Financial Reporting Advisory Board Paper

Discount rates update

Issue:	This paper provides an update on the provisions discount rate options following consultation with departments.
Impact on guidance:	No impact on the FReM. Any updated rates will continue to be published in the Public Expenditure System paper in December.
IAS/IFRS adaptation?	No, this is a methodology paper on how to apply the existing discount rate requirements in the accounting standards.
Impact on WGA?	No impact at this stage, any changes to the methodology will be reflected in the following years' accounts.
IPSAS compliant?	Yes. IPSASB have an active Public Sector Measurement Project, which will consider the issue of discount rates.
Interpretation for the public sector context?	No
Impact on budgetary and Estimates regimes?	As per existing policy. Estimates would continue to show changes in balances derived from discount rate changes.
Alignment with National Accounts	No - National Accounts exclude provisions and unfunded defined benefit public sector pension obligations.
Recommendation:	HM Treasury welcome the Board's views on: (1) The consultation feedback from departments (2) The options identified and the Treasury assessment of each (3) A steer on which option to pursue for the annual update
Timing:	HM Treasury will use the steers from the Board to inform the discount rate update in December. Any change in methodology will require consultation with ministers.

Introduction

1. At the June FRAB meeting the Treasury updated the Board on the discount rate project. It was agreed to focus on the methodology for deriving the provisions discount rate as this was where concerns had been expressed regarding the appropriateness of the current rates. The project objectives agreed with the Board were as follows:

Objectives of the discount rates review
To review the extant discount rate methodology in consultation with the FRAB, aligned to IFRS as well as the public sector context.
To calculate a discount rate that is based on an appropriate assessment of a risk-free rate, reflecting the time value of money.
Understand the methodologies for setting discount rates used elsewhere in government and any links to the rates set by HMT Treasury to value liabilities e.g. options appraisal, compensation payments.
Objective consideration and assessment of all available options, ensuring proposal can be benchmarked against private sector approaches to ensure comparability and credibility.

2. The current provisions discount rates are based on real government gilt yields on the assumption that these represent risk free investments in line with the requirements of IAS 37. The rates are split between short (less than five years), medium (five to ten years) and long-term (over ten years). Short and medium rates are updated annually, with the long-term rate updated at each spending review cycle (last updated in SR 2015). The current and historic rates are summarised below:

	Short	Medium	Long	Notes
2011-12	-	-	2.20%	Only one rate used pre 2012-13
2012-13	-1.80%	-1.00%	2.20%	
2013-14	-1.90%	-0.65%	2.20%	
2014-15	-1.50%	-1.05%	2.20%	
2015-16	-1.55%	-1.0%	-0.80%	Long-term rate updated as part of SR 2015
2016-17	-2.70%	-1.95%	-0.80%	No change to long-term rate pending DR review

International Developments

3. Discounting continues to be debated by the International Accounting Standards Board (IASB) and the European Financial Reporting Advisory Group (EFRAG). The IASB project on discount rates has been active since 2014, but they did conclude at their March meeting that no further work would be undertaken on their research project. They are planning educational sessions to discuss low or negative interest rate environments. EFRAG has expressed interest in doing further work on discounting and discussed the topic at their April meeting. The IASB have since indicated the work should continue and have asked their staff to undertake further analysis.

4. IPSASB are considering their draft strategy and workplan for 2019-23 and discount rates are likely to feature in their Public Sector Measurement Project. The issue of discounting long-lived assets and liabilities in low and negative interest rate environments has been raised as a matter of concern. The Public Sector Standard Setters Forum in July 2017 also raised this issue during the session on prioritising projects for the IPSASB workplan. Therefore, it is likely that IPSASB will undertake further analysis in this area, but not until 2018 at the earliest.

Consultation with Departments

5. The Treasury has consulted with departments on the provisions discount rate, setting out the options discussed at the June FRAB meeting and asking the following questions:

   - Are there any risks associated with your provisions' liability that you do not reflect in your cashflow forecasts that might impact on the appropriateness of the discount rate? If so, why? If not, why not, and what alternatives do you propose?
   - How does your department treat inflation when valuing provisions?
   - Do you agree with the issues identified above when considering the impact of discount rate changes on provisions? If so, why? If not, why not, and what alternatives do you propose?
   - Do you have any comments on the appropriateness of the above options in setting the general provisions discount rate?
   - In your view are there any other options we should be considering which we haven't identified above? If so, what? If not, why not, and what alternatives do you propose?
   - Do you have any further comments on the options set out above, particularly on the assessment criteria?

- Which is your preferred option for the provisions discount rate? Please explain why.
- Do you have any other comments on the general provisions discount rates not mentioned above?

6. The responses received covered 75% of total provisions reported in the 2015-16 Whole of Government Accounts and included the departments responsible for clinical negligence and nuclear decommissioning, the two largest government provisions.

7. The Treasury asked the first question on risks to the liability to test the assumption that the rate should be risk free. All departments confirmed that all other risks were incorporated into their cashflow forecasts so it was appropriate to use a risk-free discount rate, confirming the Treasury assumption.

8. Most departments do not use inflation in their cashflow forecasts and therefore apply the real discount rates provided by Treasury. NHS Resolution (responsible for clinical negligence claims) do apply inflation to their cashflows and convert the Treasury provided rates into nominal values. Their inflation methodology differs for the projection of different types of expected expenditure and includes an explicit prudence margin of 0.3% to reflect the uncertainties underlying the claims estimates. To convert to nominal rates, they use RPI projections.

9. All departments confirmed the presentational difficulties associated with fluctuations in the discount rate and continuing to use negative real rates. There was concern that this can have a real economic impact, for example the recent change in the Personal Injury Discount Rate (from 2.2% to -0.75%) had increased the actual claim settlement values. It was accepted that the presentational difficulties could be mitigated to some extent by adding a more detailed narrative that explained this impact, perhaps by referencing movements in the undiscounted cashflows. One department suggested Treasury should provide a standard narrative on how discounting affects liabilities. We do not feel this is appropriate, but do accept we could share good practice across departments, to help build wider understanding and consensus on the impact of discount rate movements.

10. Responses to the remaining questions have been incorporated into the assessment of the options in the next section.

11. There were several other comments and reflections raised during the consultation that are summarised below for the Boards interest and consideration.

- The Department for Business, Energy and Industrial Strategy (BEIS) have raised the further option of introducing a zero-rate floor on the discount rate.
- It has been suggested that we use the Bank of England interest rate as a proxy for the discount rate. However, we do not view this as a risk-free rate as required by IAS 37.
- Whilst stability is seen as an important issue, but keeping discount rates static for a period potentially creates large fluctuations when they are eventually updated. It was suggested that more frequent updates to the long-term rate would enable users of the accounts to become more familiar with the movements and impact of a change in rate.
- Any changes in methodology will require ministerial agreement prior to implementation. The views of the Board on the available options will inform our advice.

Assessment of options

12. The departmental feedback has been included in the assessment of the options below. This table reflects previous papers to the Board and feedback on the options from departments

Option	Advantages	Disadvantages
Maintain Status Quo	• IFRS compliant • Based on government gilts and therefore risk free • Consistency with methodology agreed at previous Board meetings	• Publication of real rates has been temporarily suspended by Bank of England • Leads to negative rates • Impact increases over longer durations • Does not address the underlying issues
Provide nominal rates only	• IFRS compliant • Based on government gilts and therefore technically risk free • We could use an RPI assumption to convert back to real rates if required	• Requires all departments to come up with forecast inflation assumptions • Consistency issues and cost implications • Most departments are against this option due to issues on determining inflation assumption

		(although Treasury could provide a central assumption)
Use a broader pool of gilts	• IFRS compliant • More reflective of a market rate • Could mitigate short term fluctuations in long term rate	• Question over whether it reflects a risk-free rate • Yes, it reduces market risk but not counterparty risk (government gilts can still be considered the only pure risk free financial instrument) • Difficult to assess which pool of gilts would be appropriate (government provisions are not backed by asset investments) • Technically challenging to calculate
Use a recognised index (such as SONIA or BOE interest rates)	• IFRS compliant • Reflects a market assessment of the time value of money • SONIA specifically derived to be a risk-free rate and used in financial markets	• Only intended to be used as an interest rate benchmark • Vitality in the underlying index as updated daily. • SONIA is potentially moving to a new basis from 2018 so may not be a stable methodology
Weighted average cost of capital	• IFRS compliant • Common approach in the private sector • Easier to understand and explain to users of the accounts	• How to define and calculate WACC for the public sector? • Complex methodology • No other country uses this approach in their public sector
Definite rates specific to each type of provision	• Compliant with IFRS assuming it was based on market rates • Rates reflect the specific liability	• Highly complex and subjective • Lack of consistency across government • Costly to administer and review

Use an average based on historic rates	• Potentially compliant with IFRS • Minimises the impact of short term fluctuations in gilt rates • Consistent with our approach on the financial instruments discount rate	• Conceptual issues – how is it different to WACC? • Are we still in unique circumstances post financial crisis, therefore a historic average is less useful? • Could be complex to define and maintain the methodology

Summary of options against review objectives

13. As explained in paragraph (1) Treasury agreed the objectives for the provisions discount rate review and it is important to test all the identified options against these criteria. The table below summarises our assessment of compliance to the objectives to facilitate discussion on the preferred option.

	IFRS compliant?	Risk Free?	Private Sector Comparative
Status Quo	Yes	Yes	Some
Nominal Rates	Yes	Yes	No
Broader pool of gilts	Yes	Yes – from a market perspective	Yes
Use a recognised index	Yes	Yes	No
Weighted average cost of capital	Yes	Yes	Yes
Rates specific to provision	Yes	Yes	No
Average based on historic rates	Yes	Yes	Yes

Conclusion

14. The FRAB are asked for their views on:

- The comments raised during the consultation process
- The options analysis set out in this paper
- The summary of the options against the review objectives

- Any conclusions on which approach to take forward

HM Treasury
16 November 2017