HM TREASURY

Financial Reporting Advisory Board Paper

Discount rates update

Issue:	At the November meeting the Board agreed to a review of the discount rate methodology used by HM Treasury to value liabilities. This paper provides the Board with a project plan for review and identifies issues for consideration and discussion. HM Treasury welcome the Board's views on the scope, objectives and content of the review.
Impact on guidance:	No impact on the FReM. Any 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 the project plan and the objectives of the review.
Timing:	HM Treasury will progress the review and report early findings at the FRAB meeting in June.

Introduction

1. At the FRAB meeting in **November 2016**, HM Treasury presented a paper on discount rates and secured agreement to review it's discount rate policy for valuing public sector liabilities. As a result of this review changes to the long-term provisions rate were delayed by 12 months and will now be updated in November 2017, following the conclusions of the methodology review.
2. This paper provides the Board with a plan for the discount rates review and identifies some initial issues for consideration. HM Treasury welcome the Board's views on the plan and approach.

Overview of current methodology

3. **Provisions:** The discount rates for provisions 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 adjusted for the other risks by adjusting the 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[1].

4. The current methodology results in a negative discount rate for short (-2.70%), medium (-1.95%) and long-term (-0.8%) provisions. As discussed at the previous Board meeting this leads to the current value of the liability exceeding it's total settlement amount. This raises a conceptional question of whether this is reflecting a true picture of the time value of money across the expected settlement periods for the affected liabilities.

5. **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 (GAD).

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

Review of existing policy

6. There are a number of reasons why a review of the extant methodology is considered necessary:

    - **Links to accounting standards:** It can be unclear how the current methodology links to the principles of discounting in the accounting standards. In the presence of negative rates, the present value of an asset or liability would exceed it's recoverable or settlement amount. This appears counterintuitive and may not provide relevant information for readers of the accounts.
    - **Understanding of accounts**: There is confusion across government on how the current methodology derives a negative rate and how to explain the resultant impact on the financial statements. This makes it difficult for readers of the accounts to understand the underlying movements in assets and liabilities.
    - **Scrutiny:** Effective Parliamentary scrutiny may be undermined as an incommensurate amount of time is taken to explain the discounting methodology rather than discussing the substance of liabilities.
    - **Stability:** Significant fluctuations in valuations can make it difficult to identify and respond to underlying movements in liabilities.
    - **Feedback:** Views from the preparer community have highlighted challenges in explaining the discount rate movements. Feedback on the simplifying and streamlining project in 2016 identified the difficulty of discussing the effect of changes in the discount rates for users of the accounts. One audit committee chair challenged the complexity of the narrative on discount rates in accounts, particularly from the perspective of a user without specialised knowledge of the subject in an environment of negative rates.

7. In light of these issues HM Treasury has identified the key objectives for the discount rate review. These will be used to identify and assess the options available for adjusting the methodology.

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 (e.g. investment appraisal, compensation payments) and how these link to the rates set by HM Treasury to value liabilities

Objective consideration and assessment of all available options, ensuring proposal can be benchmarked against private sector approaches to ensure comparability and credibility.

8. **Do the Board agree with the objectives of the review?**

Timing

9. HM Treasury are planning to conduct the review and provide a final recommendation to the FRAB in November 2017 for approval. Key dates are set out below:

- **March 2017:** Report to the FRAB on the plan and scope of the review.
- **June 2017:** Report to the FRAB on initial conclusions of the review seeking tentative agreement to preferred option and identifying any further considerations.
- **Summer 2017:** Consultation with account preparers and users
- **October 2017:** Consultation with Ministers on proposed changes to the methodology and rates.
- **November 2017:** New methodology in place and indicative rates for 2017-18 provided to FRAB for approval.
- **November 2017:** Write to departments informing them of the outcome of the review and new rates in time for Supplementary Estimates.
- **December 2017**: Formally issue paper with updated rates.

10. While HM Treasury believes the timetable is achievable there remains a risk of delay due to unforeseen circumstances. These risks will be managed by the project lead and the FRAB informed of any changes to the timetable or scope of the review. If the changes are deemed significant an update will be sent to the Board for comment as an 'out of meeting' paper.

11. **Do the Board agree with the proposed timetable for the review?**

Stakeholders

12. There are a significant number of internal and external stakeholders who will be interested in the conclusions of the methodology review. Appropriate consultation with these stakeholders is key to ensure a successful implementation of any changes to the current approach. An indicative stakeholder list is set out below which will inform the consultation process.

Internal	External
- Other Treasury teams (Pay and Pensions, Fiscal Policy) - NAO - Department of Health (clinical negligence) - BEIS (nuclear decommissioning) - Ministers - Other Government Departments - Government Actuaries Department	- EFRAG - IASB - IPSASB - Professional accountancy firms - Accounting institutions

13. Do the Board have futher suggestions for who the Treasury should consult?

Key Issues

14. As with any methodology review there are a number of issues that need to be considered and addressed during the project. HM Treasury has identified initial issues for the Board's comment, summarised below.

15. Negative rates: The existing methodology for provisions leads to a negative rate for both short and long-term provisions. The review will consider whether this is appropriate and reflects the time value of money as required in IAS 37.

16. Scope of project: The key objective is to review the methodology used to determine the discount rate for provisions (long-term and short-term). It seems appropriate to utilise the opportunity to also review the unfunded pensions and financial instruments discount rate. This will help facilitate a consistent methodology (where appropriate) across the public sector balance sheet, but does risk delays in the overall timetable due to the additional requirement.

17. Policy discount rates: It is a clear objective of the review that the discount rate methodology should be aligned to the relevant accounting standards and any interpretations discussed with the Board. Given discount rates are used elsewhere in government and may be affected by changes in the accounting methodology, it appears prudent to take due consideration of these factors in any review. For example, if the review updates the interpretation of a 'risk-free' rate this could have an impact on wider methodologies used in government. Fundamentally, they do have a different purpose, so it may only be necessary to set out these differences clearly in the review as comparatives rather than drivers of the methodology.

18. Annuality versus spending review stability: Another consideration for the review is to determine when the rates should be updated. Currently the provisions

short-term rate is updated annually, with the long-term rate updated at each Spending Review cycle. This choice inevitably means striking a balance between having stability in the rates to inform Parliamentary scrutiny and responding to changes to the rates on an annual basis, potentially smoothing the profile of movements. The advantages and disadvantages will be fully assessed during the review, but HM Treasury consider ensuring consistency across government as the key objective.

19. **Inflation assumption:** The current provisions methodology produces a real discount rate and this is ultimately what leads to a negative value. This may be a realistic situation in some areas (e.g. financial investments), but it remains an issue when valuing liabilities (e.g. provisions and pensions) on a risk free and prudent basis to determine an 'exit price' for the liability.

20. **Unfunded pensions:** These are unique to the public sector as there are no scheme assets to fund the payments as they fall due, rather a deliberate policy choice to fund through current expenditure each year. In this respect they are similar to provisions, where payments are made from current expenditure as the liability crystalises. With this in mind, HM Treasury feel unfunded pension schemes should be part of the review and the same objectives applied to the discount rate methodology. This will ensure the approach for all rates set by HM Treasury (provisions, unfunded pension schemes and financial instruments) are reviewed at the same time, driving consistency in approach, even if the conclusion is to continue with the same methodology.

21. **Do the Board have any comments on the issues set out above?**

Recommendation

22. HM Treasury welcome the Board's views on the questions raised in this paper. This will inform the detailed analysis and review phase that will report to the FRAB meeting in June.

HM Treasury

16 March 2017