

GIVE CREDIT WHERE CREDIT'S DUE



PAUL STANWORTH OF RBS ASKS WHETHER THE CREDIT RATING AGENCIES NEED TO ADOPT A DIFFERENT, MORE CONSISTENT APPROACH IN LIGHT OF THE FRS17 ACCOUNTING REFORM.

The actuarial and accounting worlds are alive with FRS17 – the new accounting standard for pensions. Dove-tailing with the anticipated abolition of the minimum funding requirement (MFR) announced in the last budget together with the Treasury's latest proposals, the impact on balance sheets and the sterling capital markets is being hotly debated. Although the crunch date for compliance is mid-2003, many leading companies are looking to become compliant early.

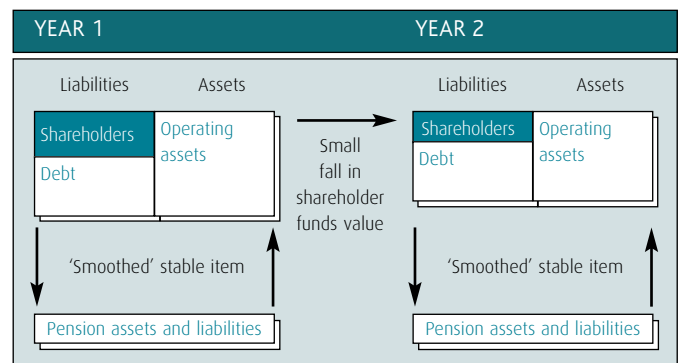
However, there is a notable silence from the credit rating agencies over the reforms and this article considers whether a new approach should be adopted by the rating agencies to bring consistency with their approach to insurance companies and other collateralised obligations.

A BRIEF HISTORY. The introduction of FRS17 on December 2000 brought with it a broadly prescribed method to value the assets and liabilities of a pension scheme. This was significantly different from the more discretionary SSAP24 used previously, which adopted a 'prudent basis' for reserving that allowed for some smoothing of changes in these reserves. In addition, in September 2001, the Treasury published the government's proposed statutory replacement for the MFR, which aims to reduce the chances of pension scheme members losing out. In particular, it is considering that any shortfall in the pension fund on a wind-up of the company or fund being a priority debt. The Treasury also proposes increased transparency and a statutory duty of care on the scheme actuary.

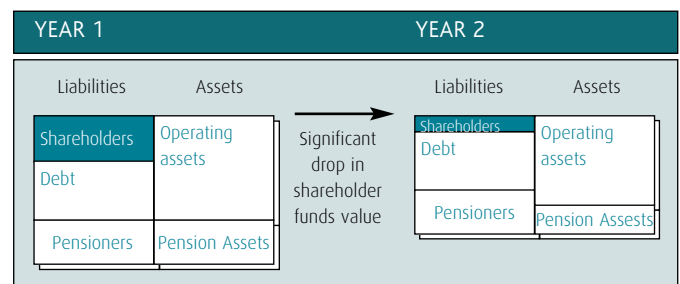
In summary, FRS17's aim is to give a true picture, without margins, of the pension scheme on the balance sheet, with actuaries becoming more personally liable for declaring pension scheme solvency and the possibility that pensioners may soon be senior creditors the wind-up of a company.

HOW WILL FRS17 AFFECT BALANCE SHEET MANAGEMENT? The following diagram shows the impact of changes from SSAP24 to FRS17 with a typically equity-biased pension fund for a scenario where operating asset values fall, equity markets fall and yields on bonds fall. This is an example that mirrors the UK markets in 2000 and 2001.

First, under the previous SSAP24 accounting regime:



Looking at the same example after FRS17 has been adopted:



This conceptual example highlights the restrictions companies will face under FRS17 in managing balance sheet volatility. The possible effects on individual companies are numerous, but the principle changes relevant to the solvency of a company can be summarised in three main points:

- although the economic situation of companies has not altered (that is, they were always exposed to the pension fund asset liability risks), FRS17 brings any mismatch 'on balance sheet' and can create significantly more balance sheet volatility;
- the impact of pension fund investment policy will therefore

'THE BIAS IN UK PENSION FUNDS TOWARDS EQUITIES CREATES A MISMATCH VERSUS THE ACCOUNTING VALUE OF THE LIABILITIES AND CREATES SIGNIFICANT FINANCIAL RISK FOR COMPANIES'

become apparent and transparent. It is probable that company directors may wish to influence pension fund asset allocation as part of their corporate governance. In addition, balance sheet hedging techniques are likely to be considered in conjunction with the pension scheme risks, and not separately as now exists;

- the impact of balance sheet volatility may spread as far as debt covenants since balance sheet restrictions exist as part of either bank or capital markets borrowing. Once again this brings the directors into the asset allocation and risk management process to a greater extent than was previously the case.

The impact on pension funds of individual companies will depend on two main points. The first is the size of the pension fund in relation to the size of the company. The greater the relative size of the pension scheme assets versus the operating assets of a company, the greater the impact. The second is the extent of the mismatch of pension fund assets and liabilities. The bias in UK pension funds towards equities creates a mismatch versus the accounting value of the liabilities and creates significant financial risk for companies. The risk is identical to issuing a long-term bond and investing the proceeds in equities, which few UK companies would consider.

WHAT IS THE MAGNITUDE OF THESE RISKS? Looking first at the returns observed in the market over recent history (Table 1), it is

TABLE 1

Year	FTSE 250	Over 10 year gilts	S&P 500 (£ terms)	FTSE300 Euro Bloc (£ terms)	Over 10 Corporate bonds
1996	15.9%	7.6%	8.10%	–	8.5%
1997	10.8%	21.1%	37.40%	–	21.8%
1998	5.1%	28.5%	26.50%	–	21.6%
1999	41.1%	-1.4%	24.20%	14%	-1.3%
2000	5.6%	8.1%	0.30%	5.30%	10.6%

TABLE 2

Year	FRS17 Pension liabilities annual revaluation	Pension fund performance (%)	FRS17 asset and liability
1996	17%	13.5%	-3.5%
1997	28.8%	15.5%	-13.3%
1998	38.4%	11.9%	-26.5%
1999	-7.6%	30.9%	38.5%
2000	5.4%	5.6%	0.2%

clear that there is a significant divergence in asset returns. Translated into balance sheet volatility, an example of a typical case can illustrate the point. Assuming a pension liability with approximately modified duration of 20 years discounted with AA corporate bond yields, and a portfolio is 70% UK equities, 10% US equities and 20% gilts. Table 2 shows the experience over the past five years assuming parity between assets and liabilities at the start of each year with no inflows or outflows. As a rule of thumb, the volatility as a percentage of liabilities or 'FRS17 mismatch factor' for each asset class has been estimated as the standard deviation of returns of the asset from the liability valuation and is set out in Table 3.

TABLE 3

Asset class	FRS17 Mismatch factor
UK equities	30.8%
US equities	17.9%
Gilts	7.5%
Corporate bonds	9.7%

The main observations are:

- high quality bonds create the least volatility. This is intuitively obvious since it closely resembles the benchmark for discounting the liabilities;
- equities produce about two to three times the volatility of bonds; and
- the volatility may not be eliminated through typical investment assets, as the duration of the liabilities is ultra long.

In fact, FRS17 creates a significant vicious circle when there is an economic downturn. Pension funds holding equities will find that it is likely equity values will decline as interest rates and bond yields fall. In this case, the liabilities will increase, but the collateral (equities) will fall and a deficit will emerge. The 'vicious' part of the circle is that this will occur when the sponsoring companies' ability to increase contribution is declining too (since the poor trading conditions prompted the equity decline in the first place). We have observed this clearly in the Japanese economy over the 1990s and issues are still outstanding over the Anglo-Saxon economies in the new millennium. If pensioners become entitled to prior rights over debt, this squeeze on solvency may become a significant factor for companies' lenders to consider.

In summary, these examples demonstrate the influence that asset allocation has economically on the solvency of companies. This is intuitively obvious since companies have always been the sum of two halves – the one half being the assets comprising of operating and investment assets financed by the other half consisting of pension scheme members, debt holders and shareholder. The change is simply the transparency created by FRS17.

BUT HOW HAVE THE CREDIT RATING AGENCIES INCORPORATED THESE INFLUENCES INTO CREDITWORTHINESS? Broadly, they have not. Both Standard and Poor's and Moody's look at pensions in a similar ways. S&P has an elaborate method to calculate the pension deficit or surplus, by looking at pension assets and liabilities. However, any pension deficit is let off lightly for two reasons: "there is uncertainty with respect to estimating the ultimate size of the liability; and the company has considerable discretion over what has to be paid

in a given year". There is no explicit discussion of the mismatch by S&P, no suggestion that whether pension assets are held in bonds to match pension liabilities or equities is relevant to their assessment of risk. Similarly, Moody's has no clear allowance for pension collateral in its methodology, although the agency has a methodology to compare European unfunded schemes with US companies, which "simulates a pre-funding of the liabilities in independent pension funds US-style".

This is inconsistent to the more clearly documented and sensible approach taken by the credit rating agencies to insurance strength ratings and, indeed, the rating approaches to collateralised bond obligations (CBOs). The pension fund collateralisation concept is the same. In all situations, a company has undertaken a collateralised obligation. Although there is more discretion over what a pensioner receives from a pension scheme, than what a bondholder receives from their CBO, a number of factors are bringing them closer.

Pensioners may be elevated to senior creditor (above all debt) on wind-up. In the meantime, the Equitable Life court case shows how the public (in this case, Equitable's policyholders) can expect to receive what was 'reasonably expected' creating a contingent liability.

In fact, what a pensioner in a scheme reasonably expects is that if the sponsor becomes bankrupt there is a payout which allows them to transfer their pension to a safer company. In plain English, they will want enough cash to secure an annuity from an insurer. If the Treasury and DSS recommendations also increase the ranking of pensioners to senior creditor, the pension is beginning to look very 'bond-like' indeed. So why are the agencies ignoring the extent and quality of collateral held by the scheme against these liabilities?

It is curious, since in the case of insurers, they have taken note. Recently, S&P highlighted the 'decline in equity markets' as part of their basis for reviewing the UK life insurer sector's financial strength rating, even though the liabilities are mostly with profits, equally affording them the discretion over the ultimate size of the liabilities. Among all agencies, insurance ratings have clear methodologies that focus on asset quality. Similarly, CBOs have distinct methodologies for rating on the basis of quality and match of collateral assets. However, a company backing a significant pensions liability (which could be larger than their total debt) with inadequate, highly volatile assets would go largely without a mention. This is a significant inconsistency with their methodology.

For those companies with material pension liabilities, economic balance sheet volatility can be materially affected by the value of collateral. Companies should be able to improve their credit rating by switching to matching assets to be consistent with other rating methodologies.

WHEN WILL THE RATINGS AGENCIES ACT? FRS17 has successfully removed the opaque reporting of pension fund assets and liabilities. The new reporting basis will clearly show the risks that pension schemes run between a transferable basis for calculating the pension liabilities and these liabilities. In addition, Treasury proposals will bring clarity to the rights of pensioners.

The outstanding question is, when will the rating agencies bring consistency to their methodologies? Companies managing their pension funds prudently should be given an acknowledgement via a higher credit rating than the same company holding either inadequate or highly volatile assets. In summary, the rating agencies should give credit where credit is due.

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