HM Treasury
1 Horse Guards Road
London SW1A 2HQ
www.gov.uk/hm-treasury

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19 October 2023

Dear Accounting Officer

GOVERNMENT FUNDS TO MEET SPECIFIC LIABILITIES

Contact

Please address enquiries on the issues covered in this DAO letter to HM Treasury's Balance Sheet Team: Fiscal-BST@hmtreasury.gov.uk

Action

All Accounting Officers should be aware of the attached new guidance providing further detail on the approach for funding specific liabilities and take appropriate action as necessary.

Context

Most public sector liabilities are not funded in advance by holding assets, consistent with the general principle against funding in advance of need. However, in some cases, holding funds can support financial resilience and transfer financial risk associated with funding the given liability away from the consolidated fund (and so general taxpayers). But, if financial risk is not sufficiently transferred away from the consolidated fund, creating or maintaining a fund in this way increases fiscal risk and is unlikely to be the most financially efficient way of meeting future liabilities.

While this approach is long-standing, the annex sets out new guidance to clarify the government's policy regarding funds for specific liabilities, including when funds can be held against specific liabilities and when such liabilities should be unfunded. In summary:

- government can hold funds for specific liabilities if any financial risk sits outside of the consolidated fund (e.g., if the scheme or its sponsor are funded by a levy on industry or fees), but generally government should not hold or set up a fund when all financial risk explicitly sits with the consolidated fund (and so general taxpayers);
- any decisions relating to funding or defunding should take into account these guidelines, plus any broader issues (e.g., objectives, barriers including legal, fiscal impacts);
- fiscal sustainability should be considered in both funding and defunding decisions.

The guidance will be incorporated into the next edition of Managing Public Money.

David Fairbrother
Treasury Officer of Accounts

Annex: Funding for specific liabilities

The approach to meeting specific future liabilities is governed by the principles set out below. They are intentionally broad to accommodate the range of liabilities this may apply to and the complexities of different cases.

Principles

A. **Funds should only be held to meet specific liabilities if any financial risk associated with the liabilities sits outside of the consolidated fund.** In these circumstances, if assets are insufficient to meet the liabilities, there should be no permanent recourse to the consolidated fund and so general taxpayers. Funds should only be set up if there is a policy rationale and it explicitly transfers risk away from the consolidated fund, which requires the fund's sponsor/controlling entity to have the ability to raise funds independently (e.g., imposing a levy, increasing service fees) and/or have levers to reduce the liability. For example, government-backed reinsurers accumulate funds via a levy on industry, and this fund pays out (rather than the consolidated fund) if a given event crystallises.

B. **If all financial risk and/or levers of control explicitly sits with the consolidated fund, or government would be willing to make this risk ownership explicit where it is not already, the liability should not be funded** (unless there is a fiscal sustainability reason to do so – see principle C). For example, government may provide explicit backing if the sponsor is captive, i.e., cannot raise money via trading or imposing levies. There is an opportunity cost to holding assets in a fund which are invested with the sole objective of having sufficient returns to meet future liabilities and holding funds can create allocative inefficiencies at the whole public sector level. General taxpayers are already exposed to all of the risk, so the liability could be more efficiently managed in the round with other unfunded liabilities, met out of general taxation as they fall due, rather than taking on additional market risk via private sector investment.

C. **Fiscal sustainability should be considered as part of any assessment of defunding an existing scheme, and any concerns may overrule principles A and B.** Whether defunding is fiscally sustainable should be determined by the Treasury. This will be informed by quantitative analysis of future liabilities and associated cash flows and fiscal implications included in the business case. The Treasury's assessment will consider factors such as the size of the liabilities and their profile, whether liabilities are time-limited and the extent to which defunding might create trade-offs with other spend in future years.

D. **Assets from defunding should be transferred to the Treasury**, given the fiscal risk associated with the liabilities sits with the consolidated fund and this allows for optimal allocative efficiency

E. **These principles do not preclude setting up a fund where the rationale strictly relates to fiscal sustainability.** There may be a limited number of cases where there is a wider policy reason for having a fund that does not abide by these principles.

Assessing the case for creating a fund

As set out in principle A, funds can be held to meet specific liabilities if the existence of the fund is transferring risk associated with funding the liabilities away from general taxpayers – i.e., any financial risk sits outside the consolidated fund.

Departments should consider whether there are opportunities to transfer risk away from general taxpayers through the creation of a fund, for example funded by a levy on industry. This could include where government has an implicit liability. There should be a clear rationale for the creation of such a fund, and it would require Treasury approval. It should be demonstrable that any shortfall in this fund being able to pay for the liabilities it is set up to meet will not be permanently met by the consolidated fund.

Assessing the case for defunding an existing fund

Where a fund exists that is inconsistent with principles A and B, the Treasury will request that departments produce a business case for defunding. This will generally be on a reactive basis, when issues arise which would otherwise require alternative action. In this case, the relevant department should produce a business case for defunding with input from relevant experts as needed (e.g., UK Government Investments and the Government Actuary's Department). Assessments should be sent to the relevant Treasury spending or policy team. The final decision on whether to defund will require Treasury consent. Departments should engage their ministers as they see fit.

The Green Book process should be applied in a proportionate manner. The business case should consider carefully the five cases for public value: strategic, economic, commercial, financial and management, and should not merely try to demonstrate the highest possible cost-benefit ratio.

The department should first determine whether there are any prohibitive barriers to defunding. This should include consideration of any major presentational issues or stakeholder risks, as well as any legislative requirements and legal risk. In some cases, barriers or risks may be significant, such as when legislation is required, but not prohibitive. If it is determined that there are no prohibitive barriers to defunding, the department should produce a full assessment of defunding the scheme. The rest of this section provides further guidance, in addition to the general guidance on producing a business case as set out in the Green Book, on how to approach this assessment.

The strategic case should refer to the principles above, which set out the ministerial mandate for how specific liabilities should be funded. Departments should set out how and why all financial risk associated with the fund explicitly sits with the consolidated fund, and so why the fund meet the conditions for defunding. This assessment, with consideration of any barriers to defunding, will be the crux of the decision to defund or not, given this is assessing the feasibility and implications of applying government policy.

In making these judgements, departments should have regard to the permanence of the institutional arrangements that they are assessing and the likelihood that this could change in the future, as defunding is a permanent change.

The economic case should consider any whole economy impacts resulting from defunding. The process of defunding has implications for public finances and the balance sheet, however the proceeds from the disposal of assets are not an economic benefit – no new resources have been produced or consumed. That should instead be considered in the financial case. The main economic benefit is the assumption that selling financial assets held in the public sector to the private sector increases allocative efficiency from a whole economy perspective. This is unquantifiable, so it is not meaningful to try and factor this into any Net Present Social Value (NPSV) or Benefit Cost Ratio (BCR). There may be other economic costs and benefits associated with defunding, such as reduced need for administrative staff. Some of these may be quantifiable and monetisable. As such, departments may wish to express these benefits or costs using a NPSV or BCR calculation. The financial case should include quantitative analysis of future assets, liabilities and cash flows. This includes administrative costs, any affordability considerations (for example, if a pension scheme needs to be transferred and operated by central government) and fiscal impacts. This is necessary to understand fiscal, accounting and budgeting implications of defunding, and for the Treasury to make an assessment of fiscal sustainability.

The financial efficiency case for holding funds or not is what underpins the principles set out above. Generally, it is more efficient for liabilities to be met by general taxation as they fall due rather than to pre-fund them. Investing funds into private sector assets both increases financial risk on the public sector balance sheet and, when funds move from the public sector to the private sector, increases public sector net debt. This reduces fiscal space. Rather than funds being held for the specific purpose of meeting liabilities, releasing these funds for alternative use increases allocative efficiency from a whole public sector perspective.

As assets will be returned to the Treasury, departments do not need to consider the alternative use of funds in the financial or economic case.

As covered in Principle C, the Treasury should determine whether there are any risks to fiscal sustainability from defunding the scheme.

The remainder of the business case should cover commercial and management considerations, including:

- Details and necessary processes for any legislation required;
- Plans for the future management of liabilities;
- High level assessment of different defunding strategies, including asset disposal options;
- Any wider implementation or delivery requirements and risks associated with the specific case;

- Any future analysis or processes required if HMT ministers agree to defund the scheme.

The assessment of asset disposal options included in the initial business case does not need to equate to a comprehensive trading plan, which would be developed if ministers agree to defunding the scheme, but should include an overview of the different disposal options and a judgement about the feasibility and costs of each option, identifying any risks to delivery. Any disposal strategy should consider the liquidity of the assets and the market the assets would be sold into. Consideration of the appropriate method for gilt disposal, which may include cancellation, should be discussed with the Treasury in conjunction with the Debt Management Office.