PMQ: If we've just agreed the Brexit Divorce Bill – how much for the Pensions liability?

By Visiting Professor John Clancy, Centre for Brexit Studies

We are now told that 95% of the Brexit withdrawal is done. But presumably, as the most basic dictum of the entire process is "nothing is agreed until everything is agreed", that percentage is pretty meaningless.

Indeed, it is in itself self-defeating to seek to reassure by showing how close it all actually apparently is, when it isn't.

Media reports suggest, though, that within all this almost-agreement, there is at least full actual-agreement on one important aspect of withdrawal: the UK's Brexit Divorce Bill. So, three cheers for that, then.

The problem is, though, that it is extremely unlikely that the biggest chunk of the bill is likely to have been agreed, because the bill for the Pensions liability has not yet been delivered. It has not, in fact, been calculated. There may have been a stab at it, but it can't be calculated – yet.

And recent stats coming out of Europe seem to suggest that the massive, multi-billion UK share of the EU Commission's Pensions Bill will be a lot higher than it was when the draft Withdrawal Agreement was constructed. Is the 95% of Agreement based on last year's figures? Or has the 95% been reached using the projected 2018 year-end figures from the EU statisticians? Or for year-end 2020?

So we can only possibly have agreed to pay a future (as yet unspecified) pensions bill. We can only have agreed (or have we?) to pay a bill based on a formula which we've pre-agreed.

The UK's been on the hook for €9-10Billion in EU Commission's post-Brexit pensions since the accounts for 2017 came out in spring 2018.

The problem is, those spring figures were themselves a bit of a shock, and were ultra-sensitive to two statistics in particular: the nominal discount rate; and the EU rate of inflation.

	Liability	Nominal Discount Rate
2017	€ 73.122	1.9%
2016	€ 67.231	1.7%
2015	€ 64.242	2.0%
2014	€ 59.053	2.0%
2013	€ 46.818	3.7%
2012	€ 42.503	3.6%

The single biggest determinant of the size of the Pension liability has been the discount rate used by the EU Commission's accountants in their annual accounts. As that discount rate fell, so then dramatically rose the Liabilities Reported in the year end accounts.

So a bill of €42.5 Billion rocketed to €73.1Billion (with a U.K. share soaring from €5.1Billion to €9.1Billion).

So the discount rate only fell by 1.7% – how did we end up with such a massive jump? The reason is that to work out the actual rate applied to the fund we have to also deduct the inflation rate to calculate the "effective" real discount rate.

	Liability	Nominal Discount Rate	Inflation	Real Discount Rate
2017	€ 73.122	1.9%	1.5%	0.4%
2016	€ 67.231	1.7%	1.4%	0.3%
2015	€ 64.242	2.0%	1.4%	0.6%
2014	€ 59.053	2.0%	1.3%	0.7%
2013	€ 46.818	3.7%	1.9%	1.9%
2012	€ 42.503	3.6%	2.0%	1.6%

So, the Real is Discount rate collapsed four-fold – from 1.6% to 0.4%. Hence the suddenly soaring liabilities. It coincided with the ECBs “whatever it takes”, “bazooka” Bond buying QE spree.

The discount rate is used by pensions folk (like reverse compound interest) to chip away at a big debt and to a future date. They calculate all cash flows in and out, but “discount” or chip away at the final figure, backwards to today. This is meant to tell us what that big future debt is worth today. And therefore how much should be in the fund today to meet all the debts of the future.

The discount rate is the rate at which you chip away. So the higher the rate, the more gets chipped away. You can think of the total future debt as a huge iceberg, the discount rate is how many ice cubes a minute you chip off the iceberg. The more ice cubes per minute, the smaller the iceberg becomes.

It sort of makes sense, then, how we have ended up with the huge increase in liabilities.

The problem is, as I indicated earlier, neither the discount rate for 2018, nor the final inflation rate for the EU has been calculated. Has the PM’s team been given the estimate?

Well here's the real problem regardless: we can have a pretty good stab at both figures. And they don't make good reading for the UK Brexit Bill.

The big problem is that EU inflation is now running (September 2018) at 2.2%. Again, the ECBs "whatever it takes", "bazooka" Bond buying QE spree was actually designed to bring inflation back to target above 2%. It worked.

You can see from the figures above that unless the Nominal Discount Rate is raised to above 2.2% there will be a negative real discount rate.

The further problem is that the yields on EU sovereign Bonds are pretty much where they were at the beginning of the year. Long term yields are what the reality-challenged pensions folk continue (inexplicably) to use to set the nominal discount rate. They are still around the 1.9% level.

If the nominal discount rate pitches in at 1.9% again, which is highly probable, then we'll have a negative real discount rate in the 2018 figures.

That is an historic event, in any event. But it also means that the Liability figure will soar again this year.

In fact, we are entering Alice in Wonderland accounting territory here.

The conundrum is that discount rate theory itself really does not allow for negative interest rates for discounting, it stops at zero really. Whilst accountants in business may very well use them in the real world to determine rates of return, they're not meant to happen in the pensions world. But in the 'Carry On Pensions' world, instead of dumping the calculation and using expected returns over time, they just did the dud maths instead.

If we end up with a negative 0.3% real discount rate, it's difficult to predict what, how and why the liabilities figure will actually be reported in the accounts. Exponential effects happen to massively increase liabilities when normal discount rates go below 3%, and more so the nearer we get to 0%. As we go below zero it really will be up to the EU

accountants to have a stab at reporting the liabilities figure in bizarre world. It could very well be nearer €100 Billion than €73 Billion. In which case, the U.K. bill could go up €3.4 Billion overnight.

As former Bank of England Governor Lord Mervyn King said only last month of the using of a discount rate to assess liabilities: “If the answer to a question is very sensitive to a number that is almost impossible to predict, it is time to ask a different question.” Quite right.

So – question for the Prime Minister: if everything **is** so agreed on the divorce bill, have the EU negotiators actually told you what is the real discount rate the EU will be using to fix the EU Pensions liability for 2018?