DWP Department for Work and Pensions

Private Pensions Policy and Regulation

Accounting Standards Board
Aldwych House
71-91 Aldwych
London
WC2B 4HN

Our address: 3rd Floor, The Adelphi, 1-11 John Adam Street, London, WC2N 6HT

Our phone number: 020 7962 8554
Our fax number: 020 7962 8676
Website: www.dwp.gov.uk

Date: 8 July 2008

Dear Sir

DISCUSSION PAPER
THE FINANCIAL REPORTING OF PENSIONS

Introduction

The Department for Work and Pensions (DWP) welcomes the opportunity to comment on the United Kingdom Accounting Standards Board's (UK ASB's) discussion paper which proposes wide-ranging reforms to pension accounting. We would also be grateful if you would consider meeting DWP and HM Treasury at our earliest mutual convenience to discuss the issues outlined in this letter.

At the same time we fully acknowledge the autonomy of independent regulatory bodies such as the UK ASB, and have thus taken what we hope you would regard as a considered view in preparing and submitting this informal response.

Being aware of the discussions you have already had with the Pensions Regulator and their possible intention to respond separately on matters relating to pension scheme accounts, our concerns focus on some of your proposals for the representation of pension liabilities in company accounts.

While our response highlights those of your proposals which are of concern to the DWP and to those commentators who have publicly expressed their views, we are well aware of your parallel concerns regarding the deficiencies in current pensions accounting standards and respect your aims to contribute to the longer-term review.

However, while the DWP fully supports objectives which ensure that pension scheme liabilities are transparently acknowledged and catered for by sponsoring employers, we trust that you will pay due regard to the concerns repeatedly raised by these employers, trade bodies, and other representatives of the pensions industry. Many of those concerned will be responding to your consultation independently.

Specific concerns

The use of a risk-free discount rate

Those proposals which have gained the widest press coverage, and are reported to cause the greatest concern for industry, relate to the use of a 'risk-free' discount rate for discounting liabilities. While the UK ASB has neither defined 'risk-free' nor put a cost on its effect, most commentators have interpreted this to be the returns which can generally be expected from low risk investments such as government bonds.

Attempts to quantify the effect of this change from the currently used AA corporate bonds vary as investment returns considered over the short term are highly volatile. However, increases in liabilities of between 10 to 30 per cent have been estimated when compared with current liability levels based on less conservative discount rates.

While these proposals for the reporting of pensions in company accounts may be defended as introducing enhanced levels of prominence and accountability for pensions liabilities, and whilst in theory they may not represent much more than a paper cost to businesses, in practice they are likely to give rise to unintended consequences and so have more far-reaching impacts.

Indeed as these proposals currently stand, they are detrimental to the perceptions of employers running defined benefit (DB) schemes and to those of their investors. Employers' perceptions are likely to directly discourage their future provision of DB schemes, while wider negative assessment of businesses' attractiveness in turn depresses their profits, their dividends available for shareholders, and ultimately their wages and employment opportunities available for current and future staff.

In asking that you re-consider your choice of using a risk-free rate of return the DWP is not simply advocating the avoidance of an 'unpalatable truth'. Instead we would like to highlight the counter-arguments and multiple likely behavioural effects – such as an increased focus on gilt-based strategies, a continuing trend towards buyouts, and ultimately a further move away from defined benefit pension schemes - which make a risk-free discount rate both inappropriate and unnecessarily harsh.

The use of a single figure for quantifying liabilities

The net effect of your proposals supports the continued use of a single number for quantifying liabilities. However, such use of a precise point estimate may erroneously create an illusion of certainty as it does not allow for the potentially wide range of future outcomes for key variables such as life expectancy. Furthermore, users of accounts such as shareholders and investment analysts can be misled about the likely impact of pension liabilities on a company as these variables change.

While your discussion paper promotes the use of sensitivity analysis, this technique only tells us by how much a number will change with altered assumptions, but does not state how much confidence we can have in that number.

Current and ongoing research at the **Pensions Institute (PI)** suggests that priority could be given to developing new tools (such as fan charts) which measure and communicate the uncertainties inherent in the measurement of pension scheme liabilities. Several other organisations have similarly questioned the usefulness of a single number, and we would ask that you consider these new methodologies when taking forward your recommendations.

The new expectations on multi-employer schemes

The Department has also been approached directly by organisations with well recognised and long standing multi-employer scheme DB pension provision for their employees – with these companies expressing concerns for the potential wide-ranging impacts of your proposals on their organisations.

Accordingly, some multi-employer schemes are particularly concerned about the way each employer may be expected to include its share of the scheme's deficit or surplus in its own accounts. This differs from current FRS17 rules which include a provision for multi-employer schemes - if individual employers are unable to consistently and reasonably identify their share of the underlying assets and liabilities - to be exempt from these accounting requirements. We suggest that this proposal adds regulatory cost and burden on sponsoring employers and schemes without enhancing protection for pension scheme members

While you do suggest several alternative approaches these options are still a serious concern for some multi-employer schemes. We should therefore be grateful if you would reconsider these proposals as the need for the flexibility currently allowed in FRS17 still applies. Indeed a number of well established multi-employer schemes continue to have strong overall employer covenants even though the possibility of each individual sponsor within the scheme being able to disentangle their liabilities and reliably quantify their shares becomes an impractical task.

Next Steps

We know that your discussion paper was approved by Europe's 'Pro-active Accounting Activities in Europe' (PAAinE) initiative and understand that you aim to maintain an international focus in conjunction with the International Accounting Standards Board and its American equivalent the Financial Accounting Standards Board.

We would therefore welcome some clarification on the timing and scope of accounting standards which are likely to be introduced over the next three to five.

Yours sincerely

[signed by C B Evans and sent by email]

C B EVANS
Deputy Director