HM Treasury

Public Expenditure System

PES (2007) 02 **01 February 2007** **Secretariat: 020 7270 5525**

GUIDANCE ON MANAGING THE CHANGE IN DISCOUNT RATES FOR PENSION LIABILITIES

Purpose

1. As noted in PES(2006)08 (3 August 2006), the discount rate for pension liabilities is to be reviewed annually. This PES paper announces the change in the discount rate from 31 March 2007 and provides departments and pension schemes with guidance on how the impact will be managed in departmental budgets.

New Rates

2. The discount rate for pension liabilities will change from 2.8 per cent real to **1.8 per cent real** with effect from 31 March 2007.

3. This rate does not apply for investment appraisal purposes, for calculating employer pension contributions or for provisions other than for pension liabilities. The guidance in PES(2004)04 (8 April 2004) as it relates to provisions remains extant (i.e. the discount rate for general provisions remains at 2.2 per cent real).

Summary

4. The adjustment to the discount rate will have no effect on the ASLC being paid out by departments. The overnight increase in pension liabilities will be recognised in the STRGL for 2006-07 and there will be no other impact on 2006-07 figures, which are based (correctly) on the discount rate applicable at 1 April 2006.

5. This reduction in the discount rate will not affect the figures in Estimates for 2006-07 (as these figures are (correctly) based on the discount rate applying at April 2006). The use of a revised discount rate will however affect Budgets and Supply Estimates for 2007-08 and subsequent years. The lower discount rate will also result in a lower charge for the unwinding of the discount (interest charge) in the existing pension liability provision and a higher current service cost. Departments will need to agree revised provision figures and updates must be made in datasets due for return by **8 February 2007** (the same timing as the COINS deadline). This will enable the impact of these changes to be reflected in the Main Estimates for 2007-08..

Background

6. In June 2006, the Financial Reporting Advisory Board (FRAB) agreed that the discount rate for pensions should be reviewed annually using market conditions on 31 January rather than, as previously agreed, ahead of each spending review period. The arrangements for the review of the discount rate for other long-term liabilities remain unchanged, i.e. they will be reviewed ahead of each spending review period.

Real Discount Rate

7. The discount rate is used for three related purposes in financial reports:

- Valuing the liabilities
- Computing the interest costs on the stock of liabilities (the equivalent of unwinding the discount as existing liabilities roll forward one year).
- Calculating the current service cost (the cost of accruing liabilities)

8. From 2005-06, the accounts of the public sector pension schemes within central government prepared under the requirements of Financial Reporting Standard (FRS) 17 have been using a real discount rate of 2.8 per cent reflecting GAD's advice on the appropriate AA corporate bond rate. GAD has advised that the AA corporate bond rate as at 31 January 2007 is **1.8 per cent**.

Accounting treatment

9. The change in the discount rate will affect the accounting arrangements for departments only if they recognise a pension liability on their balance sheets. For such departments, and for the accounts of the public sector pension schemes within central government, the effects will be:

- The pension liability at 31 March 2007 will be discounted at the new rate, resulting in an increase in the value of the pension liability shown on the balance sheet. The change in the value of the pension liability will be reflected through reserves (Statement of Total Recognised Gains and Losses (STRGL) and will not affect the OCS or Revenue Account for 2006-07);
- (Other things being equal) a reduction in the interest charge to the OCS or Revenue Account in following years as a result of a lower level of discount being unwound even though applied to a higher starting liability figure;
- A higher current service cost for 2007/08 and following years.

Budgeting Treatment

10. The movement in the STRGL as a result of the change in the discount rate is not a cost in departmental budgets. However, budgets going forward will need to be adjusted to reflect the effect of the change in discount rate (a) on the unwinding of the discount (interest charge), and (b) on the current service cost. For large unfunded schemes this will result in a change to AME numbers. ASLCs rate is separately determined by the relevant authority and will be unaffected.

Estimates Treatment

11. There is no impact on the face of an Estimate directly related to a discount change, although the Estimates for the interest charge (unwinding of the discount) and, depending on how it is determined, the current service cost will need to reflect the new discount rate.

Impact of the change in the discount rate on public unfunded pensions

SCAPE and other discount rates

12. Various arrangements are in place for setting employer contributions in unfunded schemes that

also require a discount rate. Most of these arrangements are based on the SCAPE methodology that uses a fixed real discount rate. These arrangements are unaffected by the discount rate used for FRS17 purposes. Schemes and their actuaries should continue to use existing arrangements: in particular, under SCAPE, the real rate of return of 3.5 per cent should continue to be used.

Treatment of inflation

13. Typically, liabilities of unfunded pension schemes are computed by discounting a projection of real expenditures using a real discount rate. The effect of the inflation rate is fairly small and confined to a few arrangements for paying pensions without indexation or certain timing effects. Schemes should continue to take actuarial advice as to the long-run effect of inflation on scheme liabilities.

14. However, to arrive at an estimate of the interest cost, it is necessary to assume a rate of inflation because the required interest rate is a nominal one rather than a real one. It is appropriate when reporting the change in liabilities from one year to another to apply a short-term inflation rate (reflecting the Government's target inflation rate) rather than reflect whatever long-term rate is assumed by the actuary. Public service schemes use an inflation assumption of **2.75 per cent**, because their benefits are indexed to the RPI and assessments of real earnings growth are made relative to the RPI. (The inflation rate measured by the Consumer Price Index is 2 per cent, and the long-run difference between CPI and RPI is expected to be around ¾ percentage points).

15. The appropriate interest rate to be used in assessing interest costs of scheme liabilities is **4.6 per cent**, being the product of the real interest rate of **1.8 per cent** and an inflation rate of **2.75 per cent.**

Differences between estimates and outturn

16. As required by FRS17, the annual accounts will reflect an interest cost based on assumptions made at the beginning of the year. The actuary will, however, assess the pension liability at the year-end on the basis of actual experience. The effects of any deviation of actual inflation from the assumption of RPI growth at **2.5 per cent** and the change in the RPI growth assumption to **2.75 per cent** will be reflected for the 2006-07 resource accounts in the STRGL.

Local Authorities

17. This guidance does not apply directly to local authority schemes and the unfunded liabilities of police and fire authorities. Those schemes should follow guidance provided by CIPFA.

Funded schemes

18. The application of a discount rate based on returns from AA corporate bonds at 31 January each year will not apply to funded schemes within central government. In accordance with FRS17, they should use a discount rate based on returns from AA corporate bonds at 31 March each year (or their financial year-end if different).

Action Required

19. Pension schemes and departments with pension liabilities should seek immediate advice from their actuaries on the implications of this change in discount rate for Estimates for 2007/08 and following years.

Queries

20. If you have any queries regarding the content of this PES paper please contact:

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General

21. Electronic versions of PES papers issued since November 1999 may be found on the Treasury's website:

http://www.hmtreasury.gsi.gov.uk/psd/pes_papers/PES_papers_home.htm

The PES secretariat on 020 7270 5525 can supply further information on PES papers.