FRAB 128 (10)
24th November 2016

HM TREASURY

Financial Reporting Advisory Board Paper

HM Treasury discount rates policy – discussion paper

Issue:	This paper provides the Board with indicative discount rates to be used in 2016-17. HM Treasury welcome the Board's views on whether there is an appetite to review the discount rate methodology to address concerns with the current negative rates.
Impact on guidance:	No impact on the FReM. The updated rates will be published in the Public Expenditure System paper in early December.
IAS/IFRS adaptation?	No
Impact on WGA?	No impact at this stage.
IPSAS compliant?	Yes
Interpretation for the public sector context?	Yes
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 whether there is an appetite to review the discount rate methodology to address concerns with the current negative rates. If the review is agreed, HM Treasury also seek Board approval to delay updating the long-term provisions rate by one year.
Timing:	In the interim, rates will be updated in line with existing policies.

Introduction

1. At the FRAB meeting in **June 2015**, HM Treasury presented a paper on discount rates and confirmed that it had decided to maintain its existing policies on discount rates, including the policy agreed by the Board in 2011[1] for provisions.
2. In addition to the normal annual updates to the rates for post-employment benefits and short and medium term provisions, which are set in good time for the Supplementary Supply Estimates, the rate for long term provisions was updated for 2015-16 as part of the Spending Round 2013. This rate is set at each Spending Review, using the methodology previously agreed with the Board, so theoretically should be updated for Spending Review 2015, which sets budgets for 2016-17.
3. This paper provides the Board with indicative short-term and medium-term updated rates to be used in 2016-17. HM Treasury welcome the Board's views on whether there is an appetite to review the discount rate policy and potentially introducing a floor for the real discount rate at zero when the methodology results in negative rates.
4. HM Treasury are also proposing to delay updating the long-term provisions' rate by one year, due to the time and analysis required to undertake the above review and share conclusions with the Board. The long-term rate was recently updated in November 2015.

Background

5. In **April 2014** HM Treasury presented a paper[2] to the Board that considered from first principles its objectives in the use of discount rates in financial and other reporting. The aim was to assess whether the current approach is fit for purpose following feedback from the 'Simplifying and Streamlining of Accounts' project (SSA), as well as PAC comments that users find the use of different rates and frequent changes in those rates confusing.
6. At the time HM Treasury proposed that where the FReM currently permits discounting of non-financial liabilities (i.e. those outside of the scope of the financial instrument standards) to adjust for the time value of money (as is the case for provisions and post-employment benefits), **that future cash flows expressed in current prices should be discounted based upon OBR forecasts of long term real GDP growth**, as a general measure of the public sector's changing capacity over time to meet obligations.

[1] http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/frab109_09.pdf

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/312808/FRAB__120__04_-_Discount_rates.pdf

7. The Board were unsupportive of this approach predominantly because of the views of several members that:

    - this would constitute a departure from IFRS;
    - any changes should have reference to the measurement objectives within accounting standards;
    - the proposal may actually introduce volatility; and
    - improved disclosures on the effected balances could help users understand more clearly the impact of discount rates.

8. HM Treasury presented another paper[3] to the Board in **March 2015**, expanding further on the above proposed option. The paper addressed in more specific terms HM Treasury's proposed adaptions, in respect of IAS 19 *Post-employment benefits* and IAS 37 *Provisions*, and why they would be appropriate in the public sector context. The paper also provided two further options in light of previous feedback from Board members:

    - **an adaption to the FReM to set the real discount rate at zero** (for the time value of money) where the rate is already set by HM Treasury under existing interpretations of IAS 19 and IAS 37; and
    - **a presentational change to a gross and net (of discounting) presentation of these non-financial liabilities** on the face of the Statement of Financial Position, to show more clearly the effect of discounting.

9. At the **March 2015** meeting, the Board were generally supportive of the principle of harmonisation of the two rates but at the time did not see a strong case for adapting IFRS as outlined in HM Treasury's lead option, nor was the Board supportive of the two further options considered. The general consensus was that the existing approach struck the right balance between IFRS compliance and adaptations necessitated by the public sector context.

10. At the **June 2015** meeting, HM Treasury presented a paper[4] to the Board concluding to continue with the existing policies on discount rates, including the policy agreed by the Board in 2011 for provisions, and in light of this updating the long term provisions rate in 2015-16; the year for which budgets were set at the 2013 Spending Round.

Overview of methodology

11. **Provisions:** The discount rates are based on market data in accordance with IAS 37 which requires a pre-tax rate that reflects current market assessments of the time value of money. Where departments use this rate they are expected to have already

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/427698/FRAB_123_04_Discount_rates.pdf
[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/448922/FRAB_124__3__Discount_Rates.pdf

adjusted for the other risks through adjustments to estimates of future cash flows. Therefore the rate represents a risk free rate and a market assessment of the time value of money. The market rates are published by the Bank of England on a daily basis and are subject to prevailing market conditions[5].

12. **Post-Employment Benefit Obligations:** The FReM complies with IAS 19 which requires that the rate used to discount post-employment benefit obligations (both funded and unfunded) is determined by reference to market yields on high quality corporate bonds. In practice, the rate for unfunded schemes is derived from a 15 year spot rate on an AA corporate bond index with adjustments to bring the bond duration up to 15 years by extrapolation based on UK Government bonds, and appropriate adjustments to reflect that pensions are uprated by CPI not RPI. This methodology was developed with the support of the Government Actuaries Department.

Indicative updated 2016-17 rates

13. The rates are reflective of the yields on index linked gilts:

Post-employment benefits		
	2015-16	2016-17*
Real Rate	1.37%	0.00%

* Indicative rates based on data at 28/10/2016

Provisions		
Real Rate	2015-16	2016-17*
Short-term	-1.55%	-2.70%
Medium-term	-1.00%	-2.10%

* Indicative rates based on data at 28/10/2016

14. The new rates will be published in the normal way through the Public Expenditure System paper in early December. The paper cannot be published sooner because it uses market data as at 30th November in accordance with the accounting policy agreed with the Board.

15. In addition to the normal annual updates to the rates for post-employment benefits and short and medium term provisions, the rate for long term provisions should be updated in 2016-17. The long term rate is set at each spending review, so theoretically is due to be updated for Spending Review 2015 which sets budgets for 2016-17.

[5] http://www.bankofengland.co.uk/statistics/Pages/yieldcurve/archive.aspx

16. HM Treasury are proposing to delay updating the long-term provisions' rate by one year, due to the time and analysis required to undertake the proposed review to the discount rate methodology. The long-term rate was last updated in November 2015 and HM Treasury are seeking to limit unnecessary volatility in departmental budgets and accounts until the review on the methodology has concluded.

Review of existing policy

17. The use of discount rates is important in financial reporting, as in actuarial and other economic measurement systems, to reflect the time value of money. The aim of the accounts is to give a fair picture of present value, to reflect what would rationally be paid to settle the liability at the year-end, and without discounting this would not be possible. The higher the discount rate, the lower the liability present value will be when it is applied. Conversely, a decrease in the discount rate leads to an increase in the reported liability. This does raise a conceptual question, **are negative discount rates reflecting a fair picture of present value?**

18. For those departments with significant provisions the change in rates, particularly the long term rate, will have a significant impact on the size of the provisions in their accounts and the level of non-cash budget cover they require. When the rate was updated in **December 2015** for the 2013 Spending Round, which set budgets for 2015-16, a number of departments were confused by the rate changes and expressed concern that the changes were not as expected.

19. In 2016 HM Treasury received feedback from preparers on the first year (2015-16) of implementing the Simplifying and Streamlining of Accounts' (SSA) agenda. A departmental preparer voiced the difficulty of simplifying the discussion of the effect of changes in the discount rates for the users of the accounts.

20. In addition the Chair of a departmental Audit and Review Committee challenged the complexity of the narrative on discount rates in the accounts, particularly from the perspective of a user without specialised knowledge of the subject.

21. The NAO also provided some feedback on the application of the SSA agenda in 2015-16. As a part of this feedback they commented that a number of bodies affected by the move to negative discount rates for provisions did provide some clear commentary in this area. The NAO encourage bodies to critically assess the risk they face and ensure these are incorporated in the management commentary.

22. The change in the discount rates in 2015-16 had other unintended effects, particularly, for a department where the change in discount rates did not only

impact the size of their provision but also impacted their in-year and future years' income reported in their accounts and budget.

23. In light of the feedback received as a result of the rate changes, and our own observations that discussions on liabilities are often disproportionately focused on trying to understand the meaning of a liability discounted by a negative discount rate, HM Treasury are asking the Board's views on whether there is an appetite for HM Treasury to review the methodology for discount rates. This will set out a range of options, including introducing a floor for the real discount rate at zero, where the methodology results in a negative rate.

24. Putting a floor on the discount rate will alleviate the complexities in explaining how changes contribute to the overall movement in the liabilities. This will help decision-makers understand and use the analysis contained in the financial statements. It does, however, represent a departure from the established methodology and, if rates remain negative, will result in a significant reduction in liabilities as a result of applying the floor for the first time.

IASB review of discount rate in IFRS

25. In December 2012 the IASB added a research project on discount rates to its work programme. This came about following feedback that the reasons for differences in discount rate requirements under various IFRS is not well understood and could be considered inconsistent.

26. While HM Treasury believes the research project may provide valuable clarity and consistency in the way rates are used in the standards, it does not consider it necessary to wait for the conclusions of this project before proceeding with any changes to its own discount rates policies. This is because the project will not address the public sector contextual issues, which are one of the principal drivers for a proposed change, and because the IASB confirmed in October 2016 that there would not be any discussion on negative interest rates in the discount rate research project, even given the level of interest on this topic.

Recommendation

27. HM Treasury welcome the Board's views on whether there is an appetite to review the discount rate policy and potentially introducing a floor for the real discount rate at zero when the methodology results in negative rates. Additionally, HM Treasury seeks the Board's approval to delay updating the long-term provisions' discount rate for one year until the after the review.