through commutation rates, and other actuarial factors.

We note that, for the FPS, the Government Actuary determines the approach for a number of these factors. We therefore believe that it will be important that the choice of discount rate underlying these factors is carefully and transparently reviewed.

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

We support the alignment of the SCAPE discount rate reviews with the scheme valuation cycle.

We would suggest that, if the STPR-based discount rate is used, then the regular check should potentially lead to a review of the methodology if the difference between the GDP- and STPR-based methodologies has become too wide. It may also be helpful to consult more widely on the approach used to setting other related assumptions within the valuations, such as the short-term financial assumptions and long-term salary assumption once the SCAPE discount rate methodology has been set at each valuation.

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Appendix: Questions on the proposed reforms to the discount rate methodology

1. What has happened to the transparency and simplicity principle?

2. In your review from 2010/11 you concluded that the STPR was an economic appraisal methodology and that you felt it appropriate to use the GDP as being a financial appraisal methodology. Why has this changed? Are Treasury of the view that their estimates for long-term GDP growth are more suitable for valuation purposes than the figures produced by the OBR (which would appear to be the case if STPR is adopted) and, if so, what is the reason for this view?

3. You are consulting on the removal of the catastrophe element from the STPR. Is this a recognition that, in contrast to the position where STPR is used to compare money being paid out now with future returns (where putting a lower value on those returns for risk may be prudent), obtaining a lower value for discounting pension liabilities is less prudent?

4. The time preference element is not discussed in the consultation, but we understand that this element represents the prioritisation of current versus future taxpayers. What is the HMT view of the use of the time preference element for pension scheme liabilities? Do HMT think that the inclusion of such an element no longer represents the risk to the taxpayer noted by some respondents to the 2010 consultation, since longer term the cost of public sector pensions should fall following the reforms and the amortisation of extra legacy and remedy costs. If so, do you now believe that if the GDP approach were to be retained, it should include an additional time preference element?

5. If the GDP approach is retained in its current form, do you think that the notional asset should be rebased to reflect any change in interest rate methodology (commensurate to how the notional assets might have moved)?

6. Are you expecting to consult on the setting of other related assumptions such as salary growth? If a long-term rate of discount is used and stability is prioritised, will there still be short term assumptions for pension increases and salaries?

7. The change in discount rate could impact on the derivation of factors for the 1992 commutation factor and more generally or early and late retirement factors. What principles will be used by the Government Actuary in deciding

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on the appropriate way to determine the discount rate for this purpose and will HMT be discussing these principles with the GA?

8. You are consulting on aligning the reviews of the SCAPE discount rate with the scheme valuation cycle. Would such a review cover the full methodology or just the values of the components?

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