HM Treasury

Financial Reporting Advisory Board Paper

Discount Rates

Issue:	Whether discount rates should be updated on an annual basis. .
Impact on guidance:	Yes, if approved by the FRAB. Guidance will be updated via PES papers.
IAS/IFRS adaptation or interpretation?	No.
Impact on WGA?	Potentially, any discount rate changes will have an impact on WGA in the appropriate years.
IPSAS compliant?	Yes.
Impact on Estimates/budgetary regime?	Potentially, any rate changes will have an impact on budgetary requirements.
Alignment with National Accounts (ESA10):	N/A
Recommendation:	General provisions rates are all updated annual from 2021-21.
Timing:	Any changes approved would be published in Public Expenditure System (PES) paper – anticipated from December 2021.

DETAIL

Background

1. HM Treasury publishes, via an annual Public Expenditure System (PES) paper to government departments, discount rates to apply to the following items reported in annual reports and accounts :
    - General Provisions
    - Post-employment benefits liabilities
    - Financial Instruments
    - Leases (under IFRS 16)

2. The **general provisions** discount rates are used to discount future cash flows related to provisions recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

3. The **post-employment benefit** discount rate, applied in accordance with IAS 19 *Employee Benefits,* is used mainly for the financial reporting of unfunded public service pension schemes and early departure provisions.

4. The **financial instrument** discount rate is used for some financial instruments in accordance with the requirements of the Financial Reporting Manual (FReM) and IFRS 9 *Financial Instruments*.

5. The **lease** discount rate is used where entities apply the HM Treasury discount rate promulgated in PES papers as their incremental borrowing rate, in accordance with the requirements of the FReM and IFRS 16 Leases.

6. At the November 2020 board meeting (FRAB 142), the Board questioned the policy for updating general provisions discount rates being linked to a Spending Review (SR) timetable. It noted that, recent economic and fiscal events have resulted in the timing of such SRs having been subject to change and the influence of independent external events. The Board requested that HM Treasury return to the Board with a paper which considers the relevance of this policy going forward. In response, this paper sets out proposals for the Board's consideration.

General long term and very long-term discount rates

7. General Provisions are currently split into four term categories with times frames applied for the inflation of cash flows, so that cash flows are inflated in line with the OBR CPI inflation forecast (full details and current rates can be found in the PES paper – please note this will require a Government One Finance log in):

    - Short (<5 years),
    - Medium (5-10 years),
    - Long (10-40 years); and
    - Very long (>40 years)

8. Long term and very long-term general provisions discount rates have historically been updated, (promulgated via a PES paper), in-line with SRs which typically cover a period of between 3-4 years. SRs set the spending limits for government departments allowing a level of certainty to make long term plans. Rates have been updated in line with SRs to support departments ability to plan over the same period agreed through settlement limits.

9. Given the budgetary implications of a change in discount rates and agreed departmental settlement plans, HM Treasury has maintained its update cycle in-line with SRs. However, since 2019, the government has undertaken single year spending rounds instead of multi-year SRs due to wider economic uncertainty, including from the COVID-19 pandemic.

10. The recent historical pattern of spending review cycles leads to a stronger case for reviewing and updating long term and very long term general discount rates on an annual basis; offering consistency with the update cycle of both short and medium term rates. Moreover, departments have become accustomed to the issue of annual discount rates and plan accordingly on this basis. HM Treasury proposes to permanently adopt an annual update cycle of discount rates moving forward, irrespective of the Spending Review duration. HM Treasury will conduct a light touch consultation with departments with significant provisions, before implementing the change.

11. Given the impact changes to discount rates can have on Supplementary Estimates, HM Treasury proposes to maintain using rates as at 30th November each year as a year-end proxy and as previously agreed with FRAB.

12. If FRAB agrees with the proposal to move to setting general long term and very long-term discount rates on an annual basis, the rates will be updated for 2021-22 and published in December 2021.

Updating the financial instrument rate

13. The financial instrument discount rate aims to be a measure of the government's long term cost of borrowing. The FReM adaptation to apply the higher of the financial instrument rate and the rate intrinsic to the instrument is intended to capture the cost of departmental lending below the government's cost of borrowing. Department's do not shoulder the Exchequer financing costs of their assets, and government debt interest costs are not part of the Supply process (where Parliament authorises government expenditure each year). The rate is representative of the costs of government's financing decisions and it is represented as a single rate using a historic 10 year average of the yield on the mean maturity of gilt stock. It has been expressed with reference to RPI and nominally, as the most significant category of government loans to which it was applied was student loans, which are currently indexed linked to RPI. At present, the rate as applied to flows expressed in current prices is RPI +0.7%, where the financial instrument is index linked to RPI. Where the financial instrument is not linked to an inflationary index, and a nominal rate is required, 3.7% may be used.

14. HM Treasury intends to update the financial instrument rate in 2021-22 and tentatively intends to similarly shift to an annual update of this rate. It will be consulting further with internal stakeholders and the key affected departments to understand the implications of an annual update and return to the Board on this issue in November. The methodology is expected to remain broadly unchanged but advice will be sought from GAD including in respect of the implications of the planned reforms to RPI from 2030[1] and the merits or otherwise of continuing to set a rate with reference to RPI.

Recommendation

15. **The Board is requested to agree the proposed policy change to updating general provisions long term and very long term discount rates on an annual basis from 2021-22**.

16. **The Board notes and provides comment on the Treasury's plans to update the financial instrument rate.**

HM Treasury
24th June 2021

[1] A consultation on the Reform to Retail Prices Index (RPI) methodology