

Pensions Week, 14 April 2003

FRS17 - adjustment through experience

One lesson that can be learnt from the Minimum Funding Requirement (MFR) experience in the actuarial profession is that prescribed calculations often need adjustment in the light of experience, and that failure to do this has simply created greater problems. In our view, FRS17 and its successors need to go through the process, and from our perspective that needs to start now.

As of the end of March, the credit margin of long-dated AA stocks (ie the yield above that of an equivalent gilt) was down to 0.7%pa, whereas it was 0.9%pa for long-dated all-credit ratings, and 1%pa across all-dated, all-credit. Now, these latter two may not sound far away from the 0.7%pa figure, but if either was adopted in calculations, they would feed through to significant reductions in quoted liability values. The market in AA stocks is shrinking rapidly, principally due to downgrades of stocks, and consequently, there is a very small market in long-dated AA stocks underpinning the ASB's calculation basis (the whole AA market is now down to £33bn, compared with £43bn a year ago, and of this only £14bn is long-dated).

We believe the UK market average in 1999 when FRED 20 was under discussion was AA, but it is now heading towards single A. So, there is arguably a good case for moving from long-dated AA to either long-dated all-credit or long-dated A-rated yields, and to consider whether the long-dated market is overly distorted by supply limitations.

It does seem odd that other liabilities in accounting are not discounted in such a prescribed way - for example, for fixed asset and goodwill impairment reviews, ASB allows (in FRS 11) that "the discount rate used should be an estimate of the rate that the market would expect on an equally risky investment", while for deferred tax (FRS 19) it is "the post-tax yields to maturity that could be obtained at the balance sheet date on government bonds with maturity dates and in currencies similar to those of the deferred tax assets or liabilities".

In the former case, you sometimes see the company's weighted average cost of capital (typically 7% or more), whereas under FRS 17 we have seen discount rates of between 5% and just over 6%, and under FRS 19 companies are having to use an even lower discount rate, with many companies not discounting deferred tax balances at all on grounds of materiality.

So here is a suggestion. Remove the AA-rated single-discount rate. Introduce a differential discount rate used (as the actuarial profession has tended to use for MFR and scheme-specific funding rates) which distinguishes between active liabilities and pensioner liabilities, particularly as they become closer to payment. If, say, 2% ahead of corporates was used for active liabilities, and a corporate yield for pensioners, then the weighted average would be slightly above corporate yields in general (rather than being the distorted yield on long-dated AA corporates) and a significant amount of the FTSE 100 pension "deficits" would be removed at a stroke!

Food for thought?

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The ASB's response to *Pensions Week* was:

The short answer to [*Pensions Week's*] enquiry is that the ASB has no current plans to amend the reference in FRS 17 to the use of the AA bond rate to discount pension liabilities.

That rate corresponds to the rate that is required under the equivalent International Standard IAS 19. In consequence ASB would be unlikely to make a change on this point without coordinating its decision with the IASB. To the extent that the all-credit long term rate is close to the AA bond rate, the effect of using it could be very similar. However, when the two diverge, it is not necessarily the case that the all-credit rate should be used, even if there are few investment opportunities in the market for AA bonds. The object in setting the discount rate is to allow for the risk borne by the employer. The margin over gilts is intended to reflect the limited freedom that most employers have to take action to mitigate the consequences to them, for example by reducing benefits or closing the scheme, in the event of serious adverse movements in their financial commitment in respect of the scheme. It would not be right to overstate that flexibility by using too large a margin over a risk free rate.

Jagger & Associates' comment on this was:

The ASB's defence is to be expected. We would simply observe that whilst the ASB's position has some theoretical justification, they should perhaps take on board the wider social consequences of continuing with it. We think this is an area where debate has some way to run, particularly as people become more aware of the anomalous effects which the current prescribed assumptions can have.

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