

CREDIT CRUNCH & RISING INFLATION MAKE FOR TOXIC PENSION ACCOUNTING COCKTAIL

by Jill kerby



The 'credit crunch', rising inflation and the pension accounting standards, FRS 17 and IAS 19, combine to form a potentially unpleasant cocktail for companies with defined benefit pension plans. Pension fund performance recovered in April, much to the relief of fund managers and trustees, but a single month (or even two) does not a steady years' growth make. Is it all 'bad news' or can something be done to make the toxic cocktail more palatable?

In a grim report to clients back in early April Watson Wyatt's Niall Herlihy, said that the first quarter of 2008 "was marked by severe setbacks for global equities that taken with negative returns during the latter half of 2007 have left Irish pension funds reeling."

Herlihy believes that the reason for poor investment returns (which recovered somewhat in April) haven't been properly explored and that many pension fund managers may not "even be aware that there is an emerging problem."

The impact of the deepening credit crunch and worries about funding levels, which emerged back in December, plus volatile market conditions, "is potentially frightening for trustees and sponsors of DB schemes."

According to Herlihy more than half of pensions schemes, if measured at the end of March 2008, would "face deficits under the statutory minimum Funding Standard" and that such DB pension fund trustees would need to "seek additional funding from employers if they are to meet statutory obligations."

For many, he says, this won't be the first time, or perhaps even the third time that they will need to seek additional funding from employers.

"It remains to be seen whether the latest funding concerns will lead to further restructuring of Irish final salary pension schemes and it is genuinely difficult to say whether this will emerge as a serious trend until better data is available about the current crisis," Herlihy wrote. The loss in coverage under the Funding Standard in some schemes where calculations have been done are as high as 15%-20% over the year to the end of March, he concluded.

And while there is a level of "guesswork" involved in assessing how many schemes may be affected, "unless markets improve considerably, the next funding crisis could prove even more serious than the previous collapse in funding levels."

The technical issues regarding the funding standard means that an increasing

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number of company actuaries are burning the midnight oil.

Although there are important differences between FRS 17 and IAS 19, broadly speaking, for the purposes of the two pension accounting standards, the assets of a defined benefit pension scheme are based on market value and the liabilities of the scheme are capitalised using a AA-rated corporate bond yield. If there is an excess of assets over liabilities, subject to certain limits, a 'pension asset' appears on the balance sheet of the employer sponsoring the defined benefit pension scheme. Similarly, if there is an excess of liabilities over assets a 'pension liability' appears on the balance sheet of the sponsoring employer of the defined benefit pension scheme.

Throughout this article, we will refer to the 'pension asset' and 'pension liability' as surplus and deficit respectively.

The Hewitt Managed Pension Fund index is a reasonably good barometer of the performance of pension scheme assets. The index is down more than 17% in the period from the beginning of the 'credit crunch' say, 30th June 2007 to 31st March 2008. Despite the rise in the yield on AA-rated corporate bonds over this period, the fall in the value of pension scheme assets may not be matched by an equal fall in the value of pension liabilities. In this scenario, it's not hard to see how balance sheet figures for pension surpluses may have fallen and balance sheet figures for pension deficits may have risen.

A fall in the value of the pension surplus or rise in the value of the pension deficit

figure on the balance sheet, in cases where the surplus or deficit is large relative to the company's net assets, may cause the company to breach a 'balance sheet' borrowing covenant. This could give a lender the opportunity to call in a loan. Refinancing a loan in the current 'credit crunch' environment may be extremely difficult and is likely to be more expensive.

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CREDIT STANDING AT RISK

Even if balance sheet borrowing covenants are not breached, a reduction in the pension surplus or an increase in the pension deficit figure may cause the credit standing of the company to fall, making it more difficult or more expensive to raise loan capital in the current 'credit crunch' environment. Such reductions in the balance sheet pension surpluses or increases in balance sheet deficits may also impact dividend policy and executive compensation systems which are balance sheet related.

In order to capitalise the value of the pension liabilities, the pension accounting standards, IAS 19 and FRS17, mandate



the use of a discount rate which is in line with the AA-rated corporate bond yield for the maturity period of the related pension liabilities.

The yield on a basket of €-denominated AA-rated corporate bonds has drifted upwards over the period from 30th June 2007 to 31st March 2008 by something of the order of 0.85%. All other things being equal, discounting pension liabilities at a higher yield should mean a fall in pension liabilities. A rise in yield of this order of magnitude for a pension scheme with liabilities having an average duration of 20 years may mean that the fall in assets is matched reasonably closely by a similar fall in liabilities.

However, pension schemes may have to look at the inflation assumption in their valuation model with a view to increasing it in this new economic environment. So the net effect on the liabilities of the rise in the discount rate and a rise in the inflation assumption may mean that the liabilities have not fallen in value by as much as the assets. Thus pension surpluses may reduce and pension deficits may increase.

IMPACT ON PROFIT & LOSS ACCOUNT

Another feature of the standards is the impact on the profit and loss account of the difference between: (a) the interest cost (the increase in the present value of the defined benefit pension obligations as a result of moving one period closer to settlement); and (ii) the expected return on the defined benefit pension scheme's

assets. The discount rate applied to the average value of the accrued liabilities during the accounting period less the expected return on assets of the pension fund during the same period is, broadly speaking, charged to the profit and loss account under both FRS 17 and IAS 19 and is sometimes described as a 'financing cost'.

The rise in the discount rate is not 'all good news'; a higher discount rate feeds through to the performance statement under both standards in the form of higher 'financing cost' assuming that the expected return on the assets does not change. This rise in the discount rate has a negative effect on profits and earnings.

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On the other hand, all other things being equal, increasing the expected return on the assets of the pension fund improves reported profit.

WHAT CAN BE DONE?

Little can be done about the yield on AA-rated corporate bonds as it is determined

by the market. Better matching of the changes in the value of the assets to the changes in the value of the liabilities would be one possible approach; but there are few matching assets for pensioner mortality. Matching the liabilities using a portfolio of assets consisting of bonds has its own difficulties not least in terms of its impact on the profit and loss account through the 'financing cost' – excess of interest cost over expected return on assets.

The latest proposals from the Accounting Standards Board suggesting that the risk-free government bond yield rather than the AA-rated corporate bond yield be used to discount pension liabilities would increase pension liabilities further.

Despite these difficulties in the management of the pension surplus or deficit on the sponsoring employer's balance sheet, action could be taken to reduce the risk and hence the swings in the value of the asset portfolio.

Investors need to find assets that have their periods of positive and negative performance at different times to the main asset in many pension portfolios - equities - and which have similar or higher long-term returns to equities. If such assets can be found, the swings in the value of the pension portfolio will be reduced without compromising on return and if such assets are expected to have higher long-term returns, then, all other things being equal, the 'financing cost' in the performance statement could be reduced leading to higher reported profits.