The voice of banking
& financial services

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Dear Ian,

The Financial Reporting of Pensions Discussion Paper

General comments

This is the British Bankers' Association's response to the above discussion paper. The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

At the outset we would like to express our support for the Accounting Standards Board's involvement in this project and underline the importance that we place on European standard setters working cooperatively through EFRAG pro-actively to lead the debate on the future direction of accounting standards. At a time when International Financial Reporting Standards are being adopted for use in ever more jurisdictions, it is increasingly important for Europe to engage in debates with one voice whenever possible.

Notwithstanding this, however, we must highlight the importance we place on consistency within the framework for financial reporting. We are firm supporters of the International Accounting Standards Board's desire to update its conceptual framework and to provide a sound foundation for developing future accounting standards. Whilst we acknowledge that the discussion paper was necessarily written within the context of the current conceptual framework, it would be unfortunate if a position reached by the ASB and EFRAG differed materially to the concepts agreed during the current debate on the conceptual framework. This is particularly true in respect of the measurement of assets and liabilities. We also note that the IASB is pursing a new standard for Insurance Contracts. The outcome of this project should surely influence future changes to the arrangements for the financial reporting of pensions.

Before we comment on the specific questions, we would like to highlight two issues raised in the paper of fundamental importance to our members. The first concerns whether the liability to pay benefits should be based on expectations of employees' pensionable salaries when they leave service or on current salaries excluding non-discretionary increases. We would favour an outcome which allows firms to estimate expected future salary increases and the impact this will have on their

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scheme. Intuitively a final salary scheme must be more valuable to the employee (and expensive to the employer) than a career average scheme and therefore should result in the employer recognising a larger liability.

The second is that we cannot agree with the proposal that liabilities should be measured by reference to a risk-free rate. In our view, a risk-free discount rate will overstate the liability and we cannot agree that users of accounts will be best served by including what will be a 'worse case scenario' number on the face of the balance sheet. The use of a risk-free rate is inconsistent with the valuation of other liabilities and with the IASB framework. Its use would fail to recognise the affect on the valuation of the liability of the employer's right to change accrued benefits in a way that reduces the liability and does not allow for conditionalities in the benefits, such as discretionary benefit formula and the ability to restrict future pensionable salary growth (if salary projection is included in the liability). It would be extremely difficult to adjust for these possibilities in the projected cash flows on a scheme by scheme basis. Therefore we consider that they should be taken into account in determining the appropriate discount rate. Whilst there may be no purely conceptual reason to use a AA corporate bond rate, such a rate is at least as relatively simple to apply and understand as a risk free rate and includes some allowance for the factors mentioned above.

Below we comment on the specific questions raised in the paper.

Specific comments

Chapter 2: Liabilities to pay benefits

1. *Should a liability to pay benefits that is recognised be based on expectations of employee's pensionable salaries when they leave service, or on current salaries (including non-discretionary increases)?*

We believe it is appropriate for the liability to pay benefits to include expectations of future salary increases. As a pension that is linked to final salary must result in a higher liability than one that is linked only to current or average salary. If expectations of future salary increases are not taken into account, the liability reported would be the same as for a plan based on career average salaries and would understate the liability. In our view, the sponsoring company is in the best position to estimate the expected future salary increases and the impact on their scheme. We also note that if future salary increases are not taken into account there will be an additional past service cost as soon as they are granted.

2. *Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pensionable obligations?*

We agree with the view expressed in paragraph 5.6 that the reporting of pension liabilities should be based upon the premise that the liability is owed to the workforce as a whole with suitable assumptions i.e. akin to collective provisioning. We also have sympathy with the view expressed in paragraph 5.7 that taking the whole workforce as the unit of account will increase the confidence in the measurement of the liability.

3. *Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?*

Yes, we do. However this is subject to ensuring that the cost of service based accrual is recognised.

Chapter 3: Assets and liabilities: reporting entity considerations

4. *Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?*

We do. In our view, the degree to which the entity exercises the power of control should be the principle governing whether or not it is appropriate to consolidate (as it is in IAS 27). We note, however, that the IASB is undertaking a review of IAS 27 and SIC-12; it would be unwise to draw too definitive a conclusion on consolidation therefore until this project is completed.

The paper rightly notes that given the independence required of pension plan trustees in the UK, it is unlikely that a requirement to consolidate would have a significant effect, although the difference (if any) between pension trusts and share scheme trusts should be explored and documented in the final paper.

Chapter 4: Recognition of pension assets and liabilities

5. *Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a 'corridor') approach?*

Yes, we agree that changes in the value of assets and liabilities should be reflected in the period in which they occur and should not be smoothed over a period of time. This fits with the IASB's proposals to eliminate the corridor approach. However, we would highlight the volatility that this would introduce into the income statement. Relatively small changes in assumptions can lead to considerable changes in what are by their nature long-term liabilities. Therefore, any change will need to be made in the context of the development of meaningful performance reporting.

We would also add that whenever possible we favour accounting standards based on principles rather than rules. In this context we agree with the conclusions in paragraph 5.1 that deferral mechanisms require the adoption of arbitrary rules and thus do not provide transparent information.

Chapter 5: Measurement of liabilities to pay benefits

6. *Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:*

- *Regulatory measures should not replace measures derived from general accounting principles?*
- *The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*
- *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?*
- *Expenses of administering the plan's accrued benefits should be reflected in the liability?*

<u>Regulatory measures v accounting principles</u>

We agree that regulatory measures should not replace measures derived from general accounting principles. In particular, we note that regulatory measures differ between jurisdictions. Therefore, if the intention behind the paper is to provide a possible blueprint for a future international accounting standard, it would be unwise to suggest a measure on which practices are not comparable.

However, the best indication of expected future cash flows is the amounts that the company will be required to pay under the regulatory measures. Therefore regulatory measures cannot be entirely ignored. In particular, where the regulatory measures result in additional obligations that are not recognised in the accounting measures, any additional obligation should be recognised. The whole asset ceiling issue should be reconsidered to determine if a less complex solution can be developed.

Risk-free discount rate

Not only do we have serious concerns about the implications of valuing liabilities by reference to a risk-free rate but we also believe the paper fails to justify why a risk-free rate is conceptually superior to the current AA corporate bond rate. A risk-free rate will overstate the liability because it will not include allowances for:

> a) credit risk. Including credit risk in liabilities is not just a pensions issue. Pension liabilities should be determined on a consistent basis with other liabilities and with the IASB's framework.
>
> (b) the right of an employer to change accrued benefits. This can be significant in some jurisdictions (e.g. US post-retirement healthcare). The argument is that if possibilities exist for the sponsoring employer to change benefits, that reduce the value of such plans to members who should, all else being equal, demand separate compensation for that risk. The cost of that compensation will be accounted for separately, so to ignore the possibility of plan changes results in double counting.
>
> (c) conditionalities in the benefits. This is not an allowance related to the right of the employer to change plan rules. Rather this is related to things such as the discretionary part of benefit revaluation formula, possibilities to restrict pensionable salary growth (if salary projection is included in the liabilities).

It would be extremely difficult to adjust for these possibilities in the projected cash flows on a scheme by scheme basis. The volume of disclosure required to explain the possibilities, the judgements underlying them and their impact on the liability probably makes it untenable only to reflect this in disclosure. Therefore we consider that they should be taken into account in determining the appropriate discount rate. Whilst there may be no purely conceptual reason to use a AA corporate bond rate, such a rate is at least as relatively simple to apply and understand as a risk free rate and includes some allowance for the factors mentioned above.

Riskiness of a liability

We believe information about the riskiness of a liability should include non-performance risk as well as credit risk.

Credit risk

We disagree with the view reached in the discussion paper that liabilities should not reflect credit risk.

Expenses

We agree that measures of the liability should reflect the expenses of managing the scheme.

7. ***Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes?***

We would suggest that the liability should be reported at an amount based on the probability of different outcomes arising in accordance with IAS 37. The experience in the UK for example is that employees choose to take part of their benefits in cash even though the conversion terms almost invariably result in a payment less than the value of the pension given up.

Chapter 6: Measurement of assets held to pay benefits

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

We agree with the conclusions reached in chapter 6. Assets traded in deep and liquid markets should indeed continue to be measured and reported at their market value. Suitable valuation techniques should be used to measure assets where this is not the case. The reporting of gains and losses on assets should be considered as part of the development of appropriate performance reporting.

Chapter 7: Measurement of employer interests in assets and liabilities of trusts and similar entities

9. ***Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?***

Yes, we do.

Chapter 8: Presentation in the financial statements

10. ***Do you agree that different components of changes in liabilities and/or assets should be presented separately?***

Yes. This is key to developing appropriate performance reporting that reflects the different nature and predictive value of the different components of the changes.

11. ***Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?***

Whilst we can see the conceptual reasons to report actual rather than expected returns, we have serious concerns about the impact of the resulting volatility on performance reporting. In our view, the income statement should show a stable view of long-term liabilities with short-term fluctuations being shown in other comprehensive income. We would suggest that the ASB waits for the outcome of the IASB's financial statement presentation project before pursuing this point.

Chapter 9: Disclosures in the employer's financial statements

12. ***Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?***

We agree with the objectives of disclosure identified in paragraph 2.13. They should indeed provide information that explains the risks arising from the provision of pension benefits, having regard to the materiality of the amounts involved.

We would add that large institutions may operate a number of different, often small, pension schemes throughout their group. In such cases, we believe it is important that disclosures focus upon those schemes which are material to the entity.

Q: Do we have any examples of requirements which should be deleted?

Chapter 10: Accounting for multi-employer plans

13. Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

In principle, yes. Although we must stress that in practice this is often not practical due to the nature of the scheme and lack of information. We also point out that the accounting for group schemes, where subsidiaries recognise their payment obligations and make disclosures about the scheme as a whole should be retained as it appropriately reflects the nature of the group scheme.

Chapter 11: Financial reporting by pension plans

14. *Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?*

In principle we agree that IAS 26 should eventually be withdrawn and that if a pension plans is producing general purpose financial statements they should be prepared in a manner consistent with IFRS, including the recognition of the scheme's liability in a manner reflecting the principles used to determine the employer's liability. However, we also recognise that local law may require the production of financial statements for other purposes, particularly to reflect the trustees' stewardship of the schemes assets.

15. *Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should reflect the employer's credit risk?*

We agree that when an employer undertakes to make payments to a plan, then the plan should recognise an asset based on the difference between its liability in respect of future benefits and the market value of assets available to pay those benefits. The amount reported should reflect the employer's credit risk.

In our view, however, users of the financial statements would be better served if the statements explained how trustees are dealing with any funding gap.

General Questions

16. *Are there types of pension arrangements that require further consideration? Please identify the specific features of these arrangements and suggest how the principles of this paper would require development to secure appropriate financial reporting for them.*

We suggest that further consideration needs to be given to trusts with multiple arrangements. We also reiterate the point made above in relation to question 13, that the accounting for group schemes should be retained.

17. *Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in further development?*

As large groups often operate numerous pension schemes (many of which are small), we believe that comprehensive disclosures should only be made for those schemes which are materially important to the group.

Yours sincerely,

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