Response No.66

Association of British Insurers

The Financial Reporting of Pensions

The ABI's response to the PAAinE Discussion Paper

Introduction

1. The Association of British Insurers (ABI) is pleased to respond to the discussion paper on The Financial Reporting of Pensions published in January 2008 by the Pro-active Accounting Activities in Europe umbrella group.

2. Our Association represents nearly 400 member companies which between them provide around 91% of the UK's domestic insurance. As institutional investors they have around £1.3 trillion of assets under management. Our response reflects our members' interests as investors in companies and therefore users of accounts of sponsoring employers, as sponsoring employers of pension schemes, and as providers of pension products. It is essential that users are provided with the information they need to make judgments about the costs, risks and other implications of the existence of pension schemes.

General comments

3. We welcome this opportunity to consider afresh the subject of pensions accounting, which raises complex issues.

4. The paper adopts a long-term perspective in exploring the implications of applying a general accounting approach as for other areas of accounts. In doing so it throws issues peculiar to pensions in sharper relief and gives a proper focus on the needs to justify any unique solutions. Particularly welcome is the recognition of differences between accounts on the one hand, and budgets and investment strategies on the other, and of the significant implications of those differences. It is important that all concerned need to interpret accounts appropriately and not react in a knee-jerk way.

5. The particular nature of pension liabilities and the significance of investment risk, inflation risk and longevity risk and the way these interact need to be recognised. These give rise to significant challenges which need to be met through appropriate recognition, measurement, and presentation and disclosure. More work will be needed, as the PAAinE paper acknowledges.

6. We highlight here especially that any substantial changes to current pension accounting requirements – eg how to reflect changes in the values of pension assets and liabilities and how to reflect the time value of money in measuring liabilities – need to increase the decision-usefulness of accounts. The paper itself recognises that there are challenges in deriving an appropriate discount rate that achieves this goal and our response concurs.

7. Investors will not want their ability to understand the business to be impaired by the mixing of predictive and non-predictive information in accounts. Further, it is important that the needs of regulators and the impact of regulation are taken into account – they have a material impact on pension costs and do in practice influence the operation of markets and so are relevant to the accounting regime. In this regard, we highlight that it would not be right to move to a Government-bond derived rate for discounting very long liabilities as this would amount to replacing one “wrong” rate with another.

8. For the more immediate future, the IASB’s consultation on amending IAS 19 provides the focus for debate. We will be responding to the IASB, as, no doubt will EFRAG and associated standard setters. We would be happy to discuss our comments with you in that context as well.

9. We set out our responses to your specific questions in the annex to this letter.

ANNEX
Questions for consultation

Q1 Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non-discretionary increases)?

1. We consider that there is a strong case for concluding that future salary increases are not relevant in the same way to the determination of the present liability. Were pension accounting to be based on expectations of future funding obligations it would be right to take future salary increases into account. However if accounting is to be based, as now, on assessing the present value of the obligation we do not consider expectations of future salary increases to be relevant. Nevertheless, where there is an obligation, for example under a trust deed governing the scheme of a funding standard, to fund in anticipation of future increases and where the employer is not entitled to refunds of contribution in the event of surpluses crystallising it would seem that the liability should reflect the present value of expected funding costs if this should give the higher figure.

Q2 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 pension obligations?

2. Liability recognition should be based on criteria that do not distinguish between an individual employee and the workforce as a whole. Consideration of the workforce assists in measurement of the values of liabilities to a number of individual employees.

Q3 Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

3. Yes, this is the principle that should apply if the obligations are to be measured directly. As per our answer to Q1, however, if the accounting treatment were to be derived from expected outturns we would consider it necessary to take into account some obligations that are expected to crystallise in the future related to entitlements that have already accrued.

4. We note, however, that a statutory obligation, as in the UK, to increase the deferred pensions of leavers to offset the impact of inflation can cause measurement difficulties on which there may different views. At one extreme, inflation is a future event and shouldn't be anticipated in measurement. At the other, indexation is allowed for all current employees and adjustments are made subsequently. In between, indexation is allowed as from expected future leaving dates (with or without allowing for future salary increases).

Q4 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?

5. We would not expect a pension scheme to be consolidated in most circumstances. We note, however, that pension accounting presents challenges for the consolidation boundary. Working through them may shed further light on whether the criteria currently used are appropriate. Nevertheless, for users of accounts who will be concerned primarily with the entity and the impact of its business activities, the net impact of its pension obligations is what matters most. If additional information is required about pension scheme assets, so that the risks relating to the pension obligations may be understood clearly, this should be provided, as now, through supplementary disclosure.

Q5 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?

6. We oppose the use of the corridor approach, the impact of which is to delay or obscure the recognition of changes in pension scheme financial position which is to the detriment of usefulness of the accounts. If changes in valuation of assets, liabilities, surpluses or deficits are material and can be measured reliably they should be recognised immediately.

7. Those who support the use of a corridor approach appear to do so on the grounds that this reduces or eliminates shorter-run volatility that is not meaningful in the context of discharging longer-run liabilities. If this concern is right then the correct remedy would be to seek a different methodology for discounting the liability, one that is more consistent with the rate of return expected on an appropriate portfolio of assets.

8. In any case, the immediate recognition of changes in assets and liabilities relating to pension plans has the potential to change many entities' accounts significantly. The key will be how components of the changes will be presented. It is important that reflecting volatility in values should not diminish the decision-usefulness of accounts.

Q6 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?**

9. We agree that regulatory measures, applied for whatever reason, are not a substitute for recognition of the present economic value of pension obligations for accounting purposes.

10. However, regulatory requirements can have a material impact on the actual costs faced by providers of pension benefits and do in practice influence the operation of markets and so are relevant to the accounting regime.

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

11. We recognise that risks relating to future cash flows generally could in principle be captured within the estimates made of those cash flows, and that discounting these at a risk-free rate could in turn provide an estimate of the present value. However, in the case of valuation of pension liabilities there are significant difficulties with this straightforward approach.

    a. The lack of sufficient risk-free securities at all maturities prevents the derivation of a true risk-free yield curve off which valuation of liabilities can be undertaken, and this currently significantly distorts pensions deficits. In practice the swaps market provides a more obvious liquid benchmark for high durations but this inevitably incorporates a risk premium relating to the creditworthiness of participants in the swaps market. Further, the swaps market also suffers from the same problem at the long end of the yield curve.

    b. Because longevity itself directly impacts on duration risk it will not be possible to identify which 'risk-free' securities will prove to be required to provide a risk-free match to the liabilities.

    c. As noted earlier, the uncertainty associated with longevity (which cannot be effectively hedged or diversified) is qualitatively different and distinct from the other principal variables faced by pension schemes, i.e. interest rate and inflation risk (which are capable of close matching through holding of assets which eliminate such variables). The cash-flows representing the future liabilities of the pension scheme are the product of the interaction of all of these very different risk variables and not simply the summation.

12. Many consider that the valuation of liabilities without observable prices is dependent on the valuation of effective matching assets. This approach brings further considerations into play.

    d. The length of life of pension liabilities which can be extremely long. Especially in an environment of limited supply of fixed interest securities it is possible that a portfolio making use to a greater or lesser extent of other assets will increase the efficiency of match. This will be both because higher expected returns over prolonged periods will progressively outweigh higher volatility of returns and also that diversification of asset classes will provide an enhanced risk-adjusted rate of return.

    e. Uncertainty of longevity together with the very long-dated nature of pension liabilities reduces the efficacy of fixed interest securities (fixed cash flows and duration) as matching assets. This would support the view expressed in Paragraph 6.49 that portfolios including higher return assets than Government bonds might be expected in some circumstances to provide a more efficient reference portfolio. However, the existence of mortality risk of itself could not be expected to reduce total risk, at least unless these risks were to be thought to be negatively correlated.

13. As we indicate in our comments relating to credit risk we do not think that use of a AA bond rate can be conceptually correct. However, use of the AA bond rate, or some similar formulation, in giving allowance for movements in credit spreads, might in practice achieve a closer alignment with likely movements on an appropriate/efficient portfolio. On this basis, further thought could be given to whether a better formulation can be found that gives due allowance should be made for investment returns on other baskets of assets. The merits of this approach should be weighed against another possibility, of moving explicitly to a swaps-derived discount rate. However, we do not believe it would be right to move to a Government-bond derived rate for discounting very long liabilities as this would amount to replacing one "wrong" rate with another.

- **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 that by adjusting the amount of the reported liability?**

14. We consider that relevant information about riskiness of liabilities should be reported by way of disclosure. However, to do so as a substitute for reflection of riskiness within the values on the face of the accounts should be seen as a pragmatic response to difficulties of quantification. Accounting should recognise that accounting numbers that reflect risk in an incomplete way may not give an accurate impression of the size and dynamic characteristics of those risks.

15. We agree with the analysis in the paper of the difficulties in taking longevity risks into account in measuring pension liabilities. However, we do not necessarily agree with the paper's conclusion that the uncertainties are normally such as to preclude a full valuation process. Whilst we agree that disclosures will be necessary, we suggest that the recent emergence of a market for pension plans shows that methodologies may exist that would enable valuations to reflect longevity risks more fully and directly.

- **The liability should not be reduced to reflect its credit risk?**

16. We agree. To reduce the size of the liability on this account would be inconsistent with the going concern concept. It is not right in principle, or helpful to users in practice, to incorporate a reduction in the size of the liability to reflect a belief that the entity can default on its liability unless it can do so while remaining a going concern without collateral damage to its other assets.

17. The discussion paper notes correctly (Ch 5 Paragraph 6.16) that regulatory measures would, if anything, tend instead to increase, not reduce, the cost of discharging the liability for companies with weaker covenants. This reinforces our view that credit risk associated with the company and the value of its covenant should not alter the recognised values of pension liabilities as they impact on the company's financial statements.

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

18. It is hard to argue that they should not. These costs are inescapable and are rolled up in the price of annuity buy-outs quoted by insurance companies. This is economic reality and not a function of regulatory requirements.

Q7 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?

19. The amount should be the one that reflects the probability of different outcomes.

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

20. Yes but the apparent reasoning (see Paragraph 3.2) is questionable. The case for using current value for assets, where prices in deep and liquid markets are the norm, is considerably stronger than that for pension liabilities.

Q9 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?

21. This approach is in effect to consolidate the plan, though it is not clear that the PAAinE is being consistent here in applying 'normal accounting rules'. Of particular relevance is consideration of the nature of the residual liability and asset representing respectively the guarantee given by the company to make good funding shortfalls as they emerge and to receive repayments or enjoy 'pension holidays' should they eventuate, as would be the case for other guarantees for third parties.

Q10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?

22. Yes.

Q11 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?

22. The actual return achieved on assets represents an important component of financial performance and of shareholder value creation/ destruction and should be reported in an appropriate manner. What is important is that the presentation of this information should not be in a way that distorts performance achieved from the entity's operating activities. Recognition within financing activities would be appropriate.

23. The proposal that operating performance would then recognise pension cost on a basis consistent with accounting for costs within the calculation of surpluses and deficits reflected in the balance sheet, rather than the expected cost (which would

reflect the expected return on assets the fund invests in rather than matching assets), has some validity.

24. Its acceptability would be the greater if a clear consensus can be achieved that the actual accounting measurement of pension values is right. In the absence of such a consensus there may still be a case for calculating pension cost for P&L purposes based on expected returns on assets. That approach would also remove the bias that otherwise would be expected in practice to prevail towards gains rather than losses over time in financing income.

25. We agree in any event that the expected return on the scheme's assets should be disclosed.

Q12 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?

27. Yes, such disclosures seem necessary to users of accounts and appropriate.

Q13 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?

28. We agree that the same principles should be applied in relation to single- and multi-employer plans. We agree also with the use of a proportionate approach to identifying shares of collective pensions assets or liabilities, but only as a default where there is no better basis. We question whether it may more often be possible to identify the obligation of the employer using normal accounting criteria such as whether there is a legal or constructive obligation under IAS 37 (as it may be revised) than seems to be assumed, and we suggest that further work may need to be carried out in this area.

Q14 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?

29. We do not comment here on pension plan accounting.

Q15 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?

30. Please see our response to Q14.

Q16 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.

31. We have no particular suggestions to propose at this time.

Q17 Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

32. We have no particular suggestions to propose at this time.

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