DISCOUNT RATES FOR PENSION LIABILTIES AND PROVISIONS: FUTURE APPROACH

Issue: Discount rate to be used for measuring pension liabilities and provisions. Revised Treasury proposal to base the rate for pension liabilities on AA corporate bond rates (more in line with FRS 17).

Action: The Board's approval is requested to the proposed approach.

Timing: To take effect from the 2004 spending review and 2005-06 accounts.

DETAIL

Position reached at FRAB 59 - 4.11.02

1. At its 4th November meeting the Board agreed:

   a. For pension liabilities:

   i. The real discount rate (previously agreed by the Board to be based on index linked gilts) should be reviewed every two years to fit in with biannual spending reviews (SR). For example, the rate fixed in SR 2004 will apply to accounting years 2005-06 and 2006-07.

   ii. Until then accounts will continue to use the existing real discount rate of 3.5% - ie for 2003-04 and 2004-05.

   iii. Where it is different to the discount rate used in the accounts, the latest discount rate should be disclosed in notes to the accounts – eg the 2004-05 accounts will use the current 3.5% and disclose the revised rate arising from SR 2004.

   iv. If there were exceptional circumstances – structural changes (eg firm decision to join the euro) giving rise to significant changes in market conditions between formal reviews of the discount rate – the latter would be reviewed.

   v. A steer should be given on the considerations to be taken into account in setting the discount rate. The FRAB wished to be involved in development of the steer.

   b. For provisions:

   i. The same discount rate as for pension liabilities (above) should be used with effect from 2003-04.

Informal discussion

2. The Treasury discussed the discount rate further, informally, with some members of the Board: [redacted]. Views emerging from this discussion were:

    a. The discount rate should be determined from an average (mean or median?) of actual rates going back no more than two years.
    b. Rounding should be to the nearest 0.1 % rather than to the nearest 0.5%.

Revised Treasury proposal

3. Following this discussion the Treasury looked again at its proposals and concluded that it would be preferable to move closer to FRS 17 *Retirement benefits* by basing its discount rate for pension liabilities on the AA corporate bond rate envisaged by the FRS rather than on the return on index-linked gilts as previously proposed. FRS 17 specifies the AA bond rate, rather than a risk free rate, to reflect the ability of an employer to reduce its liability (ie the AA bond rate, being higher than a risk free rate, produces a lower value of the liability).

4. The previous Treasury proposal was based on the presumption that it would be possible to achieve a high degree of stability in the real rate by taking a long-term view of the cost of government borrowing. It had envisaged keeping the discount rate for financial reporting and for determining employer contributions in line such the accounts would reveal how far employers were bearing the cost of pension commitments. The Treasury now recognise the strong feelings in the FRAB against building in a higher degree of stability to the discount rate than is necessary to deliver orderly budgeting over an SR cycle and the wish of the FRAB to reflect the intentions of the FRS as closely as practical. Reporting using a discount rate based on the AA corporate bond rate would have the advantage of enabling ready comparison with the private sector. While it could be argued that a risk free rate was more appropriate for government because its ability to reduce its pension liabilities are less than in the private sector, the Treasury recognises that the approach taken in FRS 17 of using the AA bond rate is a rather broad brush one intended to accommodate different levels of discretion that exist for different scheme liabilities. Appendix IV to the FRS acknowledges that, in principle, the premium over the risk free rate should vary from scheme to scheme, reflecting the different levels of discretion; but notes that in the interests of objectivity and international harmonisation the ASB decided to adopt a standard discount rate - the AA corporate bond rate.

5. For these reasons the Treasury would prefer to use a rate based on the AA corporate bond rate for discounting pension liabilities. The Treasury wishes to retain the concept, agreed by the Board in November, of fixing the rate every two years at each SR – for budgeting reasons explained at the Board's November meeting.

6. For discounting provisions, however, the Treasury proposes to stick with the proposed use of a rate based on the return on index-linked gilts. This would be compatible with FRS 12 *Provisions, contingent liabilities and contingent assets*. Basing it on the AA corporate bond rate would not be compatible with this FRS. As with the rate for discounting pension liabilities the Treasury wishes to retain the concept of fixing the rate every two years at each SR.

7. In conclusion, the Treasury proposes:

   a. Two real discount rates:

      i. For pension liabilities: a rate based on the AA corporate bond rate.

      ii. For provisions: a rate based on the return on index-linked gilts.

   b. Both discount rates:

      i. To be fixed every two years at each SR as in 1a i above. They would take effect from 2005-06 (ie the first year covered by SR 2004). Until then 3.5% will continue to be used (ie continuation of GAD's rate for discounting pension liabilities, and continuation of the cost of capital rate for discounting provisions).

      ii. To be based on an assessment of the typical rate over a period of, say, three months in order to avoid locking in to a rate which was unusually high or low on one particular day, and rounded to the nearest 0.1%.

      iii. As with the previous proposal, where it is different to the discount rate used in the accounts, the latest discount rate should be disclosed in notes to the accounts – eg the 2004-05 accounts will use the current 3.5% and disclose the revised rate arising from SR 2004.

      iv. The review would set a real rate for the SR cycle – inflation would be a forecast in Estimates and actual uplift in the liabilities for the financial reports.

8. The Board is asked to endorse the above approach.

6.3.03