ALL FOR ONE AND ONE FOR ALL

THE CREATION OF A SINGLE CAPITAL MARKET IN EUROPE SPELLS GOOD NEWS FOR EVERYBODY, NOT LEAST UK PENSIONS FUNDS, SAYS **GRAHAM BISHOP** OF SCHRODER SALOMON SMITH BARNEY.

The European Union's Financial Services Action Plan (FSAP) has profound implications for treasurers. The creation of a single capital market in Europe is now seen as a key test for Europe's ability to gain full advantage from the advent of the single currency. If it succeeds, it will mean a deeper and more liquid market to borrow from and in which to invest – especially pension assets. However, the standard accounting principles required by a single capital market, and the UK's domestic legislation on the minimum funding requirement (MFR) for pension funds, may have serious consequences for corporate pension fund investment, and even for the UK's euro debate. (See *Son of MFR: FRS 17 – Mother of All Distortions or New Reality?* by Graham Bishop, Schroder Salomon Smith Barney.)

SLOWLY BUT SURELY. The FSAP is the European Commission's update of the 1992 Programme for the original single market in financial services to take into account the coming of the euro, enlargement and technological change. The FSAP seems to be becalmed amid a constitutional crisis between the European Parliament and the Commission about implementing the Lamfalussy Committee's proposals on governance. But many market participants are keen to see that the Parliament does achieve the ability to review the implementation of secondary legislation to ensure it conforms to the original market-opening intentions. Taking the broader view, a short delay to achieve these desirable goals may be a small price to pay for the eventual gain.

The process is vigorously championed by the UK government but is fraught with difficulties, as demonstrated by the controversy over the Prospectus Directive. But it is important to get a prospectus that is capable of launching a security across the whole of Europe if the individual investor is to be able to disintermediate savings institutions. A successful Prospectus Directive will increase the treasurer's ability to borrow throughout the EU. To make the single prospectus a reality, a key part of the FSAP strategy is that all listed EU firms should use international accounting standards by 2005. Investors would then have simple comparisons across the EU.

The UK accounting profession has taken the lead and FRS 17, the UK counterpart to the relevant international accounting standard, already requires initial disclosures. Therefore, in the spring of 2002, UK companies will have to reveal much more about the health of their pension funds, and the scale is significant – the £700bn market value of pension fund assets is similar to the net asset value of UK plc itself.

SETTING STANDARDS. FRS 17 is a bond-based liability calculation. It will force the sponsors to reveal that their balance sheets are much more vulnerable to swings in equity markets than many investors realised. Unless equities recover strongly, many firms will report uncomfortable FRS 17 deficits on their balance sheets. The Myners Report may state that FRS 17 "is simply a requirement to report" rather than a statutory requirement, but finance directors ignore such standards at their peril.

Treasurers are already responding. Boots recently made the switch from equities to bonds. Without that switch, Boots would have reported a deficit corresponding to a 20% of shareholders' funds solely because of movements in the value of pension fund assets. Many other UK companies will not be starting from such a strong position and the result may mean an acceleration of the shift from defined benefit to defined contribution schemes and to increase the attractiveness of long-dated bonds over equities. And £700bn of pension assets are going to find it hard to manoeuvre within a £300bn investible UK fixed income market without causing severe distortions. The distortions risk creating a spiral as long-dated yields are forced down and deficits rise correspondingly – publicised annually under FRS 17.

But what can be done? One scenario would see the UK joining EMU within the next few years. Then the UK funds would be fishing in a bond market that is about four times their total assets, rather than half, so the risk of distortion would be much lower. The 15-year plus segment is three times the size of the corresponding gilt market – and yields are about 15% higher. This alone would have a major impact on pension liabilities.

The merits of UK euro membership are hotly contested on both sides. Joining the euro could save treasurers a huge headache in the coming years and underpinning the safety of UK pension funds may be a relevant factor.

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