24 July 2008

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Andrew Leonard
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Dear Andrew

The Financial Reporting of Pensions – A PAAinE Discussion Paper

IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of over £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Discussion Paper on the financial reporting of pensions from the perspective of institutional investors.

IMA welcomes the ASB issuing this Discussion Paper and fundamentally reconsidering pension accounting rather than seeking to improve existing standards and in general, we believe that the Paper provides a good analysis of the issues and find it difficult to fault on technical grounds. That said, we believe its practical implications cannot be ignored in that certain the proposals are likely to have significant behavioural consequences. In particular, one of the more controversial proposals is the use of the risk free rate to discount pension liabilities as opposed to the corporate bond rate that is currently used. This will significantly increase the valuation of pension liabilities. We believe the consequences of such a change are such that they could undermine the very objective it was designed to achieve. To this end, we have written to The Rt. Hon. James Purnell MP, Secretary of State for Work and Pensions, on the wider policy issues and copied our letter to the Department of Business, Enterprise and Regulatory Reform, the Treasury and the Pensions Regulator. A copy of our letter is attached at Annex 1.

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Furthermore, as the Discussion Paper aims to contribute to the development of a new international standard on pensions by the International Accounting Standards Board (IASB), it is likely to be sometime before its proposals have any effect. The IASB also recently issued a Discussion Paper as Phase 1 of a project to address pensions accounting. However, this is unlikely to lead to any effective amendments until January 2013 and even then will only really make sense in the context of Phase 2, which is yet to be started. IMA considers that a review of pensions accounting is long overdue in that the existing standards, FRS 17 and IAS 19, tend to produce chaotic figures that are inconclusive. From the above time frame, it will be some time before any changes take effect. In conclusion, we consider pensions accounting should be more of a priority for the respective boards.

Our answers to the specific questions raised in the Discussion Paper are set out in the attached Annex 2 and our main points are as set out below.

- Although the ASB's views are divided, we consider future salary increases should be taken into account when they are non-discretionary, for example, increases in pay to reflect inflation (question 1).
- We recognise that the majority of UK schemes being governed by trustees acting for the members rather than the employer will not fall to be consolidated. The Paper alludes to the fact that it may require pension assets and liabilities to be shown gross where the employer has a direct obligation to pay benefits contrary to the requirements of IAS 19. We consider that in instances where the entity has ring-fenced assets to meet its obligations and they cannot be used for any other purpose, they should continue to be shown net (question 4).
- We agree that in general, pension plan assets and liabilities should be recognised immediately, rather than deferred and recognised over a number of accounting periods and that the "corridor" approach should be abolished. That said, certain members believe that there should be a measure of smoothing in order spread volatility over several years and to capture the benefits of a long-term funding regime provided there is full transparency of the methodology (question 5).
- The Paper assumes that the liability stream is a constant when age distribution and mortality assumptions will be major flaws in measuring liabilities using the risk free rate. Whilst there may be difficulties in taking longevity risks into account, we believe the emergence of the buy-out market indicates that there may be a means of estimating these (question 6).
- To reflect the economic conditions as at the balance sheet date, we agree that assets held to pay benefits should be reported at current values (question 8).
- We would welcome more clarity as to where pension costs are recognised in comprehensive income (question 10).
- We agree that the actual return on assets should be reflected rather than the expected return in that the latter can more than offset the interest charge on the pension liabilities even when the scheme is in deficit. Thus entities can report financial income from a scheme that is a net liability which seems illogical (question 11).

If you would like to discuss any of the points in this letter or the attached or if you would like to discuss any issues further then please do call me on 020 7269 4668.

Yours sincerely

Liz Murrall, Director Corporate Governance and Reporting

Investment Management Association

ima

24 July 2008

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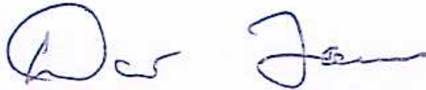

The Financial Reporting of Pensions

IMA has responded to the UK Accounting Standards Board's discussion paper on this subject. I enclose for information a copy of our response. I am writing to you about the wider policy implications which this raises.

The paper fundamentally reconsiders pension accounting, rather than seeking to improve existing standards, and we believe in many respects it provides a good analysis of the issues. We find it difficult to fault the paper on technical grounds, but we cannot ignore its practical implications in that certain of the proposals are likely to have significant behavioural consequences. I would like to make you aware of these, and of the possible causes.

We have already seen significant closures of defined benefit pension schemes in the private sector both to new entrants and to future accruals. While this has in large measure reflected a growing unwillingness of scheme sponsors to take on uncertain and open ended future liabilities, accounting treatment has played its part. In particular, the introduction of FRS 17 and IAS 19 led to much publicity about the implications of including pension fund deficits on sponsor company balance sheets.

The discussion paper's proposals will take matters further by requiring liabilities to be discounted using a risk free rate as opposed to the corporate bond rate that is currently used. Such a change will significantly increase the valuation of pension liabilities – research undertaken for the National Association of Pension Funds estimated that as at December 2007, the liabilities for a young scheme would have doubled, a medium scheme increased by 60 per cent and a mature scheme by 24 per cent.

But the use of the risk free rate in reality gives a misleading picture of a scheme's ability to fund its liabilities. A pension scheme has a time horizon stretching many

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decades into the future. It does not in general need short term liquidity and investment decisions need not be driven by liquidity considerations. Thus assets can be invested for the long term, capturing the premium that long term investment yields. In particular, equities have over many years delivered long run returns significantly above risk free assets, and indeed have exhibited lower volatility over the long term than fixed income investments because they are better able to offer protection against inflation.

The use of the risk free rate for valuing liabilities will inevitably drive pension schemes into a more conservative asset allocation, accelerating the trend towards bonds seen in recent years. This is likely to reduce pension scheme returns over time, and may ultimately call into question their ability to meet their long term liabilities. Moreover, bonds are a less good inflation hedge than equities, potentially leaving schemes exposed to the risk of unanticipated inflation.

It may be noted that, in many instances, use of the risk free rate would value a scheme's liabilities at more than the cost of a total buy-out. There is an active growing market for pension liabilities in the UK, and to quote the chief executive of one such company specialising in buying defined benefit schemes "there will be cases where the imposition of this accounting standard will cause the cost of pension liabilities to rise above the level of buy out". It seems illogical to seek to value liabilities at more than they could be discharged in the market.

Lastly, although the paper does not define which risk free rate should be used, it is likely that gilts or Government bonds will be chosen, resulting in large scale demand for gilts in order to reduce volatility in the profit and loss account. Current breakeven yields for index-linked gilts indicate that demand for these instruments is outstripping supply and unless there is a significant increase in their issuance, a change to the risk free rate will further reinforce it.

Having pointed out the potential consequences of change, however, I should stress that we do not call for fundamental change in the ASB proposals. The job of an accounting standard is to recognise the economic realities. In this particular case, we do not fault the general logic underlying the proposals. It follows, therefore, that the consequences I have outlined follow not from the proposed accounting standard but from the regulatory environment in which it is set, which it would seem has the effect of requiring pension scheme valuations to be immunised against short term fluctuations. Thus, changes introduced with entirely understandable and laudable motives may end up having consequences which undermine the very objectives they were designed to achieve.

I am sending copies of this letter to John Hutton at BERR, to Kitty Ussher at the Treasury, to David Norgrove at the Pensions Regulator.

R B Saunders
Chief Executive

IMA RESPONSE TO DISCUSSION PAPER ON THE FINANCIAL REPORTING OF PENSIONS

IMA's answers to the specific questions in the Discussion Paper (DP) are set out below.

Chapter 2, Liabilities to pay benefits

A liability for pensions arises in exchange for an employee's services as those services are provided. The liability will be subject to a number of uncertainties — for example, the mortality of scheme members which affect the amount of the liability rather than its existence. The liability should include all benefits to which there is a present commitment (whether through a legal or a constructive obligation), but should not include benefits that are genuinely discretionary.

An issue in applying this principle arises where benefits relate to final salaries. Some (including a majority of ASB members) consider that the present commitment, and hence the liability, relates to current salary levels only, as there is discretion over future salary increases. Others believe that the liability should include the effect of expected increases in salary, as is currently required. Which view is to be taken may depend on whether the liability is viewed as the aggregate of amounts owed to individuals, or as an obligation to the workforce as a whole, since there may be greater discretion over salaries of individuals than over the whole workforce.

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)?,

IMA believes that the liability to pay benefits should take account of future salary increases when they are non-discretionary. For example, whether or not a contractual condition or a constructive obligation from past practice, employers will tend to increase salaries in line with inflation and employees have a valid expectation that they will be. That said, salary increases that arise from promotions or which are conditional are much more uncertain and we do not believe that they should be taken into account unless there is a specific or constructive obligation to provide such an increase. In this respect, an increasing number of defined benefit schemes are paid up with no active members and for them the question of future salary increases will not arise.

The DP does not differentiate between defined benefit (DB) and defined contribution (DC) schemes. In this respect, the pension obligation for a DB scheme is based on the final salary of the employee whereas for a DC scheme it depends on the contributions paid. Thus as the effects of future salary increases only need to be considered for DB schemes, it may be appropriate to retain some distinction between DB and DC schemes

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?

IMA considers that financial reporting should be based on the premise that a liability is owed to the workforce as a whole, as opposed to an individual employee, in that this aligns more closely with the entity's expected cash flows and provides more meaningful information.

Chapter 3, Assets and liabilities: reporting entity considerations

The liability may be retained by the employer (as is often the case in Germany, for instance); passed to another party such as an insurance company; or rest with a pension plan sponsored by the employer. In the last instance, which is typical of UK pension schemes, the employer should report a liability only in respect of any guarantee it has given—typically the amount by which the liability to pay benefits exceeds the amount of assets in the plan. However, this assumes that the plan is genuinely independent of the employer, for example where it is governed by trustees that are bound to act in the interests of members rather than in the interest of the employer. If the employer controls the plan, it should be consolidated in the employer's financial statements. This differs from the requirements of current accounting standards which provide an exemption from the usual principles of consolidation for pension plans.

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

IMA agrees that recognition should be based on the principle of reflecting only present obligations as liabilities subject to our comments in question 1 as to what constitutes a present obligation.

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?

In general, IMA agrees that the consolidation of pension plans should be subject to the same principles that are usually applied in determining whether consolidation is appropriate, i.e. it should be based on the notion of control. We also recognise that as the majority of UK plans are governed by trustees which are bound to act in the interests of the members rather than the employer, they will not fall to be consolidated in the sponsor's accounts. The sponsor will report the liability in respect of the guarantee given – typically the amount by which the liability to pay benefits exceeds the amount of the assets in the plan with supplementary information being disclosed in the notes.

That said, we have some concerns that the Discussion Paper alludes to the fact that it may require pension assets and liabilities which are currently shown net to be shown gross where the employer has a direct obligation to pay benefits contrary to the requirements of IAS 19. In this respect, in instances where the entity concerned has effectively ring-fenced assets to meet its pension obligations and they cannot be used for any other purpose, we consider showing them gross could be misleading and would not benefit users.

Chapter 4, Recognition of pension assets and liabilities

The amount of pension deficits and surpluses can change markedly in a single accounting period. Current accounting standards, however, permit or require some of these changes not to be reported in the primary financial statements, or to be spread over a number of accounting periods. One example of this is IAS 19, which permits the so-called 'corridor' approach. The Paper notes that these provisions have no principled basis, give rise to considerable complexity and impair transparency. It therefore proposes that all changes in the amounts of pension deficits and surpluses should be reported in the period in which they arise.

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)?

In general in the interests of transparency, IMA supports changes in pension plan assets and liabilities being recognised immediately, rather than deferred and recognised over a number of accounting periods and the abolition of the so called "corridor" approach. The "corridor" method causes confusion and additional work for users and its abolition should simplify and improve pension accounting. In particular, a measurement model that properly reflects the long term nature of a pension plan's assets and liabilities should obviate the need for measures that seek to address short-term volatility and such treatment is consistent with that afforded to other assets and liabilities.

That said, there are certain of our members who believe that accounts should have a measure of smoothing in order spread volatility over several years. They recognise that this will be seen by some as a retrograde step, but believe it to be the only way to capture the benefit of a long-term funding regime. There would, however, need to be full transparency of the methodology adopted to ensure that its inclusion does not impair investors' ability to make their own judgments.

Chapter 5, Measurement of liabilities to pay benefits

In most countries, there is a regulatory requirement to quantify pension liabilities to enable an assessment of the appropriate level of funding. The techniques used in this process rely on a number of assumptions, including the return that is expected to be made on assets in the time before the benefits will be paid. The Paper notes that these measures do not attempt to assess the present economic burden of the liability and take credit for income that lies in the future: it therefore concludes that they do not provide an appropriate basis for financial reporting.

Instead, the liability should be quantified for financial reporting purposes at an assessment of the cost of settling the benefit, which will typically reflect all future cash flows (including the expenses of administering the liability). Information about the riskiness of the liability is better conveyed by disclosure than by adjustment to the amount of the liability, and so the cash flows should be discounted at a risk-free rate. The rate should not, the Paper proposes, be increased to reflect the credit risk of the liability. This approach differs from current practice, under which cash flows are typically discounted at a high-quality corporate bond rate.

Q6. Do you agree with the Paper's views on the measurement of liabilities to pay benefits? In particular, do you agree that:

- Regulatory measures should not replace measures derived from general accounting principles?

IMA agrees that regulatory measures are not a replacement for measures derived from general accounting principles. Regulatory measures are used to determine a level of funding but do not necessarily reflect the full underlying obligation in that they ignore the employer's obligation to fund the scheme if the assets do not perform as expected. Furthermore, regulatory measures would differ between jurisdictions resulting in a lack of comparability.

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

The Discussion Paper suggests that substituting a risk-free rate of return for the corporate bond rate calculates the liability on a more realistic "economic" basis. In many respects, we find it difficult to fault the logic in the Paper. However, it assumes that the accrued liability stream is a constant which is not correct. Employees only start receiving benefits at some point in the future and then do not live for ever - the age distribution of the plan beneficiaries and the mortality assumptions will be important sources of error in this approximation. Whilst the Paper, correctly in our view, highlights the difficulties in taking longevity risks into account, the emergence of the buy out market indicates that there may be means of estimating these.

- 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 than by adjusting the amount of the reported liability?

IMA agrees that information on the risk that the amount of pension benefits will differ from today's expectations is best conveyed by disclosure than by adjusting the amount of the reported liability. That said, we do not believe that risks should only be disclosed and not considered in the valuation, as noted above.

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

IMA aggress that 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?

IMA agrees that the expenses of administering the plan's accrued benefits should be reflected in the liability.

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?

Where employees have options to receive benefits in different ways, IMA believes that the liability should be reported at an amount that reflects the probability of

different outcomes on the basis that this is better aligned with the expected cash flows and the entity's economic position. It is also consistent with a total-workforce approach as set out in question 2 above.

Chapter 6, Measurement of assets held to pay benefits

Consistent with current standards, the Paper proposes that assets held in order to fund pension benefits should be reported at a current value.

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

In general, IMA agrees that assets held to pay benefits should be reported at current values. This reflects the economic conditions as at the balance sheet date and provides more useful information to users than reporting them at historical values. In this respect, we query the assertion in the Paper that it is aiming to base the principles of accounting for pensions on principles in general standards. As set out in the Paper, IAS 39 uses different measures for assets depending on their nature[1]. For example, investments held to maturity and loans and receivables not quoted in an active market are valued at amortised cost using the effective interest method, and unquoted investments whose value cannot be reliably measured are valued at cost.

These investments could be held as pension assets and yet these same principles are not applied. That said, we agree with the presumption in the Paper "that if assets are being held to provide pensions and security of pensions, those responsible should have some of their value on an ongoing basis, and that there is some methodology available for estimating their value, otherwise questions would be raised as to their accountability and governance[2]".

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

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?

IMA agrees 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.

Chapter 8, Presentation in the financial statements

Part of the change in a pension liability in an accounting period is due to service received and changes made to benefits: this should be reported in the income statement within operating activities. The return on assets and the finance cost relating to the liability (the unwinding of the discount) should be reported in financing, as should the effect of a change in the discount rate. Other changes relate

[1] Page 160

[2] Page 158, paragraph 3.28

primarily to changes in assumptions and should be reported as income or expenses, but not as part of operating activities or financing.

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

IMA would appreciate more clarity as to where pension costs are recognised in comprehensive income. At present users are frequently unable to distinguish between changes in pension liabilities arising from variations in discount rates and those arising from revisions of the liability as these are combined as "actuarial gains or losses".

Under current accounting standards, financial statements report the expected return on assets, rather than the return actually made in the period. However, the Paper notes that the actual return reflects the economic events of the period, whilst the expected return does not. It therefore proposes that the actual return (including both dividends and changes in the value of the assets held) should be reported in the financial statements, and that information on the expected return should be provided by disclosure only.

Q11. Do you agree that 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?

IMA agrees 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. At present entities report the expected return on pension assets which commonly more than offset the interests charge on the pension liabilities even when the scheme is in deficit. Thus entities can report financial income from a scheme that is a net liability – this seems illogical. We are also concerned about the subjective nature of the expected rate of return. That said, using the actual return could result in increased volatility. In this respect, what is important is that volatility in performance resulting from changes in pension fund assets should be distinguished from trading/operating results.

Chapter 9, Disclosures in the employer's financial statements

The Paper sets out proposals for what an employer should disclose in respect of pensions, stemming from the principle that the financial statements should give adequate information on pension costs, risks and rewards, and funding obligations. Details of assumptions and the sensitivity of reported amounts to changes in those assumptions should be disclosed, along the lines of the ASB's Reporting Statement: Retirement Benefits - Disclosures (January 2007).

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?

IMA agrees with the objectives of disclosure that are identified in this chapter. IMA supported the ASB's Reporting Statement that requires the disclosure of:

- the relationship between the entity and the trustees of the scheme;

- the principal assumptions used to measure liabilities;
- the sensitivity of scheme liabilities to changes in the principal assumptions used to measure them;
- details of how liabilities are measured;
- future funding requirements; and
- the nature and extent of the risks arising from the assets held.

In particular, it specifies that assumptions about mortality rates should be disclosed, together with a sensitivity analysis. With average life expectancy growing, mortality rates are of increasing significance to pension liabilities. The Reporting Statement also requires the disclosure of a sensitivity analysis for the assumptions used to measure liabilities and would welcome it including a sensitivity analysis to changes in the discount rate - many companies merely disclose the discount rate itself which is insufficient on its own.

Chapter 10, Accounting for multi-employer plans

The principles for reflecting pension benefits are, in concept, equally applicable where an employer is a member of a multi-employer plan, as is common in the Netherlands, for instance. However, there are great difficulties in their application and the Paper discusses ways in which these might be addressed.

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's plan? How, in your view, should an accounting standard require that this be implemented in practice?

IMA agrees 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's plan That said, multi-employer plans can be quite diverse and care needs to be taken to ensure that they do not results in meaningless information being reported.

Chapter 11, Financial reporting by pension plans

Members of pension plans are naturally concerned that their scheme's affairs are properly managed, and financial reporting is one of the means by which their confidence in this can be strengthened. The relevant International Accounting Standard is quite old and contains a number of options. The Paper considers what would be reasonable requirements for pension plan financial reports.

At present, a plan's financial statements may exclude a liability in respect of future benefits. If a liability is included it may be at a regulatory amount that is principally intended to gauge the adequacy of funding rather than to measure the true economic burden. The Paper proposes that a pension plan's financial statements should always include this liability and that it should be stated on similar principles to that which apply to the employer—that is, an estimate of the true economic burden. It also proposes that the effect of an employer's guarantee to the plan should be transparently reported and suggests how this might be achieved.

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?

Although not strictly within IMA's remit, we consider that the information needs of users in relation to the reporting by sponsoring company and by the pension plans themselves are very different. For example, the pension plan's actuarial report is available to members and includes various measures of the plan's liabilities – going concern funding, discontinuance and the Pension Protection Fund and some will include a measure based on the risk free rate. There seems little value in including these in the plan accounts.

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?

See answer to Q14.

General questions

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.

IMA has not identified any other types of pension arrangements that require further consideration.

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?

IMA has no specific issues to raise in relation to the costs and benefits of the proposals that should be taken into account in their future development.