Wealth destroyer

When FRS 17 *Retirement Benefits* became a standard it spearheaded the Accounting Standards Board's (ASB) drive towards fair-value accounting. Both pension assets and liabilities were to be given fair values – the market values for assets and the net present value (NPV) of the best actuarial assessment of future cash outflows for liabilities. Annual changes in the difference, usually found to be a deficit, were taken to the profit and loss account, much to the irritation of finance directors. They often responded to the pressure from board colleagues who sought to remove the 'problem' of the pension scheme by seeking to guide pension fund trustees towards asset allocations whose value would move in parallel with the NPV of the pension liability, thus stabilising the reported deficit, which could then be dealt with over time by higher annual contributions to the pension fund.

Although everyone realised that the issue of increasing member longevity could not be dealt with by this tactic, and that a future acceleration in expected retail price inflation and earnings would cause the liabilities' NPV to increase, these two issues were felt to be containable since the actuarial assumptions on these variables were unlikely to change rapidly, unlike interest rates.

PARAMOUNT THREAT The threat of a direct impact on the pension deficit from a rise in the NPV of liabilities, caused by a fall in fixed interest rates across the yield curve, became paramount. For those funds invested in equities, the recent recovery in equity markets gave a useful boost to the fund's asset value, but this was wiped out by the rise in liabilities as interest rates fell.

The pension fund advisory industry pocketed record consultancy fees pointing out how the problem should be tackled by liability-driven investing. It was argued that scheme liabilities are bond-like in character and should therefore be funded by bonds. Liability-driven investing would solve the problem by matching assets to liabilities using sophisticated modified duration analysis to select just the right portfolio of fixed-rate bonds whose characteristics would immunise the size of the deficit from movements in interest rates.

Sell equities, buy bonds and no longer would short-term movements in long-term bond rates cause the deficit to widen. The finance director could tell the board that the problem was solved provided members died as expected, inflation was kept under control, and employees were given pay rises within the projected budgets. Even those Luddite directors and pension fund trustees who refused to countenance an all-bonds asset allocation could be calmed through hedging strategies that would apply a swaps-overlay to match the equity proportion with an adjusted modified duration to equal that of the liabilities' NPV. The fact that the actual cash outflows and the way they can be expected to change under different assumptions are wholly unbond-like, was not mentioned.

The predictable result was what we have seen: a plunge in the yields of long-term bonds as trustees instructed investment managers to shift asset allocations and match durations, which caused the NPV of liabilities to rise further, so sucking more companies into the liability-driven investing approach as more chief executives exhorted their finance directors to find anyone who could rid them of this turbulent pension problem.

A BROAD RANGE OF ASSETS Treasurers and those who will study for the ACT's new certificate in pensions risk management are trained to look at the economic risks faced by a company and to propose appropriate risk mitigation actions. The fact that pension obligations are determined by mortality, and earnings and retail prices inflation, but not by interest rates, means that a bullet fixed-rate bond is a poorly equipped asset to meet the actual cash outflow obligations, however good it may be in matching the reported obligation.

Although bonds, especially inflation-indexed bonds, have a role to play in meeting at least near and medium-term (say up to 10 years) cash outflows, beyond this equities and other asset classes must be considered as well. Since the long-term earnings growth of

DAVID CREED ARGUES THAT FRS 17 CAN SERIOUSLY DAMAGE YOUR WEALTH.

Executive summary

- The pensions accounting standard FRS 17 *Retirement Benefits* has been in place for two years and its influence on pension trustees, finance directors and pension scheme members is becoming profound, but is there a danger that FRS 17 could seriously damage those companies and their pension scheme members' wealth? It can, and in some cases already has.

employees determines their pension assets, and those earnings are broadly linked to the growth of the economy as a whole, there is a good argument for investing in asset classes whose total return is linked to whole economy performance, such as equities. A broad range of assets is needed to spread investment risk and promise returns, albeit at higher risks, that can match actual liabilities.

Some pensions consultants argue that since a company would never borrow to invest in equities directly, it should not do so by proxy through its pension fund, and that the 'no free lunch rule' applies to equity returns because any out-performance will be paid for through higher risk. Such arguments are not persuasive. The practicalities already experienced from a supply deficit in bonds have shown that the premium paid for 'low-risk' bonds can become exorbitant: at what price will pension funds stop buying?

An equally practical consideration is that if no pension fund (and presumably no insurance company facing similarly long-tailed risks) invested in equities, only high net worth individuals would be left to absorb equity issues by companies. Those companies would then meet the need for bonds and remove surplus equities through massive buybacks, and in time the resulting high-risk shrunken equity base, and the consequently broad junk bond base, would result in the whole-economy risk being passed back to pension funds through much higher credit risks in their bond assets.

INSUFFICIENT INFLATION INDEX-LINKED GILTS Another problem with liability-driven investing is that the ideal investment, should it be available in sufficient quantity, is inflation index-linked gilts. These have a low credit risk and can cover inflation risk, though obviously not mortality risks and only partly earnings inflation risks. All pension funds should contain index-linked gilts, at least to fund near and medium-term pensions-in-payment obligations. Even if the scheme's contractual obligation is limited to meeting only limited price inflation, most trustees like to see their scheme's pension values maintained in real terms. However, there is no possibility of sufficient index-linked gilts being made available by the Debt Management Office (DMO). As a consequence those schemes adopting liability-driven investing, and seeking to match asset and liability-modified durations, fall back on investments in fixed-rate bonds.

Fixed-rate bonds do have a minor use in funding liabilities such as guaranteed minimum pensions that are not inflation-linked and to guard against deflation (which would reduce to below zero the return on index-linked bonds, but not pensions in payment, which cannot be reduced).

How then can a suitable balance be restored that stops the pension deficit widening as interest rates fall, thus causing more companies to encourage trustees to sanction further increases in their asset allocation to bonds, so setting off the cycle again as buying pressure mounts? For those funds that feel they must hedge reported liabilities rather than the actual liabilities they will face over time, there are two actions needed – one by government and one by accounting standard setters.

First, the scarcity of long-dated index-linked gilts, and their currently excessive cost, would be overcome if the Bank of England and the Debt and Reserves Management Team could convince the Treasury to authorise the issue of a derivative swap which paid out a six-monthly cashflow similar to the total return on an index-linked gilt plus (or minus) a margin based on a nominal principal amount. The payment would be swapped against the receipt of a payment based on the Bank's variable base rate calculated on a daily basis and paid six-monthly on the same nominal principal amount (six-month Libor may be a less preferable alternative basis). If issued in volume, such an instrument would encourage the reduction of inflation through higher base rates and enable those funds wishing to adopt liability-driven investing to succeed.

If for some of the swaps the DMO-paying leg were to be limited to an inflation adjustment of up to 2.5% or 5% per annum, it would match exactly those contractual obligations faced by pension funds in meeting their limited price inflation obligation.

The issue of such a series of long-dated swaps at maturities with say five-year progression intervals from 10 to 50 years would:

- Confirm the government's seriousness in supporting and protecting the continuation of existing defined benefit schemes;
- Show that the government believes that the Treasury and the Bank acting together can control inflation;
- Avoid the over-funding issues associated with a major additional programme of conventional index-linked gilt issues;
- Not expose the Treasury to financial risk from market-driven variables over which it has little or no control; and
- Enable pension funds to invest in assets that are cash-based or whose total return is linked to a cash return.

Box 1. Pension project

The ASB announced late last year that it would be undertaking a project on accounting for pensions, which will reconsider the fundamental principles. It will be assisted by an advisory panel of experts and aims to publish the result of that work in 2006.

Many investment banks already offer swaps that are similar to that proposed here, but they are in limited supply because there are few natural sellers of inflation risk hedging products.

Second, the ASB in its current full review of FRS 17, and the International Accounting Standards Board (IASB), which followed the ASB's lead in formulating its own standard IAS 19 *Employee Benefits*, should reconsider the discount rate used to calculate the reported value of a scheme's liabilities.

Those who argue that the expected return on the actual assets held by a fund should not determine the size of the scheme's liabilities are correct. But that is not to say that the right discount rate is therefore the AA corporate bond rate, or the swaps rate, or the gilt rate, or 50bp below the gilt rate, or 100bp below the gilt rate – all of which have been proposed at various times as the accountants seem to rush towards the ultimately conservative position of reporting liabilities on a buy-out basis.

A pension obligation, just like the rest of a company's performance, should be reported in the accounts on the basis of a going concern rather than a buy-out. This is particularly so since it is impossible to know, unless an offer is made, just what a buy-out valuation of the liabilities would be. There is a case, however, for the deficit on a buy-out basis being disclosed, together with the assumptions underlying it.

UNLESS FRS 17 AND IAS 19 ARE CHANGED, AND SOON, WHAT REMAINS OF BRITAIN'S DEFINED BENEFIT PENSION SCHEMES – FOR SO LONG THE ENVY OF MANY OTHER COUNTRIES FACING THEIR UNFUNDED PENSION LIABILITIES – WILL BE CRUCIFIED BY THE ACCOUNTANTS' URGE FOR IRRELEVANT EXACTITUDE.

Any going concern discount rate chosen will be based on a subjective view of the risks. Why not accept that building assets to meet liabilities, many of which will arise only in future decades, is risky? Why not define the level of risk that is appropriate for a prudently managed fund and express it as a function of the scheme's maturity?

The salutary lesson learned in a very painful way by actuaries, that they cannot duck being the standard setters in the assessment of prudent risk management by allowing companies to use them solely as statistical risk analysts, has put them in a good position to take the lead on the question of the appropriate discount rate.

A multi-variable matrix should be agreed by the actuarial profession and regularly revised to set prudent asset allocations for schemes in various states of evolution from company start-ups to those that are closed with only defined pensioner liabilities. The asset types should cover cash, index-linked bonds, fixed-rate bonds, equities and possibly other asset categories such as property.

The matrix variables might encompass employee/pensioner average age, geographical location, sex and employment type to cover mortality risks; industry category to cover competitive risk, economic growth prospects and employee turnover and earnings growth; and employer (sponsor) financial strength. Each point on the matrix would comprise a benchmark asset allocation and each such allocation would have an assumed weighted total return which would be used to discount the scheme's liabilities estimated on assumptions that match those behind its matrix point. The variables such as future inflation rates and interest rates, and the total returns to be applied to each asset category, would be set as common across all matrix points and therefore for all companies.

CONVERGENCE BETWEEN ACTUARIAL AND REPORTED VALUES

A scheme's trustees would be free to determine its actual asset allocations as they wished in consultation with the sponsoring company's financial management and its risk appetite. The result would be a convergence between the actuarial and FRS 17 reported values of the scheme liabilities, but without the ungoverned structure that in the past allowed a company's finance director to risk the entire pension fund in equities and to pressurise the actuary into changing his or her assumptions so that pension holiday could continue for another year.

It will be argued that the reported value of a liability should be the same whichever company holds that liability. But this is to think of a pension liability in purely financial terms. Running a pension fund is a business, and some organisations will be better placed to do this than others. What is needed is a sure set of prudent standards, not the one-size-fits-all approach that has created the current potential for uneconomic pension risk hedging.

Unless FRS 17 and IAS 19 are changed, and soon, what remains of Britain's defined benefit pension schemes – for so long the envy of many other countries facing their unfunded pension liabilities – will be crucified by the accountants' urge for irrelevant exactitude. With them will go a valuable part of the wealth creation that has occurred in the last 40 to 50 years.

For more on how to deal with pensions deficits, see our supplement, 21st Century Pensions, *available at The Treasurers' Conference and accompanying next month's issue of* The Treasurer.

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