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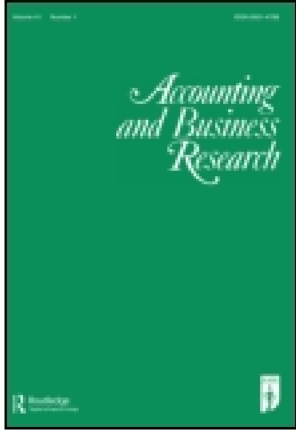

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Discussion: Pensions accounting and the investor

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Pensions accounting and the investor

Carsten Zielke*

First of all, I would like to address a question that Martin Glaum and other speakers have asked: do accounting and solvency rules affect asset allocation and management behaviour? I can confirm that they do! I am part of a team of 15 within Société Générale, and our work is to analyse the legal and solvency constraints in order to advise clients on how they can maximise benefits within the current constraints. We also publish research.

What do our clients typically do? They try to hedge. We are the major hedging experts on the market, and there are many different types of approaches you can take. One example would be to hedge – to lock in – the highest corporate bond spread, in order to have better results in 2009.

I want to keep my presentation simple and cover the following questions:

- what is pension accounting all about?
- why should investors care?
- what do companies actually think about this?
- what do we want as investors?
- how do investors react? and
- how I think they should react, given the current challenges.

Coming back to my German origins, it is interesting to see how large the pension liabilities can be, compared to the total of the balance sheet, especially in the heavy metal industry. One example is Thyssen, where pension liabilities represent 20% of the balance sheet. This is a major item, which of course investors cannot neglect.

There is a simple message: pension liabilities are always good for bad surprises! In good times people ignore the 'gains'. Last year, for instance, interest rates rose and therefore there were some gains from the discounting of liabilities being booked in the profit and loss account (P&L). That was stripped out by analysts and no credit was given for it. In bad times, of course, everybody looks at the losses on pensions. The losses are treated as a bad surprise and people ask: 'Have you seen this huge pension deficit?'

The reason, I think, why this is always looked at in a negative way might be because it is very opaque. I would like to re-enter the debate I am always having at EFRAG. The preparers and auditors always tell me: 'We have increased the disclosures.' Today an equity investor is supposed to read around 150 pages of notes in order to understand what is really going on in a company. Do you think he's really going to read them? No, he's not. He picks out bits and pieces. One would hope he picks up the disclosures on pensions! I do that, but more from an insurance interest. Increasing disclosure will not have the impact of having more efficient financial markets giving credit for pension liabilities. I think we should aim for simplification and a unification of accounting. I will come back to this a little later.

Nicholas Barr's remark earlier in the conference that 'people should take account of the time frame companies have to close the pension gap' really struck me. However this is not what is happening. I will quote from a newspaper report:

> 'The turbulence on global stock markets has resulted in BA's [British Airways] pension scheme deficit increasing by £200 million to £1.74 billion, which is now more than the market value of the airline. Despite a 17p increase in its share price yesterday to 147p, BA's market capitalisation is £1.7 billion – down 56 per cent from last year' (*The Times*, 8 November 2008).

According to the article, British Airways apparently is worth nothing because the pension deficit is higher than its market capitalisation. A similar story appeared in the press, commenting on pension deficits in some UK banks (*The Daily Telegraph*, 17 October 2008).

What do companies think about all this? They think they are doing something good for their employees. Pensions are an integral part of the salary package, and companies try to use them to keep their employees on board longer. If employees leave earlier, it is good for the company, especially in Germany. Until some years ago, an employee would lose all pension benefits if that person did

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not stay longer than 10 years. This period has been cut down to five years now.

Staying with Germany, I used to be an equity analyst for insurance companies when, in 2001, there was a pension reform promoting corporate pensions. I had the idea of looking at all the balance sheets in Germany from the DAX 100, the 100 biggest listed German companies. With my colleagues, I compared liquid assets to pension liabilities. I did some sums, and we came up with the figure of €25 billion of unfunded German pension liabilities. And then I said: 'This is great for the insurance industry. The companies have to close this pension gap – they will outsource their pension schemes.' I was very bullish on insurance companies, especially on Allianz, which was – and still is – a market leader in the corporate pension market with a current market share of around 28%.

The mistake I made was this: I disclosed the names of the companies with unfunded liabilities. One of them was Thyssen and the other one was Deutsche Post. I received a very unpleasant call after that from management! I was given an educational session by one of the most important pension advisers, who told me that what I had written was rubbish and that all this was funded because it was funded in machinery, in desks and in equipment that belonged to the companies.

When you look at today's position, it is a little bit better. Nevertheless if, for instance, you look at Deutsche Lufthansa, they are covered for only about 30% of their pension liabilities. So every time you fly Lufthansa, you should know that it is financed by the employees. That is very kind! I don't know what they will do, how they will finance the steward or stewardess when they retire. Perhaps they will have to give them cheap flights? Thinking has completely changed since 2001. In Germany, pension liabilities were basically considered as equity and as cheap refinancing. It is only within the past four years or so that this culture has changed.

What do we investors really want? Although I am not an investor, I will try to answer the question. Basically, typical investors would like fair value everywhere. And they would like the changes in fair value to go through the income statement – not outside the income statement, as in the UK, or in the statement of recognised income and expenditure (SORIE) approach, but right through the income statement. They do not want any actuarial investment assumptions involved. Overall, they want the pension liabilities outsourced. This is a little bit of an extreme position. But, except for that last point, I think the revision of IAS 19, *Employee Benefits*, reflects this point of view.

How do companies react? As has already been mentioned, they increase their disclosures. They hold some strategic talks during analyst conferences. They use the corridor approach less. In particular, they stop offering defined benefit plans – not all of them have done this, but that's the trend. And in the current discussions on how solvency should be assessed, they argue for an asset-based discount rate. I shall come back to that.

I want to point out that ceasing to offer defined benefit plans might not be a solution. Stopping defined benefit plans implies transferring the risks to the insurance industry. Consider what has happened to the insurance industry. It was regulated until 1994. Then there was an EU-wide deregulation. Now we are reaching the point where the regulators are very concerned that insurers cannot meet the guarantees given to policyholders. There is therefore a danger that this industry will be re-regulated. Consequently thinking that you can outsource pension liabilities, or that you offer defined contribution plans to get you out of your responsibilities, might be dangerous, in my opinion, from a political point of view.

At this conference, we have already heard some discussions about the discount rate and using the corporate iBox rate. During 2008, of course, we have seen an enormous rise in this rate. There has also been the discussion paper from the UK Accounting Standards Board (ASB), *The Financial Reporting of Pensions*, proposing that we should no longer use the corporate bond rate to discount pension liabilities, but the risk-free rate instead. It is a very interesting discussion and the same debate is taking place in the insurance industry.

The corridor approach is something that is not liked by investors, and the current proposals for the revision of IAS 19 would of course abolish this. Currently, under IAS 19 – and in this respect it is similar to IAS 39 – you can do whatever you want. This is something investors do not like either. I understand that International Accounting Standards are an international game, and there are many parties contributing to the discussion. It seems that the solution adopted is always to give the actors options. However, options are something investors do not like because they have to reconcile things, and very often they are not accountants so they cannot do it. Giving companies options cannot be a solution for achieving higher transparency and more rational behaviour in the financial markets.

Earlier in this conference the hope was expressed that we would have similar solvency rules for insurance and pensions. And I can tell you right now, this is not what is going to happen. There is a big war going on between the two industries because companies simply cannot comply with the EU's Solvency 2 rules as they are set out today. There is an underfunding of corporate pension liabilities of around 36%, and companies simply do

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not have the money to increase funding. There was a CEIOPS[1] conference in Frankfurt recently where it was clearly stated that if Solvency 2 is applied to companies there will no longer be pension schemes for employees because it would simply be too expensive.

So what is all the fuss about? It is about the discount rate. The insurance supervisors think that something which is guaranteed has to be safe. They ignore all of the following: market rules; return to the mean assumptions; statistical data from the past showing that in the long run you will always come back to the average return on a 30-50 year basis; especially in equity markets. They ignore all this. It used to be that in hard times the insurance supervisors would increase the stress tests in order to get the insurance companies out of equities at the worst moment, and in good times they tended to release these requirements. Now what they have agreed on is that you should use the risk-free swap rate to discount your life insurance liabilities. The swap rate is higher than the risk-free government bond rate. Traditionally it used to be 50 basis points higher. Today it is much higher because it is guaranteed by banks, and few people have great faith in banks today, so there is also a credit risk involved in this.

If you apply this discount rate to the liabilities and use the same for accounting, any insurance company writing a long-term contract would have to show an initial loss at inception. Accounting that reflects economic reality cannot show losses made on business that should normally be profitable in the long term. The US has now joined the IASB's insurance project. In the US insurance business the margins are even lower than in the European, especially continental European, business. Thus, I do not think that this method will be adopted in IFRS. We will not see the risk-free swap rate in IFRS. If there is a solvency accounting that should be different for the purposes of the insurance supervisors, then let it be. But no, we will not see big insurance companies, especially American ones, having to show big losses in their published accounts when they are successfully selling profitable products.

This is one of the challenges. The other one is the revision of IAS 19 that we have already discussed. Another challenge for unfunded plans – and this is a much more serious problem – is the decreasing workforce. We see this happening already in Germany. Every year there are more people leaving the labour market than entering it, and this is also a time bomb for pension liabilities.

What I am saying is: 'Let's find a common definition of what the right discount rate should be.' In my view – and this is going along with American proposals – it should be an asset-based rate; weighted, however, by the solvency of the company so that the credit risk is represented in the discount rate. This is what the discount rate should be for.

What is the solution? I think it is very important that we find common accounting rules for insurance companies and pension liabilities, because basically it is the same sort of business – given longevity, assuring that the employee has a decent standard of living in retirement.

One thing is clearly paramount. If you do not use a higher discount rate, the inflation risk could hit you very badly. Using a lower discount rate will drive the industry to invest very conservatively because it will not be able to support the higher implied returns and the implied volatility coming out of that from the asset side. You can force a player, by using too conservative assumptions on liabilities, to irrational behaviour on asset allocation. And then the inflation problem is not solved.

I think you should show pension liabilities at fair value, but the movements in fair value could be recycled, although it has to be done in a transparent way. This is something I have also proposed for insurance companies. You would have a sort of provision for profits. You might laugh at this as accountants – a provision for profit! But in a fair value world this is possible, and I would be happy to send you a publication about this if you are interested.

What's especially important is to increase communication with investors. Companies should explain what are they doing and why they are doing it. They should not bombard investors with hundreds of pages on what they have done. But they should explain that paying pensions to employees is an important feature in retaining them and in keeping a competitive position in a difficult environment.

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[1] Committee of European Insurance and Occupational Pensions Supervisors http://www.ceiops.org/