HM TREASURY

Financial Reporting Advisory Board Paper

Discount Rate for Pension Liabilities: IPSAS Exposure Draft 31 *Employee Benefits*

Issue:	Re-consideration of the discount rate used for measuring pension liabilities in light of the publication of IPSAS ED 31 *Employee Benefits*.
Impact on guidance:	None
IAS/IFRS adaptation?	No
IPSAS compliant?	No – ED 31 requires entities to apply a gilt rate as the rate used to discount post-employment benefit obligations, whereas both FRS 17 and IAS 19 promote the use of a high quality corporate bond rate.
Interpretation for the public sector context?	N/a
Impact on budgetary regime?	No
Alignment with National Accounts	Yes
Impact on Estimates?	Yes
Recommendation:	That the Board approves the continued use of an AA corporate bond rate for discounting pension liabilities.
Timing:	The proposals will potentially affect 2007-08.

DETAIL

Background

1. The International Public Sector Accounting Standards Board (IPSASB) published Exposure Draft (ED) 31 *Employee Benefits* in October 2006. The proposed Standard prescribes the accounting and disclosure by public sector entities for employee benefits. It is based on IAS 19 Employee Benefits. The Standard deals with four categories of employee benefits;

a) Short-term benefits, such as salaries, leave, bonuses, and non-monetary benefits (such as medical care);

b) Post-employment benefits such as pensions;

c) Long-term employee benefits;

d) Termination benefits.

2. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans. For defined benefit plans the ED requires an entity to:

'Determine the discount rate by reference to a risk-free rate based on market yields at the reporting date on government bonds of a currency and term consistent with the currency and term of the post-employment benefit obligations. Where there is no deep market in government bonds, or where market yields on government bonds at the reporting date do not reflect a risk-free rate, the discount rate should be determined by reference to market yields on high quality corporate bonds of a currency and term consistent with the currency and term of the post-employment benefit obligations.'

3. The discount rate reflects the time value of money but not the actuarial or investment risk.

4. In contrast, FRS 17 and IAS 19 require entities to apply a discount rate based on yields on high quality corporate bonds consistent with the currency and estimated term of the post-employment benefit obligations.

5. Whilst the IPSASB concluded that, in many jurisdictions, the market yields on government bonds would provide a discount rate most consistent with the principles in IAS 19, they acknowledged there may be circumstances where there is no deep market in government bonds. There may also be cases where the market yields on government bonds are not the best indicator of a risk-free rate and where the application of a discount rate based on market yields on government bonds may lead to unrealistically high discount rates and distorted carrying amounts for post-employment benefit obligations. The draft Standard therefore provides that a rate determined by reference to high quality corporate bonds could be used in these circumstances.

6. There are a number of different approaches that could be taken to disclosing the value of accrued unfunded public service pension liabilities. Commentators have argued for a number of measures including discounting by reference to a GDP deflator or to long-term gilts yields. Intrinsically these liabilities generate a long series of cashflows and government has consistently

taken the view that management of those cashflows and the accrual of the new liabilities are the critical control measures.

7. The FRAB previously considered the issue of an appropriate discount rate in March 2003 (FRAB (60) 7), when the FRAB agreed that a rate based on the AA corporate bond rate should be used from 2005-06 in order to be more in line with the requirements of FRS 17.

8. FRS 17 specifies the AA bond rate that is intended to reflect the ability of employers as a whole to finance their liability (i.e. the AA bond rate is a reflection of the average borrowing cost of corporate sponsors of pension schemes). FRS 17 ensures consistency in disclosure between employers and does not seek to require an assessment of the liability that is specific to the employer's financial circumstances.

9. In contrast, the use of a gilt-based discount rate would set government apart from other entities subject to FRS 17 (and IAS 19). It would seek to reflect in some sense the government's own circumstances when there is no clear consensus on what those circumstances are.

10. When the FRAB took its decision in 2003 it chose to replace a previous set of measures based on long-term gilt yields in favour of maintaining close consistency with FRS 17. FRS 17 remains materially unchanged since that decision was taken and the arguments used at that time remain valid.

11. Attached as an annex to this paper is a draft covering letter to IPSASB setting out the response of the FRAB on the use of gilt rather than corporate bond determined discount rate. Comments have been asked for by February 28th 2007. Although ED 31 asks for comments on ten specific issues, the proposed Standard is drawn primarily from IAS 19 and the only major departure from the IAS is the required discount rate. The Board is asked to confirm that they are content with the wording of the letter.

Impact on disclosures in resource and other accounts

12. None

IAS/IFRS compliance

13. The use of an AA corporate bond rate assessed annually is compliant with IAS 19 and FRS 17.

IPSAS compliance

14. The proposal is contrary to the treatment in ED 31 that requires entities to apply a gilt rate as the rate used to discount post-employment benefit obligations.

Proposed text for the response to the IPSASB

15. See Annex A for the proposed response to the IPSASB.

Impact on the budgetary regime

16. The interest cost will be affected by any change in the discount rate and this will have an effect on Estimates. In practice the latest opportunity to amend the Estimates for 2007-08 will be the Spring

Supplementary Estimates that are finalized in February 2008. This means that a change in the appropriate discount rate will need to be determined before the end of 2007 to give time for the appropriate calculations to be made and the Spring Supplementary Estimates prepared.

Summary and recommendation

17. That the Board approves the continued use of an AA corporate bond rate for discounting pension liabilities. That the Board approves the attached letter to be sent to IPSASB.

HM Treasury
12 February 2007