Response to the Consultation: The Financial Reporting of Pensions

Q1 Recognition of a liability to pay benefits should be based upon the current expectation of the salary which determines the payments due as pensions. In the case of final salary arrangements this would be the salary expected to be paid immediately prior to retirement. In the case of CARE arrangements it is the current best estimate of that average. In the case of members who have left service, it should reflect the statutory increases provided under current legislation, or scheme rules where these make higher provision.

Q2 The premise should be that the liability is to an individual. The presence of trusts and organised labour exist solely to enhance the negotiation position of the individual employee. The argument with respect to the entire workforce is spurious.

Q3 We agree with the concept that only present obligations should be recognised. However we would emphasis that the value of these present obligations is their projected value – PBO rather than ABO.

Q4 We agree that consolidation of pension plans should be subject to the same principles as usually applied. However we would suggest that, where schemes are organised as quasi-independent entities, there is a more relevant test than the concept of control by the sponsor; this is one of recourse and recovery. If a sponsor can recover all of the assets within a fund, then full consolidation of both assets and liabilities is appropriate. Where a sponsor is liable only for funding deficits (the scheme has recourse) and may recover only surpluses, these are the relevant items for consolidation.

It should be noted that the funding requirements of schemes without recourse should be materially higher than schemes with recourse.

Q 5 Changes should be recognised immediately. However that requires the measurement system to be precise and accurate. In the absence of such accuracy and precision smoothing mechanisms become appropriate, since the introduction of spurious volatility is costly and unproductive.

Q6 – Q9 which deal with measurement raise a number of central issues and are best dealt with in a different order from that presented in the consultation paper.

The most important aspect of any measurement system which will ultimately be used for comparison, in this case the comparison of assets and liabilities, is that the techniques used for their measurement should be mutually consistent. The mixed attribute nature of the measurement proposed is not mutually consistent. The unfortunate consequence of this is that the resulting deficit or surplus is biased and unrealistically volatile.

There are two sources of bias here. The first arises from the use of a stochastic process for assets, market prices, while using a deterministic process, a discount rate or curve, for liabilities. If we consider bonds to have an annual volatility of 10% and equities of 20%, this inconsistency would result in a bias of 1.5% per annum; the distortion to surpluses or deficits

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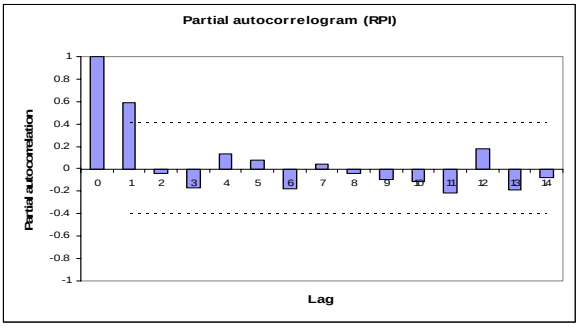
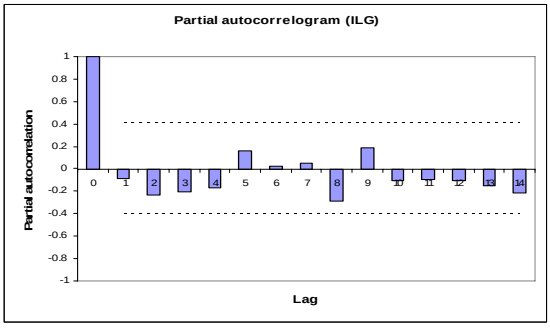
is substantial and of course costly and unproductive. The second source of bias arises from the presence of risk premia in market prices. While it is possible to disagree over the value of the risk premium going forward, the evidence for the existence of an historic risk premium, in the form of excess returns, is overwhelming.

It appears that market prices are influenced by far more than value fundamental issues – Keynes' "*Animal Spirits*" if you will. The result is a material volatility in prices which cannot be explained by financial theory.

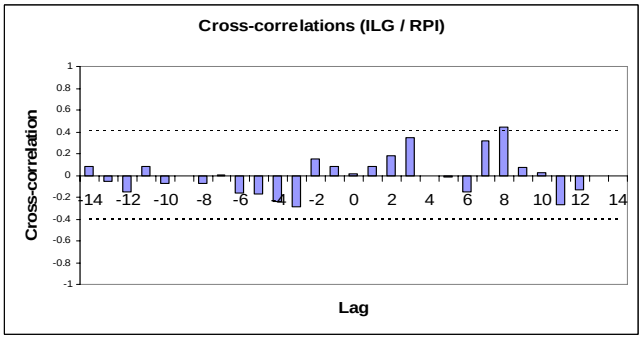
We will illustrate a number of aspects of this behaviour. Firstly, as inflation is a material risk factor for pensions, we consider the relation between the retail price index (RPI) and a total return index of long term index-linked gilts (15+ years). It would be intuitive that we can hedge inflation exposures effectively with such an index. The index is based upon market prices.

We show first the partial auto-correllograms of the proportional changes of these two series:





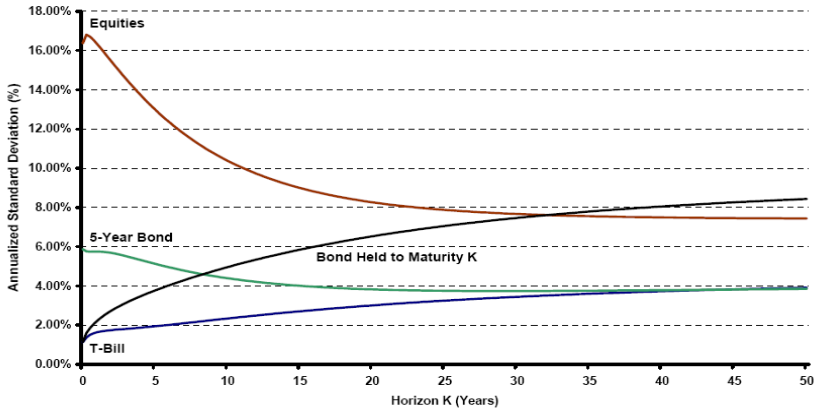
From this it is evident that the dynamics of these two series are fundamentally different and hedging using the market traded gilts would be ineffective, resulting in spurious volatility as is illustrated below.



By way of ending to this illustration we should recognise that if we hold an index-linked gilt to maturity we receive coupons linked to inflation and capital which is inflation protected. In other words the noise we have observed above is entirely rooted in the use of market prices as the measure in the intervening year by year valuations rather than the multi-year reality.

Further there is sound evidence that there is a holding period term structure to the volatility of asset prices and that these by class of asset. We reproduce below the results of one respected study (Campbell & Viceira) of this phenomenon. This is a US market study, but similar results have been found for many markets, including the UK.

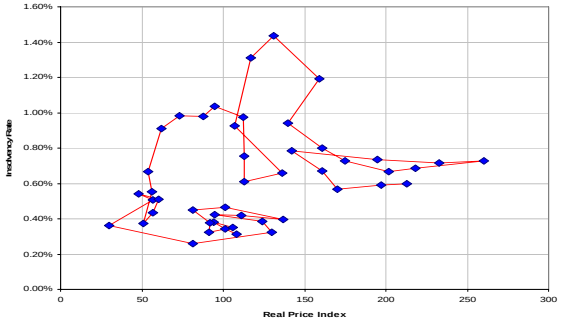
Figure 1. Annualized Percent Standard Deviations of Real Returns Implied by Quarterly VAR(1) Estimates (1952.Q-2002.Q4)

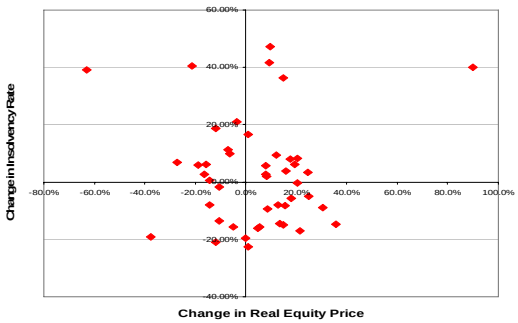


This clearly brings with it concerns that pension schemes are long term investors and that holding periods may be very long indeed.

It should be recalled that standard financial theory would posit no more than that market prices reflect fundamental value **on average**. As value is a latent, unobservable variable it is not possible to test directly the relation between it and market prices. However, the insolvency rate is observable and theory would posit a positive relationship between it and market prices.

We show below the results of such a comparison of the UK insolvency rate and real equity prices for the period 1960 – 2007. We also show a comparison of changes in these variables.





There is no relation evident.

This brings us to comment on S 28 of the Consultation which we reproduce for clarity.

"*Reporting assets held to pay benefits at current values provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits.*"

The first sentence may be true and indeed could be justified as an assertion if the time distance between the benefit ultimately payable and the price is considered; in essence this amounts to no more than asserting that uncertainty increases with time. However it does not mean that either provide us with very much useful information with respect to the sufficiency of the asset to discharge the benefit obligation at the future date at which it is payable.

There is a form of consistency of views here, but the implementation of a mixed attribute measurement system introduces material bias and noise as explained earlier.

"*The present requirement in pensions accounting standards that assets traded in active markets are measured at market values is well founded.*"

This is an untenable position. There is substantial counterfactual evidence to it.

The concern is fundamentally one that we have to consider the value relevance of today's price with respect to dates in the future and this may be very low for capital assets, such as the investments of a pension fund, where their consumption is far into the future.

We would prefer to see assets and liabilities valued consistently. One way in which this may be achieved would be to project the future cash-flows of both and then to discount them using a consistent yield curve. This would remove bias and spurious volatility.

Q8 *Do you agree that assets held to pay benefits should be reported at current values?*

We do not agree with this approach when liabilities are discounted present values of projected benefit cash-flows. It is inconsistent and leads to bias and error.

Q6 "*Regulatory measures should not replace measures derived from general accounting principles?*"

We agree with this. In general regulatory measures are ***prudent*** rather than unbiased best estimates; they typically contain conservative provisions for risk and lead to material biases. One good illustration of this would be the use of "*buy-out*" values. This is a highly regulated insurance market and we see typical buy-out values in the region of 120% of the FRS (17) value of liabilities. If this market were entirely unregulated with access to it unfettered, it appears that the liabilities of a typical pension scheme would trade in the region of 75%-80% of their FRS17 values.

"*The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*"

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We agree with this statement in principle. However there are several caveats. The first is that this risk-free rate is unobservable. We can only approximate to it by the use of interest rate curve models for most maturities. It is also clearly not a swap rate – this is a tertiary rather than secondary market. The use of the swap rate also in effect crystallises a particular liquidity term structure, a further source of noise. The second caveat is that, if assets are valued at market prices, it is more biased than the current AA corporate bond rate; the consequence of such an apparent increase of liabilities and concomitant increase in the cost of pension provision would likely be yet further abandonment of schemes.

If we adopt the use of projected cash-flows for both assets and liabilities, the choice of discount rate function is of second order importance; the use of any function consistently would eliminate bias in scheme reporting. The use of a risk-free rate would serve to eliminate bias with respect to the valuation of other assets in the consolidated company accounts.

"*Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?*

The liability should not be reduced to reflect its credit risk"

We agree with this but the issues require some further discussion not evident in the Consultation document.

Uncertainty lowers the value of an asset and the greater the uncertainty the more the value is lowered. However this uncertainty also lowers the value of the corresponding liability. Under symmetric uncertainty these values are equal and opposite in sign everywhere. However under asymmetric uncertainty this is no longer the case. Values then may be equal only if the asset and liability share a common mean and everywhere else they will differ. Asset and liability values are in general asymmetric. Credit risk is intrinsically asymmetric.

The consequence poses an intriguing problem for accounting; the double entry system may not balance. The benefit asset to a member should in her accounts reflect the likelihood of sponsor insolvency with respect to future payments by it, but in sponsor accounts, prepared on an ongoing basis, no such adjustment should be made to the liability. Perhaps the simplest way to account for sponsor default likelihood in a scheme is to carry the deficit or sponsor liability to the scheme explicitly as an asset of the scheme, but that grows complex as post-insolvency, prudent financial management of the scheme would require funding in excess of 100% of the accurately estimated liabilities as the scheme is then orphaned and faced by material uncertainty in the period prior to completion of the run-off of liabilities.

The issue is of sufficient complexity that disclosure is the cost effective manner to dispose of it.

"*Expenses of administering the plan's accrued benefits should be reflected in the liability?*"

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We disagree strongly with this idea. These are current costs of business and to treat them in this way is entirely inconsistent with the treatment of other current costs. Should we carry in our accounts the present value of the future council tax demands on our factory?

Q7 This should reflect the probabilities of different outcomes. We also note that this should not be expected to be materially different from the highest amount; it implies that the scheme is offering an option, such as partial cash commutation on retirement, which should rationally not be accepted by a member.

Q9 We agree.

Q10 Yes, we agree.

Q11 Yes, we agree.

Q12 We agree with the objectives.

Q13 We agree that the same principles as applied in single employer schemes should be applied in multi-employers cases. However there are many possible multi-employer arrangements which hold the potential to complicate this. The use of recourse and recovery tests for liabilities and assets could fully determine the appropriate treatment for any sponsor-member of the multi-employer arrangement.

The commentary leading to Q 14 deserves some discussion.

S 42 Assets available to pay benefits should be stated at current value, which is market value where the asset is traded on a market.

We do not agree with this – see our earlier comments.

Q 14 We agree that a scheme's financial reports should include it liabilities to pay pensions in the future – in other words we believe that the scheme should report its projected benefit obligation. We also agree that a scheme should report using the same principles as the employer, but we note that the values reported may differ between scheme and employer (see earlier).

Q15 The scheme should report as an asset the full extent of its claim on the sponsor employer. This amount would be the scheme deficit (to full funding) and is based upon the sponsor being an ongoing concern – it should not be adjusted for sponsor credit. When the sponsor has commenced insolvency proceedings the amount of this debt changes to become the S75 value, that is to say an actuarial estimate of the cost of provision of individual annuities for all members in the regulated insurance market. This debt is subject to recovery under the insolvency or liquidation process and provision should be made for this impairment.

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