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Testimony

My name is Ian MacFarlane, a Director at Medley Global Advisors in New York, a leading firm of macro political advisors and I am appearing here as someone with experience in the provision of pension fund products within the United Kingdom, and elsewhere in the globe, over the last 25 years.

As the US debates the issue of pension fund reform, the UK experience with the pension accounting standard FRS17 between 2001 and 2004, and a new pension bill (The Pensions Bill 2004), are I think very relevant to the US. This is particularly so at a time when both countries are grappling with aging populations, increasing longevity and mature pension schemes. The pension debate promises to be at the center of political debate in both countries for many years. Given the vastness of the topic I shall limit my remarks here to the UK experience with the FRS17 accounting standard and its relevance, in particular, to the proposed introduction of a contemporaneous interest rate for the discounting mechanism in the US.

The implications of the UK experience with FRS 17 for the US are I think unambiguous. Increased transparency is to be welcomed. Demographic trends and lower expected investment returns cry out for it. But volatility in company accounts could well be the unintended side effect, threatening dividend payments and employment. In this case the objective of ensuring retirees financial security is jeopardized by the threat of them not getting to retirement within the scheme.

I say this against the backdrop of what can only be described as a crisis within the UK pension funds industry. FRS17 was not the cause of the crisis but has certainty not helped. According to Adair Turner, the Chairman of the Pension Commission, between 60% and 70% of defined benefit schemes are now closed to new entrants. The costs of pension provision have become too much for the employer, in a cost conscious environment. While FRS17 was not the primary cause, at the minimum it added additional administrative burdens and at worst created enough uncertainty to prompt asset class switches out of equities into fixed income to obviate the uncertainties on company balance sheets. This has not always been consistent with maximizing investment returns for any given level of risk. All of this is occurring at a time when as the Pension Commission concluded ‘people must save more or work longer’.

Well they are not saving more. Since 1997 the rate of growth of consumer spending has exceeded GDP growth by 6.5% points. If ever there was a time when defined schemes were needed it is now. This is a pattern, at least in respect of consumption, eerily reflected in the US

FRS 17 is an accounting standard introduced in the UK to improve the transparency of future pension costs measured in terms of a surplus or deficit. Its primary aim is to provide shareholders with a snapshot of future costs at a particular point in time. This means that calculated pension costs can change sometimes dramatically from year to year. Under the previous accounting standard of SSAP24, which was predicated on the assumption that pensions were a long-term commitment, the principles and guidelines were left for company directors to interpret. Effectively the impact was to produce a stable pension expense from year to year. Initially the provisions of FRS 17 could be merely attached as a note to company accounts, under transitional arrangements, but as from 1 January this year full implementation has made it mandatory to include them in the reported figures for non listed companies. Listed companies now have to switch to IAS 19 (an option non- listed companies can also choose) which will be very similar to FRS17 after a technical amendment. For clarity I will limit my remarks to the historic experience with FRS17.

Concerns over FRS17 have focused primarily around the volatility it imparts to company accounts, owing to the capture of market noise and the sensitivity of actuarial estimates to even small changes in assumptions. What could be viewed as a healthy situation one year could be construed as a parlous situation the following year. For example, an increase in the longevity assumptions of employees or even the discount rate could lead to a shift to deficit or a sharp increase in the deficit. Because the approach is snapshot, this shortfall could then threaten the ability of a company to pay a dividend, although there had been no deterioration in the financial position of the company from the previous year. The share price would be hit and the cost of capital would effectively rise, reducing economic growth, if repeated across the market.

The background to the introduction of FRS17 is important in understanding how problems thrown up by FRS 17 emerged. The accounting standard did not initiate the trend to higher pension costs, but merely accentuated them. It was conceived at a time when equity returns peaked (2001), just after Advanced Corporation Tax which allowed pension funds to claim a tax credit on dividends had been abolished, and at a time when many companies had been taking a contribution holiday. FRS17 helped bring home to them the costs of ending the holiday.

The issues were further complicated by the fact that the benchmark for the UK pension industry was the default of the median holdings of various assets across all funds, rather than related to the liability structure of the individual fund. As equity returns declined post 2000 many funds found themselves with deficits, or in some instances an asset mix inappropriate to the cash flow demands as the scheme aged, both related to over exposure to equities. The median holding of equities in some asset mixes frequently rose over 80%. No effective re-balancing of the asset mix portfolios was under taken over the previous 30 years, and as equity returns exceeded bond returns the ratio of equities in the asset mix drifted up. Unsurprisingly individual schemes have recently begun to shift to client specific benchmarks.

FRS17 was therefore always going to expose deficits in the funding requirements of individual pension plans. To that end it has to be argued that in principle the accounting standard was an important step forward relative to the subjective approach of the SSAP24 guidelines. The issue is the volatility that the snapshot approach imparts to company Profit and Loss Accounts. This strikes at the heart of the proposal to use a contemporaneous discount rate rather than the 4-year average here in the US. Such an approach would merely introduce noise into the equation.

And despite all the greater transparency and rigor and efforts to move away from the subjectivity of SSAP24 there have still been quite on occasion large disparities in the numbers used for key assumptions. Variations in the discount rate used, which should be among the least controversial assumption, illustrate this point well.

Theoretically the discount rate across funds which should coalesce around the yield on AA corporate bonds with a maturity of greater than 15 years. But for 2003 a survey by actuaries Barnett Waddingham found that the discount rate used by 42 FTSE 100 companies varied between 5.25% and 5.6% compared with 5.2% and 6% the previous year. To the extent that the assumptions have to be clearly stated, however, a comparison across funds can be made.

The use of the corporate bond rather than a matching yield under the previous arrangements could also be argued to increase the accounting liability, via increasing the demand for corporate bonds and lowering interest rates. The growth in the UK corporate bond market over the last 5 years is grounds for suspicion that this is indeed the case. But, it could also equally be argued that the cash flow demands of mature pension funds, notwithstanding the decision by Boots to switch 100% into fixed income, would have resulted in an increased appetite in their own right.

There has also been a belief that FRS17 has meant the effective end of defined benefit schemes (final salary schemes) for new joiners for a company where one exists (i.e. the schemes close for new entrants). Again although the increasing shift to new employees joining defined contribution rather than defined benefit schemes has also been accelerated by the process, the increased costs to employers had also meant that the tendency had already been in place in the early 1990s. Based on figures compiled by the Government Actuarial Department there had already been a sharp fall in participation in defined benefit schemes between 1990 and 2001 prior to FRS 17.

I should like to conclude where I started by re-iterating the importance of transparency and an accurate assessment of future pension costs. It is the basis on which a free economy, or specifically how the stock market, best allocates capital. But it also seems to me that a snapshot approach in increasingly volatility also potentially works in reverse. And defined benefit schemes tend to be more prevalent in the old industries, who are not growth companies, but more value orientated dividend payers. It would be a shame if noise disrupted the painful transition many of these companies in the US are currently facing from developing market competition.