THE VOICE OF BUSINESS

CBI response to the PAAinE and ASB discussion paper– The financial reporting of pensions

1. The CBI welcomes this opportunity to respond to the Accounting Standards Board (ASB) on their consultation paper covering the financial reporting of pensions. While CBI members believe a wide-ranging review of pensions accounting ahead of any reform to IAS19 is helpful, it is clear that the paper published for consultation does not do this. Instead, it represents an organic development of the current approach to the balance sheet, which is already open to conceptual challenge, and often inconsistent. On the discounting of liabilities, for instance, conceptual arguments can be made based on practice already established in UK GAAP and IFRS for diametrically opposite approaches (for instance by comparing the approach to discounting of IAS12 – where it is banned – with that of IAS 36 or 37 – where high rates are possible).

2. ASB has long put conceptual arguments at the heart of justifying its decisions. Given the problems in the current approach to the balance sheet, the ongoing review of the conceptual framework is vital. CBI members believe it must be completed before any full review of pensions accounting takes place, in order to resolve existing issues. Following such a review, the particular place of pensions could of course be approached. At that time, we would support an approach that allowed users reliable guiding information on pensions as a going concern, and under no circumstances as a wind-up debt, as this will almost always overestimate liabilities.

3. This kind of outcome would entail either retaining a discount rate with allowance for credit risk, or a move from single-number approaches towards a range of numbers, with an expected weighted average carried on the balance sheet[1]. Any changes should be based on better decision usefulness and strong conceptual arguments, not merely a knee-jerk reaction to increase the liability carried on the balance sheet. Such an approach disguises the real issue. We would therefore propose a moratorium on change to FRS17/IAS19 while a new approach is developed following completion of the conceptual framework.

4. Many of the issues that ASB identifies in its case for reform could be addressed by this approach, as they stem not from failures in the current standard, but from more fundamental issues around the long-term unpredictable nature of pension saving, especially in db schemes. A wider project on reform of the report and accounts – hinted at by the paper in talking about the possibility of an operating-financing split in the income statement and already underway through the review of the conceptual framework – would be more worthwhile than "salami slicing" the current approach through topic-based reform.

5. In this response we set out that:
   - using a risk-free discount rate is no more conceptually sound than using a corporate bond rate. A better approach would be to acknowledge the nature of pensions through accounting that tolerated the uncertainty inherent in db schemes

[1] Businesses are prepared to work with standards setters on how such an approach may be devised.

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- the reasons that led to the choice of a rate above government bonds remain
- moving to a risk free rate would have real-world impacts that cannot be ignored
- our position – that pensions accounting must reflect the ongoing nature of the liability – suggests future salary increases should be included
- the use of actual return on assets would cause a significant perceived increase in volatility which does not reflect the economic reality of how pension schemes are financed and should be avoided unless a new approach is taken to the income statement
- pensions should be consolidated as appropriate and should not be singled out as a special case
- expenses should be included as an ongoing cost but should not include levies for government guarantee plans
- the probability of different outcomes should be reflected within the liability calculation
- multi-employer plans lack the detailed data necessary for major changes to be made
- liability figures should not be included within pension plan accounts.

Using a risk-free discount rate is no more conceptually sound than using a corporate bond rate. A better approach would be to acknowledge the nature of pensions through accounting that tolerated tolerated the uncertainty inherent in db schemes

6. The CBI made its concerns known about the conceptual basis for, and the likely practical outcomes of, FRS 17 at the time that it was introduced. We are aware that there is a need for clear, useful and consistent pensions accounting and that there are issues with the current approach, for example the effect of the recent increase in corporate bond rates due to the credit crunch. However, we do not believe the ASB have made the right proposals to tackle this for a number of reasons.

7. Recent work by Professor David Blake and his colleagues at the Pensions Institute of Cass Business School argues that any single number cannot reflect the true position of the scheme, because the risks inherent in running a defined benefit pension scheme are so great as to render any single figure inevitably wrong. This stance is intuitively correct if one looks at, for instance, the possibility of a risk-free rate existing. Even government bonds carry some risk, and a large-scale move into them and liability driven approaches by pension funds – as might be driven by a change in accounting treatment – would be unsustainable because of the demand and supply impact on their pricing, rendering previously “risk-free” assumptions as overstatements.

8. Meanwhile, even the risk-free rate fails to account for possible changes in longevity. For this reason alone, the risk-free rate proposal is conceptually no more reliable than the current FRS17 treatment, while carrying significant costs for firms and further fostering the “illusion of certainty” that Professor Blake and his colleagues have warned against. Because of this, CBI members believe that it is impossible to ascertain the worst or best case scenario for a scheme, and the most useful approach is to use a discount rate that allows for presentation of a reasonable estimate.

9. In the discussion paper, the ASB/PAAinE do not suggest what the correct risk-free rate to use would be, but any choice of a risk-free rate would still involve subjectivity in choosing the rate to use – government bonds, a buyout quote or swaps – and also in choosing how to approach extrapolating the long end of the yield curve to fit the longer term liabilities, as government bond yields end long before pension liabilities are fulfilled. Taken together, this uncertainty and subjectivity suggests that a move to risk-free discounting would not be desirable. It would be far better to adopt a prudent discount rate

– around the currently prevalent level – and acknowledge uncertainty rather than pretend that we have adequate measurement tools to measure it over 80 years and more.

10. Secondly, a pension scheme is an ongoing commitment for a sponsoring company, with wind-up and buyout relatively rare choices. In viewing the sponsoring employer as a going concern, therefore, there is little rationale for using a discount rate that values the liabilities at more than the cost of a total buy-out. Competitiveness within the pensions buy-out market recently has driven a sizable – albeit temporary – reduction in price. The chief executive of one of the major pensions buy-out providers has stated in the press that the proposals to replace the AA corporate bond discount rate currently used for calculating scheme liabilities with a risk-free rate of return, such as government gilts or a swap rate would massively overstate scheme liabilities and that the adoption of the proposals would mean companies will no longer face the prospect of having to pay a premium to crystallise the cost of meeting all their scheme obligations. Given that these firms are offering to buy out liabilities for less than the ASB's proposals would place on the balance sheet for firms without buyout quotes – and they anticipate making a significant profit from doing so – there is clearly conceptual weakness to the proposals on the basis of failing to treat the liabilities as those of a going concern.

11. Thirdly, the market value of assets is often used as an offset against the value of the liabilities on the balance sheet, implicitly allowing for the credit risk of the income streams of the investments within the market value. Therefore comparing the value of the liabilities based on a risk-free discount rate with the market value of assets would give rise to inconsistency. With more and more schemes are considering liability driven investment strategies where the assets are invested to match the liabilities, if a scheme had perfectly matched assets the accounting valuation would still show a deficit under these proposals due to the use of a risk-free rate to value the liabilities. Whilst the current approach does not remedy this completely it goes some way in dealing with it due to the use of the corporate bond discount rate.

12. Fourthly, a key ASB argument for not including credit risk is that reducing an entity's pension liability to reflect the credit risk of the liability is not useful information for users who wish to assess the entity's cash flow prospects as it does not help them to assess the amounts, timing and uncertainty of the cash outflows from its obligations. However, using a risk-free rate does nothing to address this, and therefore this cannot be seen as an argument for the proposal. Such an argument actually supports a more fundamental reform of pensions accounting. For instance, provision of the following additional information would be more helpful than using a risk free discount rate:
    - estimate of the duration of the liability
    - estimate of the actual cash flows
    - details of the mortality and other assumptions used (e.g. cash commutation rates)

13. Fifthly, treasury theory would suggest that gilt yields are lower than corporate bond yields because of the elimination of credit risk and immediate liquidity. Neither of these are appropriate to pension schemes. Liquidity is irrelevant due to the extended period over which liabilities are to be met, while credit risk is clearly an issue. One cannot argue that all risks are covered in the pricing of the cash flow model for a scheme, and therefore some allowance for credit risk is appropriate, and it would seem that discounting this at something around the sponsor's cost of capital would make sense, given the pension scheme's status as an unsecured creditor. For example, if an employer wanted to borrow money to pay off a pension scheme deficit they would have to do so at terms consistent with their credit risk which would be a corporate bond rate of return, not a risk free rate. Bearing this in mind, a discount rate around the level of the sponsors weighted average

cost of capital – or rather a proxy for it, such as corporate bond rate or 2% over swaps – seems appropriate. This suggests a level around that which is currently used.

14. Finally, it can be argued that pension liabilities are incurred in exchange for an employee's service. The application of accounting principles suggests that these liabilities should be treated the same as liabilities incurred in exchange for cash or a firm's borrowing. Borrowing is treated on terms that use corporate bond discount rates and pension liability is not materially different. The pension liabilities should be valued consistently with the measurement of other liabilities on the balance sheet.

The reasons that led to the choice of a rate above government bonds remain

15. AA corporate bonds were initially chosen as the discount rate under FRS17 to allow for the fact that sponsors of db schemes have options to reduce future benefits, not to provide discretionary benefits or salary increases and to invest in equities to make use of the higher expected returns. The use of AA corporate bonds made an allowance to reflect these options based on the premium above the risk-free rate. These options are still available to sponsors of pension schemes and thus the rationale for using a rate with a premium above the risk-free rate is still valid.

16. Whilst the current credit crunch has highlighted some potential problems with the AA bond approach – as the spread between corporate bonds and gilts has changed – this does not warrant a move to using a risk-free rate. Sponsors still have the option of reducing future benefits, not paying discretionary benefits above statutory levels, closing the scheme to future accrual and investing in equities and therefore using a risk-free rate is not appropriate as it does not reflect these options. It may be that an alternative approach could be considered to achieving this end – for instance by using swaps with an allowance of 2% for the effect of these options. The CBI would like to see such approaches fully explored.

Moving to a risk free rate would have real-world impacts that cannot be ignored

17. For the reasons set out above, we do not believe that the proposals for using a risk-free discount rate are conceptually sound. Additionally, any conceptually weak move in the discount rate would have real-world impacts which it would be indefensibly short-sighted to ignore. While we appreciate ASB's need to focus on the conceptual arguments, there is clearly enough doubt – as set out above – to suggest that a move to risk-free may drive scheme closures based on inexact data where such behaviour is neither necessary nor desirable.

18. For pension schemes, higher liabilities could feed in to a political debate about higher scheme funding liabilities and calls for additional employer contributions, especially considering that one of the Regulator's funding triggers is the FRS17 liability. Naturally cautious trustees will assume that the accounting liability increasing represents an endorsement for investment in government bonds. Companies, too, may feel under pressure to move to a less risk-tolerant approach to reduce balance sheet volatility. In the longer term, this could have severely negative outcomes:
    - reduction in the yield of government bonds, due to higher demand, leading to a downward spiral in funding that will require yet more contributions from the sponsoring employer
    - reduction in equity return due to lower demand from pension schemes, leading to lower return on capital and limitations on capital availability for firms, leading in turn, to lower investment and long-term economic damage.

19. A move to deficit accounting by reference to gilts could also encourage trustees to adopt a matching investment strategy by increasing the investment of the scheme assets in gilts. This would then have a real impact on the funding valuation and company funding requirements. This happened to some extent with corporate bonds after FRS17 was introduced – a number of major schemes can find no other source for the push into fixed income investments that they found at that time. Many of these schemes have since struggled with the increases in longevity assumptions which they have no means of funding other than by reverting to the employer.

20. Carrying such a large creditor on balance sheet, with the availability of buy-out growing, also suggests more FDs will be tempted to buyout their creditor, potentially unnecessarily, to the detriment of scheme members. This could especially be the case if the liability held on the balance sheet is higher than the buyout price in the market.

21. These proposals have already led some CBI members to report that they are considering whether to remain open to future accrual for existing members. These proposals may well prompt other companies to reconsider their pension provision and provide another reason for reducing the level of benefits provided. The unintended impact therefore could be to reduce the availability of scheme membership for employees, which is not a reasonable risk to allow if based on conceptually unsound principles.

22. Accounting valuations also have repercussions throughout much business activity. Moving to a risk-free rate will undoubtedly increase the burden for sponsors of defined benefit schemes. Members have stated in the past that the extent and effect of existing and regulatory burdens is a real reason not to change the current approach. Our members also consider that the impact of using a risk-free rate on their position in the capital markets – for instance with credit ratings agencies – will pose a particular problem. Indeed it could have an impact on issuing dividends and other normal business transactions.

Our position – that pensions accounting must reflect the ongoing nature of the liability – suggests salary increases should be included

23. As we have already set out, CBI members believe that the important information for users of company accounts to have is related to the proper shape of the liability. Just as a worst-case investment scenario is of little use to investors in understanding the true position of the scheme, companies could not avoid awarding salary increases for their employees in the normal course of business and these should be included within pension liability figures. However, if a company changed its pensionable salary increase policy, for example to limit pensionable salary increases in the long term to inflation, then this should also be reflected within the assumption.

24. Including future salary increases ensures the true position of schemes is more accurately shown. For instance, the difference between career average and final salary plans is properly reflected in the accounts under this approach, whereas under ASB proposals this substantial difference would be masked. In addition, taking out salary increases would put each company on a level footing for the salary increase assumption. However, only the sponsoring company is in a good position to estimate the expected future salary increases and impact on their db scheme. Due to the lack of information provided in the accounts relating to the proportion of the liability in respect of active members it would be difficult for users of accounts to make any judgement as to the true impact that allowing for salary increases would make, and therefore the true liability.

25. There are also volatility fears associated with removing future salary increases. If they were not included within the liability then the effect each year of the actual increase on the past service liability would need to be included within the P&L which would also increase

volatility in this element of the financial statements, further reducing decision usefulness for users.

<u>The use of actual return on assets would cause a significant perceived increase in volatility which does not reflect the economic reality of how pension schemes are financed and should be avoided unless a new approach is taken to the income statement</u>

26. The use of actual as opposed to expected returns would cause significant fluctuations in the P&L charge from year to year. CBI members could only accept such a proposal if a move to using actual return on assets took place once a full distinction is made is made between "operating" and "financing" costs so that the actual return on assets (and hence the likely volatility) could occur in the financing and not the operating section. Even then, some split of returns will be needed to avoid volatility on performance measures below operating profit.

27. If such a distinction is not made the increase in volatility resulting from using actual rather than expected returns would cause significant problems, especially for those firms with legacy pensions liabilities close to or greater than the capitalisation of the company. For users of the accounts, this would create an unhelpful lack of clarity, whereby the trading performance of the company is masked behind the investment performance of the pension scheme. Firms may react to this by choosing to reconsider their investment strategy to reduce volatility of plan assets, particularly in equities, which could affect the long term cost of providing pensions, which is not in the interest of sponsors or members.

28. Until a full distinction is made, therefore, we believe the current approach is sufficient. While it is true that investment return can be negative, whereas expected returns are not, it is equally the case that actual returns can significantly outperform prudently-set expectations. One possibility for reform within the current framework might be to standardise practice for estimating returns to ensure less prudent approaches are avoided.

<u>Pensions should be consolidated as appropriate and should not be singled out as a special case</u>

29. The CBI believes that pensions should not be singled out as a special case on consolidation and that, where the control test is passed, they should be consolidated on the balance sheet. Given the independence required of trustees in the UK, we do not believe this would have any significant impact on UK plans but it could impact on companies with overseas plans. In such cases, it is essential that the move to consolidation is properly carried out, on a timescale that allows for a transition period.

<u>Expenses should be included as an ongoing cost but should not include levies for government guarantee plans</u>

30. CBI members are comfortable with the proposal to include the future expenses of administering the plan within the liability, however we do not believe this should include levies payable to government guarantee plans which should be accounted for on an ongoing basis. An alternative route may also be maintained, whereby expenses can be deducted from the expected return.

31. Future levies to a centrally sponsored guarantee plan are in some respect under the control of the company who could reduce them for example by increasing cash funding or providing a guarantee. Additionally, future levies are unknown and it can be difficult to estimate future levies as has been experienced recently where the scaling factor for the PPF levy more than doubled from the initial estimate.

The probability of different outcomes should be reflected within the liability calculation

32. CBI members believe that the calculation of liability retains the most decision-usefulness for users of the report and accounts where it reflects the most likely outcome for the scheme. For this reason, where employees have the option to receive benefits in different ways the liability should be reported in a way that reflects the probability of different outcomes. For example, in the case of cash commutation the choice is with the employee to take the (typically lower overall value) lump sum benefit. The reality is that the majority of employees find this benefit extremely attractive and do choose to take some form of cash, even given its lower value. This should be reflected within the liability calculation.

Multi-employer plans lack the detailed data necessary for major changes to be made

33. The CBI does not believe it will be possible to materially change the way that multi-employer schemes are currently dealt with. In the majority of cases the data is not available to disclose the split of the assets and liabilities relating to the plan. Multi-employer schemes work to provide the pooling of risks and in many cases the sponsor's share of the assets and liabilities is not obtainable.

Liability figures should not be included within pension plan accounts

34. The pension plan accounts are mainly a stewardship document that confirms to members that the assets are being invested appropriately and that contributions are being paid and future benefits are secure and protected. The funding information is already provided in the statement of funding principles, schedule of contributions and recovery plan.

35. Experience has shown that plan accounts are not generally requested by members who can receive useful information regarding the funding of the pension scheme more easily through other documents. Other liability figures can be found in either the company accounts or within the valuation report. In addition, members in the UK now receive an annual funding statement which provides a more compact and easily digestible document for members who can then request copies of the formal valuation report, plan accounts or company accounts if they require more detail. This form of reporting – on a national regulatory basis – is preferable to using IFRS, as these accounts are not general purpose financial statements.

36. Therefore the CBI does not think it is necessary to include plan liabilities within the pension plans accounts as it is of little use to investors (who would use the information in the sponsoring company reports) or scheme members. Placing more costly and onerous requirements on plan accounts will provide little extra value.

Employment Policy Directorate
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