The Discount Process Is The Problem! Questions And Answers

Together with the slides, the presentation on 01 Mar 2022 can be found at the first URL below. Because the slides are "read only", the interactive chart on slide [28] can't be modified in play mode but it can be found via the second URL below. The questions asked have been briefly summarised, together with fairly succinct italicised responses, which are hopefully helpful. If I appear to have misunderstood a question or clearly not answered it, please do call me out. Anyone wanting to chat further is most welcome to contact me via the third URL below.

[1] https://www.zyen.com/events/all-events/discount-process-problem/
[2] https://www.discrate.com/outcomes/success_likelihood/success_likelihood.htm
[3] https://www.discrate.com/contact/contact.htm

Michael Mainelli

1. On slide [32], where did the "misallocated £100 b" go? It *was paid into DB pension schemes but, in my view, was not needed.*
2. Using the alternative suggested would have led to a "riskier" funding profile and the discount process approach can still be justified as "prudent"; please respond. *First, risk is a counterpart to reward, the latter of which should not be discarded as irrelevant. Second, without establishing a best estimate in advance, which I believe has been rare, no one can have been reasonably certain that they even were being prudent. In my view, it was excessively prudent.*
3. Please choose between discount rates and asset-liability modelling. *So long as there is credibly enough time (say, 15 years) ahead, I definitely choose ALM, which allows for potential liquidity problems to be identified in advance (impossible under discount process).*
4. Slide [20] mentions work in 2007 by ACCA, CISI and Zyen, which was criticised at the time for not being as approachable as "just one number". Do I think I may be criticised for suggesting ditching the discount process for long-term financial funding? *Yes, I'm sure I will but "just one number" will always be an inadequate guide to future cashflows.*

Hugh Purser Is there a "correct discount rate" that can be calculated by studying historic cash flow figures? *Studying cash flows over the past can indicate the implicit internal discount rate but that provides no reliable information about the future.* Can't backwards analysis solve the last line on slide [23]? *No, the point of that last bullet point is trying to establish the initial funding needed at outset.*

Dennis Leech Are you fundamentally criticising the concept of the time value of money? *Having reviewed what I said at the time, I am not doing that as such. Rather, I am criticising the idea that the discount rate is of any advance value in assessing time value, which I think is a a bit different.*

Chris Giles Over-prudence is a public policy issue as Treasury is paying through excessive tax relief on employer contributions. *Yes, there is a public policy issue but that is more about timing than absolute public loss. First, at the expense of other possible projects, the sponsors must pay the higher contributions in order to gain the tax relief. Second, HMRC will mostly recover the tax relief from taxing benefits when paid. Indeed, the post-2006 regime will have led to unexpected excess tax charges, in both the public and private sectors. The exception to public loss is the extent to which such excess contributions are paid on to life assurance companies or pension providers, which I believe have made high gains on buyout pricing; how those gains are eventually taxed is a whole separate issue.*

Private Comment One DB pension trustee has kindly written in, gently disagreeing that discount rates are not helpful. For a scheme which had been closed some years ago, pensions were paid out from investment income because contributions had fallen away. After some time, they were using small asset sales to supplement the income. In order to monitor the funding, the trustees considered it appropriate to use cautious discount rates and still believe that to be the case. *The comment is noted but the situation described is somewhat special. As I see it, the discount rate was virtually irrelevant because the cashflows (including asset sales) were actually quite closely matched.*

14 Mar 2022