Bring risk into the open

MARK BILLINGS, CHRIS O'BRIEN AND MARGARET WOODS DISCUSS DISCLOSURES BY MAJOR UK-LISTED COMPANIES ON THE RISKS ARISING FROM DEFINED BENEFIT PENSION SCHEMES, AND HOW THEY ARE MANAGED, AND SUGGEST HOW COMPANIES COULD EXPLAIN THESE ISSUES BETTER TO STAKEHOLDERS.

Treasurers, CFOs and CEOs are well aware of the problems posed for companies by defined benefit pension schemes (DBPS). The potential risks to corporate cash flows, credit ratings and strategic decisions are familiar. Companies providing DBPS are managing these risks in various ways: virtually all significant schemes are closed to new members and most to further accrual by existing members; many schemes have shifted the asset mix away from equities to bonds; some are pursuing formal liability-driven investment (LDI) strategies using interest rate and/or inflation swaps; and some have limited future scheme benefits, for example by capping pensionable salaries.

But many believe companies could better explain the risks arising from their DBPS and how they manage them. The ACT-Mercer 2009/2010 survey of pension financial risk found that many respondents thought that greater disclosure of the sensitivity of pension obligations to variations in assumptions would assist understanding of corporate pension risks. Consultant Lane Clark & Peacock, in its most recent annual survey on pensions accounting, expressed surprise at the very limited reporting in this area by a large number of major companies.

EXPLAIN YOURSELF These findings are consistent with our own for a recent report for the Institute of Chartered Accountants of Scotland, in which we examined the risk disclosures of FTSE-100 companies in respect of their DBPS (see box 1). Overall we found that the volume and detail of risk disclosures was very mixed, especially in relation to narrative rather than quantitative disclosures. We believe that many large companies could disclose their pension risks more effectively and are missing opportunities to explain themselves better. For example, a discussion with one FTSE-100 company after publication of our report revealed that although the company had capped index-linked increases in future pensions, its financial statements did not reveal this.

Changes in the financial reporting of liabilities from DBPS are certain in the near future as the International Accounting Standards Board (IASB) has the relevant standard, IAS 19, under review. The IASB's April 2010 exposure draft proposed enhanced disclosures relating to pension risks. These included requirements for improved disclosure of sensitivities of pension liabilities and service costs to changes in key variables, and such changes would be consistent with the IASB's approach to accounting for financial instruments.

Figure 1: Template for sensitivity disclosures

Risk variable	Change	Assets		Liabilities		Service cost	
		Increase	Decrease	Increase	Decrease	Increase	Decrease
Price inflation and salary growth	0.5%						
Real salary growth	0.5%						
Interest rates	0.5%						
Equity prices	20%						
Expectation of life	1 year						

DIFFERENT TYPES OF RISK In particular we think it is important to distinguish between 'enterprise risk' – the risks to the company from its pension scheme(s) and how they are managed – and 'point in time estimation risk' – the uncertainty surrounding accounting estimates at the balance sheet date. Disclosures relate mostly to the latter. In terms of enterprise risk, a pension scheme's assets as well as its liabilities are important. The key risks are interest rates, share prices, price inflation, salary growth and longevity.

Sensitivities can be effective in the reporting of enterprise risk. For example, how would a 0.5% change in interest rates affect scheme liabilities (with discount rates changing by 0.5%) and how would the value of assets change? Disclosure of this sensitivity would help a reader understand the extent to which the investment strategy was sheltering the company from interest rate risks in its pension scheme. At present, this is difficult or impossible to ascertain from the accounts, as there is usually no information about the duration of bond investments, or the make-up of liability-driven investment portfolios. Similarly, we would like to see the effect, not only on liabilities, but also assets; of changes in price inflation (there may be inflation-linked securities), changes in equity prices (there may be equity derivatives) and changes in longevity (there may be insurance policies or longevity derivatives).

Figure 1 suggests a template of disclosures which would report the impact of standardised increases or decreases in key risk variables on pension scheme assets and liabilities and the pension service cost in the income statement. The magnitude of change in each risk variable should reflect what is reasonably possible over say a five-year period. These sensitivities could be reported in absolute terms (ie monetary amounts) or percentage terms, which would aid comparability.

Standardised disclosures like these would show variations between companies. They would also reflect the effectiveness of asset-liability matching strategies, including the use of derivatives, employed by more than half the respondents in the most recent ACT-Mercer survey. As derivatives become increasingly widely-used in managing pension risks, financial reporting in this area threatens to follow accounting for financial instruments and become yet more complex.

Such disclosures are not necessarily appropriate for all companies. For some, the pension scheme is not an important risk factor, and lengthy compulsory disclosures are inappropriate. But we believe that disclosures of the type we suggest would give many companies the chance to express concisely, in quantitative terms, the effectiveness of their pension risk management. Those with well-managed DBPS would probably already have such information available.

Academic research shows that accounting information on pensions is reflected in equity prices and bond ratings and spreads. Companies which have worked hard to manage their pension risks but failed to articulate this through their financial statements do themselves a disservice. Companies which have failed to manage their pension risks would be exposed, either directly through the disclosures we advocate, or indirectly through their failure to provide them.

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Current practice

Of the companies in the FTSE-100 at 31 December 2009, 88 had DBPS, of which 80 had UK-based schemes. We benchmarked the disclosures in the 2009 financial statements of these companies against the 2007 Accounting Standards Board (ASB) Reporting Statement on Retirement Benefits. Only 10 companies disclosed the sensitivity of their scheme liabilities to changes in all four of the actuarial assumptions recommended by the ASB (price inflation, salary growth, discount rate, and expectation of life), and 34 companies disclosed none of these sensitivities. There were considerable variations in the size of change in the risk variables on which disclosures were based. We also examined whether companies disclosed asset allocations by investment category (the vast majority did), the duration of bond investments and potential liability buy-out costs.

Our statistical analysis showed that the companies with higher disclosure levels were those with larger or better-funded schemes (measured on the basis of IAS 19 funding ratios) and had higher market-to-book values. Banks made notably fuller disclosures, no doubt due to increased post-crisis scrutiny. We found no companies which made pension disclosures incorporating value at risk figures.

Positive aspects to our findings suggest that many companies are managing pension risks effectively. For example, we estimated the impact of a 0.5% reduction in interest rates on pension scheme assets and liabilities and hence the book value of companies' equity; the median effect was a 1.9% decrease. For a 20% fall in the value of pension scheme equity investments, the median effect was a 2.5% decrease in the book value of equity. We found these estimates encouraging, as they overstate the true impact of such changes by not reflecting the effect of relevant derivatives hedges, which financial statements do not reveal.