

Institutional Investment Advisors Limited

Pension Accounting Reform

Staple Inn, London 1 July 2008

Crispin Southgate

www.ininad.co.uk

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Introduction

- ▣ User and analyst perspective
- ▣ Build on scene setting by John Whitley
- ▣ Disclosure route to solve current issues with AA rate
- ▣ Contribution Based Promises
 - Focus on practical issues where actuarial profession can help

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User & Analyst Perspective

- ▣ Aim is to understand and forecast business activity
 - Operating flows generally more important than spot values
 - Financing flows distinguished
- ▣ We need
 - Financial information that presents business reality as seen by a rational external investor
 - Financial statements that reconcile to each other
 - Clear differentiation between operating/financing/investing
 - To be able to identify capital invested and how well management have used this capital (stewardship)
- ▣ Principles based Standards
 - Good enough, not perfect

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Analyst Priorities – IASB & FASB

- High Priority and on the Boards' current agenda
 - Conceptual Framework
 - Performance Statement/Cashflows
 - **Pensions**
 - Income Taxes
 - Leasing
- High, but don't rush it
 - Insurance (and related consequences for other standards)
- High Priority and not on the agenda
 - Reconciliation of net debt
 - Meaningful disclosure on risk and risk management

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Post Retirement Benefits

- Problem
 - "International" ASB Vs very "national" issues in pensions
- Broad principles
 - Employer has the work now, pays for it later
 - Borrow 100 today, easy. Promise a pension, more difficult
 - Three current "**flow**" elements
 - Other "**stock**" changes with a P/E of 1

Element	Reporting
Service Cost	Operating
Interest Cost	Financing
Actual Return	Investing or Financing
Other	SORIE or Separate Column

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Views on ASB/PAAinE Paper

- "Risk Free" discount rate – preferably swaps
- No smoothing
- Actual, not expected returns
- On balance, ABO rather than PBO
- Disclosures
 - Mortality - Ranges as well as values
 - Asset allocation
 - Hedging
 - Sensitivity to key assumptions
 - Regulatory measures – because they can drive cash flows

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Doubtful value of continuing to use AA rates
A change needed
In the meantime, disclosure where material

AA DISCOUNT RATE

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FTSE 100 Deficits

£40bn IAS19/FRS17 surplus at 31 March 2008

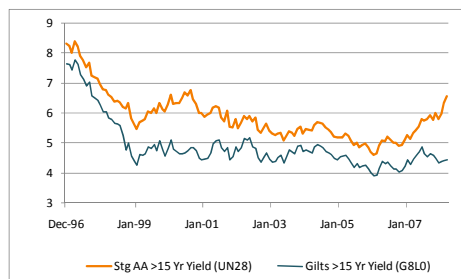


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Source: Watson Wyatt

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Long AA Yields & Gilt Yields

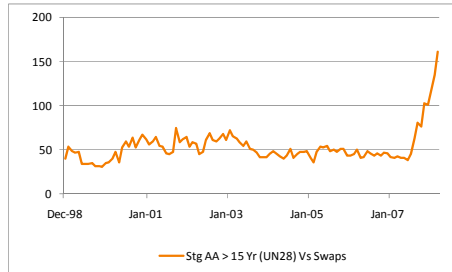


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Source: Merrill Lynch Global Index System

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Long AA Yield Spread Vs Swaps

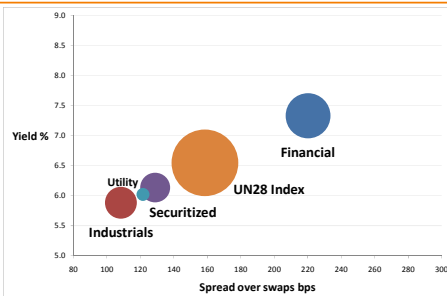


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Source: Merrill Lynch Global Index System

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Which Planet? AA Yields & Spreads 2 April 2008

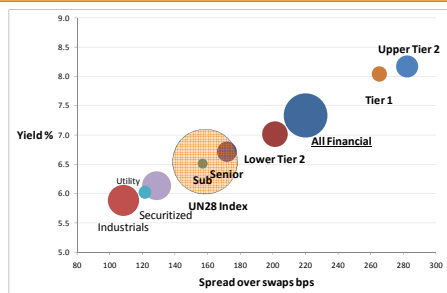


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Source: Merrill Lynch Global Index System

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Which Planet? AA Yields & Spreads 2 April 2008

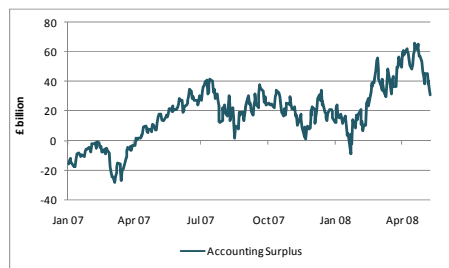


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Source: Merrill Lynch Global Index System

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FTSE 100 Deficits Data to 9 May 2008



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Source: <https://rftmtools.hewitt.com/Pensions/index/> used with permission

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FTSE 100 Deficits Data to 9 May 2008



Disclose regulatory measures that drive sponsor cashflows

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CONTRIBUTION BASED PROMISES

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Contribution Based Promises ("CBP")

- ❑ In the IASB DP on IAS19, an attempt to solve a problem
 - Esp in Belgium, Switzerland and Germany
- ❑ Proposed solution of the "contribution based promise" creates further problems
 - Esp for Netherlands (potentially 90% of schemes with actives) and UK Average Salary Plans
- ❑ Potentially unworkable
 - Fair value – "This approach considers all possible outcomes" (para 7.16 of IASB DP)
 - Practicalities and costs of widespread stochastic modelling

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Two examples of the problem

Problem 1

- ❑ Contributions of a % of current salary every year plus the return on a specified equity index

Problem 2a

- ❑ Contributions of a % of current salary every year plus actual return on assets **with a guaranteed minimum return of 4% p.a.**

Problem 2b

- ❑ With choice of lump sum **or annuity at a specified rate**

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Problem 1

- ❑ Not difficult to solve
- ❑ Fair value
- ❑ Identical to an investment linked contract with a variable annual contribution
 - C.f. Certainty equivalent embedded value in insurance
- ❑ If funded, asset value = liability value, so no net liability
- ❑ PBO Vs ABO side stepped
- ❑ Credit risk adjustment – views wanted (Para 7.29)
 - Funded or Unfunded
 - Maturity of obligation, availability of observable credit premia

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Problem 2a

- ❑ More difficult due to minimum guaranteed return
- ❑ In some countries, government sets minimum return and can change it
 - Work with current government requirements
 - Ignore future changes, just as we ignore other law change?
- ❑ Time value as well? Or just intrinsic value?
 - Fair value implies both
- ❑ Practical Issues
 - Are there observable values for very long dated options on the relevant assets?

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Problem 2b

- ❑ Much more difficult due to specified annuity rate
- ❑ Compound optionality plus expected choice
 - Accumulation phase guarantee
 - Specified annuity rate
 - Expectations of choice made - e.g. tax effects influencing the decision
- ❑ Time value as well? Or just intrinsic value?
 - Fair value implies both
 - Are there observable values for very long dated options on the relevant assets **and forward annuity rates**?
 - Consistency problem: We don't do time value for DB
 - Revert to projected unit credit pending DBO review?

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Problem 2b (continued)

- ❑ Can we solve 2b without creating huge problems for a an average salary scheme?
- ❑ Is it appropriate or practical to fair value a guaranteed forward annuity under the CBP approach?
 - FV would not be required under current IAS 39 if it were an insurance contract
- ❑ Pending PBO Vs ABO and PUC Vs Fair Value in DB
 - If PBO is maintained for any scheme with a specified annuity **and** a PUC method is used for valuation, treatment would be the same as it is now if employer specific credit risk is also ignored.
 - So why not adjust CBP defn to make 2b examples all DB?

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CBP - Conclusions

- ❑ The attempted CBP solution creates further problems
- ❑ Fair value of average salary schemes is a step too far
- ❑ Given . . .
 - the examples of what the IASB is temporarily trying to solve
 - unaddressed major issues in the current project including DBO measurement, PBO VS ABO
- ❑ . . . the key to a workable solution lies in specific practicalities that the relevant *national* actuarial profession is likely to be best placed to consider and address in their response.

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An historic example from the US of accounting that *really* irritates an analyst.
Company name not given – problem was with the standard.
Why the US changed and why the IASB should too, soon

APPENDIX: SMOOTHING & EXPECTED RETURNS

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Liabilities

<u>Plan Funding-</u> Benefit Obligation	<u>2000</u>	<u>2001</u>
Obligation, Jan 1	5628	6434
Service Cost	213	260
Interest Cost	467	515
Actuarial and other (gain)/loss	499	416
Plan amendments		168
Benefit payments	(373)	(371)
Projected Benefit Obligation at Y/E	6434	7422

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Source: Published Accounts of a US Company

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Assets

<u>Fair Value of Plan Assets</u>	<u>2000</u>	<u>2001</u>
January 1	5282	5731
Actual Return on Plan Assets	735	1
Employer Contributions	85	121
Transfers	2	
Benefit payments	(373)	(371)
Fair Value of Plan Assets at 31 Dec	5731	5482

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Source: Published Accounts of a US Company

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Recognition

<u>Balance Sheet Entry</u>	<u>2000</u>	<u>2001</u>
Fair Value of Plan Assets at 31 Dec	5731	5482
Projected Benefit Obligation at Y/E	(6434)	(7422)
Funded status @ 31 Dec	(703)	(1940)
Unrecognised prior service cost	129	286
Unrecognised transition asset	(6)	(5)
Unrecognised loss (gain)	523	1454
Accrued Benefit Cost (B/S Item)	(57)	(205)

This net obligation of 1735 is not recognised

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Source: Published Accounts of a US Company

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Smoothing

<u>Income Statement</u>	<u>2000</u>	<u>2001</u>
Service Cost	213	260
Interest Cost	467	515
Expected Return on Plan Assets	(490)	(539)
Amortization of Prior Service Cost	10	11
Amortization of Transition Asset	(1)	(1)
Amortization of unrecognised loss	17	22
Net cost /(credit)	216	268

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Source: Published Accounts of a US Company

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On Smoothed Accounting

"If, for example, you had a deficit, the Americans would knock 10 per cent of whatever is the highest, the assets or the liabilities, off that figure and then they would spread that number over the working lives of the employees, so instead of a deficit of ten million you would end up with a number like half a million. I do not think you could explain that to your grandmother. You may as well take the ten million and divide it by the cube root of the number of miles to the moon and multiply it by your shoe size. It does not mean a thing.."

Sir David Tweedie

UK Select Committee on Treasury, Minutes of Evidence
Tuesday 2 July 2002
