The Actuarial Profession
making financial sense of the future

30 July 2010

Mr John Hutton
Independent Public Service Pension Commission
1 Horse Guards Road
London
SW1A 2HQ

Dear Mr Hutton

I am writing on behalf of the Actuarial Profession in response to your call for evidence as the Chair of the Independent Public Services Pensions Commission. The Actuarial Profession represents the members of the Institute and Faculty of Actuaries, the chartered professional body for actuaries in the UK, and regulates those members for the benefit of the outside world.

One of the key issues at the heart of the debate on public service pension provision is the perception that the public sector can provide defined benefit pensions at a rate which is much cheaper, and with a better guarantee of delivery, than that provided in the private sector. Central to this is the measure of the cost of providing defined benefit pensions. A key factor in calculating this cost is the discount rate[1] used in the calculation.

The Actuarial Profession has recognised that the issue of discount rates in actuarial work is a matter of great importance and significant public interest. We have therefore established a research project on discount rates and established a cross-practice steering committee to lead the research. The committee will analyse current practice on discount rates; develop a common language and framework to describe current practice; and consider options for reducing diversity of practice and introducing a transparent framework on discount rates.

The first stage of the research project, a report on current practice on discount rates, has been published and a copy is enclosed.

Our research, which will be completed later this year, indicates that a likely framework for establishing the most appropriate discount rates to use in actuarial work will embrace two broad approaches. We welcome the opportunity to draw the initial findings of our research to the attention of the committee.

a) **Matching calculations** - where the liability is valued by reference to market instruments or models which match the characteristics of the liability. An example of

[1] The discount rate is a measure of the "time value" of money. The "time value" of money can be illustrated by considering £100 being invested today in an account paying 5% interest for one year. At the end of the time period, one year in the future, it will be worth £105. Therefore, £100 today or £105 in a year's time have exactly the same "time value" to someone using a discount rate of 5%. Costs payable over a large number of years, such as the costs of paying a pension, are each "discounted" and then added together to give a lump-sum "present value" of the total costs, sometimes called the costs stream.

this would be when the discount rate is established by reference to an equivalent matching asset. This means considering appropriate market rates (an appropriate reference rate might by the interest rate on Government bonds) adjusted, as appropriate, for such factors as default risk and illiquidity premium.

b) **Budgeting calculations** - where the measurement of the liability is by reference to how it is going to be financed. An example of this would be when the discount rate is established by reference to the asset portfolio (considering risk appetite and affordability) taking into account the nature of the liability (considering such matters as discretionary benefits and guarantees) and margins for prudence. The yield on the reference asset portfolio might then be adjusted for factors such as credit defaults and future expectations for growth.

When considering the financing of public sector pensions, it will be important to consider whether a matching calculation framework or a budgeting calculation framework is the more appropriate. As our research shows, the choice of framework should depend on the purpose of the calculation.

For example, the Government currently uses “the social time preference rate” as a discount rate in its budgeting calculations when considering long term liabilities and how society values the present compared to the future. The implication is that the Government considers that this particular discount rate is appropriate in the calculation of how accrued pension liabilities might be financed by the Government over the very long term. Following this consultation, the Government may wish to consider whether or not it still holds that view.

There are limitations to the use of budgeting calculations. In particular, the use of a matching calculation of the public sector pension costs could be more appropriate when:

a) assessing the ongoing employment cost of providing such a benefit

b) cross charging employers for the cost of pension benefits

c) calculating the cost of early retirements or enhancements to benefits

d) calculating the cost of buying "added years" of pension.

It is not for the Actuarial Profession, which is the professional body for training and regulating actuaries in the public interest to have a view on the level and generosity of benefits that are provided to public sector workers. However, we believe we have a role in pointing out a strong public interest need for appropriate measurement of the cost of such benefits.

These are complex matters and therefore might be better covered in a discussion. We would be happy to provide any such further assistance as the Pension Commission may wish.

Yours sincerely

Caroline Instance
Chief Executive
The Actuarial Profession