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18th May, 2008

Dear Andrew Lennard,

I thoroughly enjoyed the recent CASS event. I thought your presentation was excellent – logical, comprehensive and much better than anything that has gone before. The explicit presentation of the issues and the choices taken and the sincere approach to consultation does you great credit.

We have not met so I should state my credentials. I am a CA and a Past President of the Scottish Institute. I spent 34 years with Unilever – mainly in a general management role but in some senior accounting roles as well. I also served for ten years as a non-executive director of Scottish Equitable/Aegon UK plc partly as Chairman of the audit Committee and partly as non-executive Chairman of the Board. I am now retired and have no axe to grind! This letter is simply my own personal view.

Pensions are a very complex topic and so is useful accounting for them. I have never come across situations where the liabilities of a company or pension fund, or their near mirror image the pension assets of their customers, are so hard to define. Nor where the techniques deployed to value them are so very complex and beyond the comprehension of most mortals. I may say I do not yield lightly in the face of complexity!

I was in a sense very protected as Scottish Equitable was for my tenure a subsidiary of Aegon – an international provider. Aegon were fully represented on the Board and so privileged shareholders. No gap existed between management and shareholder knowledge. I am sure you have many industry contacts. Aegon are expert practitioners and I am sure would comment if you so wished. Mark Laidlaw is their Chief Financial Officer – he might even be able to correct any mistakes or misconceptions in this letter!

But personally I would not recommend accepting such a role in a quoted plc unless there was a clear coherence between:-

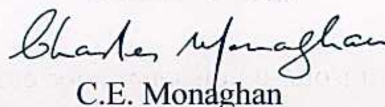
- the accounts published to the shareholders
- the solvency measures approved by the Regulator
- the aggregate of the customers' individual position statements.

Some hopefully helpful thoughts attached. No solutions I'm afraid – but, as I learned in Japan, once the problem is completely clear the right solution is generally easier to find. And "pain postponed is always pain increased" (there is a Scottish dictum for you!).

I wish you the best of luck with your hard task.

Kind regards,

Yours sincerely,



C.E. Monaghan

cc. Mark Laidlaw
David Spence

1. Helping my son, who has a freelance, hopefully viable career in front of him, has refreshed my understanding of the basic building blocks of a pension. The "bricks" so to speak out of which schemes and employers' costs/funding requirements are built.

   An individual brick is relatively easy to discuss with the beneficiary. What it makes clear is the huge sensitivity of the project to a limited number of variables – years of contribution, how early they start, years of retirement/withdrawal, annual income required in retirement, real rate of return on contributions and the rate and timing of inflation. Low single digit % changes in any of these have very significant effects. 3% per annum inflation, for instance, over 30 years will either double the pot required or halve the purchasing power of the nominal pot you were originally aiming at. The variables concerned are neither stable nor forecastable. Each brick is very risky and requires constant, at least annual, reassessment by the beneficiary. Given that, any given brick may be said to be true and fair at a particular point in time.

2. Aggregating risky bricks can only give an equally risky total of scheme liabilities. Group mortality experience may be good or bad depending on any individual's perspective! Such an aggregate could be a true and fair set of accounts – but only if it had the same degree of beneficiary buy in. That is difficult to achieve simultaneously and remains, of course, volatile.

   Such an aggregate can only, in my view, be of very marginal utility to a beneficiary. Perhaps that is why I do not remember a single worthwhile question arising out of the accounts of the company or pension fund that I was involved with in a decade! Probably the usefulness of accounts lies in enabling analysts and regulators to assess solvency and dividend capacity relative to other companies at a point in time. Absolute capacity is not I think determinable given the difficulty of valuing long term liabilities. That raises serious issues of moral/taxpayer hazard for regulators *et al.*

   It is against that background that I look at the more difficult issues.

3. It does seem to me that strict legal liabilities/commitments should be used. I don't think the "deferred pay" commitment is real today. As was pointed out in the Q and A session by a lawyer nearly all formal documents of schemes now explicitly define the "promise" as being the strict, current liability. I don't think that is mere legal finagling. Globalisation makes future regular increases unlikely for swathes of the workforce. Decreases are more likely! The system of lifetime employment has also largely disappeared. So deferred pay increase "promises" are unlikely to be realistic or deliverable. How clear members are about that is another matter.

4. It is probably best to show the liabilities and the assets separately. Both may show volatility. But it may make clear that the volatility relating to point in time value of assets is relatively less important. That might stop newspapers headlining stock exchange fluctuations as blowing £xbillion "holes" in pension funds – or repairing them for that matter.

5. The discount rate is a very vexed issue! I was intrigued that a city person said in the Q and A session that a risk free rate "didn't exist". Perhaps in strict theory that is so. However for practical purposes the rate of return on index linked government bonds is surely a correct risk free rate.

   And "index linked" is the rub. Inflation has really, thank goodness, disappeared from the accounting table. Presumably 2/3% per annum is *de minimis* for most accounting purposes. However as I wrote above that is not so for long term pensions liabilities. 25-35 years of 2 or 3% inflation makes a radical difference.

As far as my son's brick is concerned, I constantly stress that the target pot at the end of the day is uplifted by a large, regularly reviewed factor to incorporate that difference. The moving actual total is also uplifted by RPI before comparison with the actual result to date achieved by the investment manager. This generally removes any sense of comfort all round!

Using the risk free rate defined above implies a discount factor of not much over 1%. So a very high current valuation of quite long deferred liabilities. And the only deferred figure in the Balance Sheet stated in "real" terms.

I am not sure how to cope with this. Getting the brick right is the priority for me – but it is very tough. Using a 3/4% figure with 2 or 3% inflation would lessen the pain of the apparent liabilities – at the expense of also lessening implicitly the real value of long term benefits. OK if the beneficiaries understand and buy that – otherwise not!

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